
Arvid E. Roach II

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By Arvid E. Roach II

Today, suitability is achieving a place alongside disclosure and prevention of fraud as a major philosophical theme underlying the federal securities laws.¹

Introduction

All registered securities brokers must tailor their investment recommendations to the situations and goals of their customers under what have come to be known as "suitability" rules² imposed by the National Association of Securities Dealers (NASD) and the Securities and Exchange Commission (SEC). As a corollary to this basic obligation, the SEC rule, and probably the NASD rule as well, require brokers to seek out relevant facts about their customers in order to meet the customers' needs. The New York Stock Exchange (NYSE) and other securities exchanges are generally thought to impose similar suitability obligations through the vehicle of "know-your-customer" rules.³ In addition, the NASD, the SEC, the exchanges, the Municipal Securities Rulemaking Board (MSRB), and the Commodity Futures Trading Commission (CFTC) have all proposed or adopted a number of suitability rules for particular types of securi-

¹ B.A., 1972, Yale University; J.D., 1977, Harvard University. Member, New York Bar. Law Clerk to the Honorable Thomas P. Griesa, United States District Judge, Southern District of New York. The author wishes to thank Professor Louis Loss for his inspiration and guidance.


³ See notes 18-55 & accompanying text infra.

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ties. A wide variety of state rules also address the matter of suitability.

Because the language of suitability and know-your-customer rules differs significantly among these various and often overlapping jurisdictions, ascertaining the scope of suitability obligations with respect to many transactions is difficult. Several commentators view the "embryonic requirement" of suitability as one evolving toward a major independent source of brokers' liability which may reach so far as to impose a duty on brokers to investigate a security's appropriateness for each customer even in arm's length transactions with fully informed customers. A related development may be the emergence of a duty to refuse to recommend or engage in transactions that violate some absolute, objective notion of suitability.

Tracing the development of suitability principles is difficult because there are few reported authorities. Of these authorities, the majority arose in the context of discretionary accounts or other relationships in which reliance on the broker's recommendations is significant. Fraud or misdeeds tantamount to fraud are generally held to be prerequisite to the imposition of civil liability or disciplinary sanctions. Most of the reported authorities adopt a subjective view of suitability: the concept that a suitable transaction is whatever transaction the particular customer regards as suitable.

4. See notes 83-237 & accompanying text infra.
7. SEC cases either directly imposing sanctions or sustaining NASD disciplinary proceedings, SEC responses to requests for no-action letters, and court decisions constitute the bulk of the reported authorities. See notes 258-334, 335-88, 342-422 & accompanying text infra.
Because the sources of suitability principles are so fragmented and elusive, generalizations about the suitability doctrine are extremely hazardous. A major objective of this Article is simply to catalogue and place in temporal context the divergent wellsprings of suitability principles, bringing the suitability doctrine into focus as the summation of many sources not yet integrated. The Article also considers, though in less depth, the much debated, pivotal question of whether a private cause of action for damages is available under suitability rules.  

A striking combination of recent developments makes this time especially appropriate for a critical appraisal of the suitability doctrine. Serious abuses have recently been exposed in the selling of commodity futures and options, and, as a result, a suitability rule to govern such transactions has been proposed by the CFTC.  The SEC has cited suitability violations as one reason for initiating a major investigation of options trading on securities exchanges.  The SEC also recently initiated proceedings to disapprove proposals that the Commission feared would weaken any suitability obligation that exists under the NYSE know-your-customer rule, and in response, the Exchange withdrew its proposals.  The MSRB has added to these recent developments by proposing a significant new suitability rule.  Also, after eight years of debate over the regulation of tax sheltered investments, the NASD has proposed detailed suitability regulations for these securities.  In one of the growing number of lawsuits alleging suitability violations, a court recently granted the first reported award of civil damages under a suitability rule.  

Perhaps most important of all, the American Law Institute (ALI) completed in May 1978 a comprehensive codification of the federal securities laws, which will be submitted to Congress. Whether to codify suitability obligations was one of the few significant issues

8. See notes 496-540 & accompanying text infra.
10. See text accompanying notes 127-28 infra.
11. See text accompanying notes 72-75 infra.
12. See text accompanying note 206 infra.
14. See text accompanying note 343 infra.
which was resolved at the very last minute. The ALI Federal Securities Code, whether or not it is enacted by Congress, is likely to be the only effort at overall restructuring of the securities laws for decades to come. This Article concludes with an examination of the effect that congressional adoption of the present draft of the Code would have on the existing legal sources of suitability obligations, and with the author's favorable analysis of the Code draftsmen's treatment of suitability.

As presently drafted, the Code would neither establish the boundaries of suitability principles nor settle finally the question of whether a private cause of action is available under suitability rules. The Code would, however, provide the SEC with an entirely new, specific statutory grant of authority to promulgate rules governing the suitability of brokers' investment recommendations. What restraints this new grant of rulemaking power, as it is specifically worded, might place on suitability doctrine, and indeed whether the SEC would exercise this new power, are problematic.

The Code would also preserve all of the present sources of suitability authority without providing any statutory guidelines to help resolve the ambiguities of suitability doctrine as it has developed under these rubrics. With respect to NASD and exchange rules and the special SEC rules, including the general SEC suitability rule, that apply only to NASD nonmembers, the Code would give the SEC the option of finally resolving the private cause of action question and would provide the courts with guidelines for its resolution failing SEC action.

In the opinion of the author, the last-minute decision of the Code drafters to confer express power on the SEC to promulgate rules in the area of suitability was a wise one. The Code, however, should provide clearly that violation of such rules will give rise to civil liability.


SUITABILITY OBLIGATIONS OF BROKERS

Present Law

A. The Present Sources of Suitability Obligations

The NASD Suitability Rule

Of the many rules that require brokers and dealers to recommend or sell only those securities appropriate to their customers' needs and to know relevant facts about their customers, the prototype is article III, section 2, of the NASD's Rules of Fair Practice:

In 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.¹⁹


¹⁹. [1976] NASD MANUAL (CCH) ¶ 2152, at 2051.
This rule was adopted by the NASD in response to the Maloney Act of 1938, which requires the SEC to register a national securities association only if its rules are designed, *inter alia*, "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade." The NASD rule was adopted with the original Rules of Fair Practice in 1939, and was apparently predicated on a similar rule promulgated a few years earlier by the investment banking industry under the National Industrial Recovery Act.

In 1963 the SEC published the *Special Study of Securities Markets*, a thorough report which noted that the recommendation of unsuitable securities was the subject of frequent complaints by customers who contacted the SEC with reports of selling practice abuses. The *Special Study* recommended that the NASD suitability rule be better defined and more stringently enforced, especially


24. Ch. 90, 48 Stat. 195 (1933) (held unconstitutional in *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935)). The rule, adopted on March 23, 1934, read as follows: "Where an investment banker recommends to an investor the purchase or exchange of any security [he or she shall] have reasonable grounds for believing the security to be acquired by the investor is a suitable investment for such investor upon the basis of the facts, if any, disclosed by such investor as to his other security holdings and as to his investment situation and needs." *NATIONAL RECOVERY ADMINISTRATION, AMENDMENT TO CODE OF FAIR COMPETITION FOR INVESTMENT BANKERS* 9-10 (Approved Code No. 141, Amendment No. 2 (1934)). Apparently no cases were processed under the rule. Bickel, supra note 23, at 18.


in the mutual fund industry, where violations were particularly endemic. With respect to all suitability violations the Special Study concluded:

This area would seem to be a particularly appropriate one to be dealt with through statements of policy... which can provide the necessary balance between generality and specificity of standards. Such statements of policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.

Following publication of the Special Study, the NASD engaged in negotiations with the SEC which resulted in the issuance of a policy statement by the NASD Board of Governors entitled Fair Dealing with Customers. The NASD's position in negotiating with the SEC was that suitability "is a difficult concept to delineate." A more vocal dissent from the Special Study's call for elaboration of suitability obligations came from several of the smaller exchanges and from the investment banking industry.

27. Special Study, supra note 18, pt. 4, at 144, 146, 206-07, 212. Among the Special Study's other conclusions regarding mutual funds were that high pressure selling was common, id. at 146, 206-07; that salesmen had considerable influence over investment decisions, id. at 141, 206; that in most cases salesmen failed to inquire into customers' income, assets, or obligations, even though their "sales pitch" referred to such matters as taxes and estate planning, id. at 142, 207; that salesmen often failed to compare various investment options, even though their "sales pitch" claimed a particular fund was suitable, id. at 142; and that "[t]o some extent the industry [was] reluctant to concede that questions of suitability [could] ever arise in the sale of funds or plans," id. at 207.

28. Id., pt. 1, at 329. See also id., pt. 4, at 212 (recommendation concerning mutual fund selling practices).


31. In 1963, at hearings inspired by the Special Study, the President of the Investment Bankers Association presented on behalf of a committee of investment bankers a memorandum that stated: "While we agree that securities salesmen should be highly qualified to perform their function, we deny that they are or should be responsible for the 'suitability' of the purchases their customers make. Adoption of specific 'suitability' regulations could so restrict the industry as to preclude performance of its essential function in the American economy." Investor Protection, supra note 30,
The NASD policy statement covers much broader ground than does the language of the NASD suitability rule. The statement begins with a general exhortation to "ethical standards" but adds the caveat that "legitimate sales efforts" must not be dampened by "requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship." Instead sales practices are to be judged by whether they constitute fair treatment of a particular customer, rather than by whether that customer profited from the transaction. The statement lists a number of practices that "have resulted in disciplinary action" and "clearly violate this responsibility for fair dealing." Several of these practices, whether or not they are suitability violations, probably constitute fraud. These practices include churning and short-term trading in mutual fund shares, as well as such clearly fraudulent conduct as establishing fictitious accounts, violating discretionary account agreements, engaging in transactions not approved by customers, and misusing customers' property. Two proscribed practices that may not always constitute fraud and that best reflect traditional notions of what constitutes a suitability violation, are also listed.

[The first is] recommending speculative low-priced securities to customers without knowledge of or attempt to obtain information concerning the customers' other securities holdings, their financial situation and other necessary data. The principle here is that this practice, by its very nature, involves a high probability that the recommendation will not be suitable for at least some of the persons solicited. This has particular application to high pressure telephone sales campaigns. . . . [The second is] recommending the purchase of securities or the continuing purchase of securities in amounts which are inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment.

pt. 2, at 690. The memorandum asserted that the broker "need not and should not be regarded as a professional who can be expected in every case to administer generally to the financial needs of his customer, as the physician does to his patient." Id. at 700-01.

32. NASD, Special Report to NASD Members (Oct. 9, 1964); NASD Manual (CCH) ¶ 2152, at 2051.
33. See text accompanying notes 284-94 infra. In prohibiting churning by way of its general suitability rule, the NASD is unique among the various regulatory authorities. The separate anti-churning rules of, for example, the SECO program, the exchanges options regulatory programs, the MSRB, and the CFTC will not be discussed in this Article.
34. NASD, Special Report to NASD Members (Oct., 1964), NASD Manual (CCH) ¶ 2152.
35. Id. at 2051.
36. Id. at 2052.
The NASD Board of Governors summarized *Fair Dealing with Customers* as an effort designed to educate the NASD membership about various practices which were improper as violations of a suitability principle. The Board expressed its belief that to acquiesce in the SEC's recommendation that the NASD impose upon a salesman the duty of determining that securities sold to a customer are suitable given the customer's situation, holdings and needs... would be unwise and impractical, and would interject the possibility of hindsight judgment in determining whether there could conceivably have been any reasonable basis for a sale or purchase.37

The Board noted its agreement with the general principle that a reasonable basis should exist for recommendations to customers but stressed that "no affirmative obligation to ascertain a customer's resources and needs was imposed upon a salesman nor was the extremely difficult test of suitability [in all transactions] imposed upon the securities business."38

The NASD's position with respect to suitability has remained basically unchanged since the 1964 policy statement. The Associa-

37. NASD, REPORT TO MEMBERS 1964, at 8 (1965).
38. Id. In the wake of the Special Study and the NASD policy statement some segments of the industry also responded with "voluntary" suitability efforts, combined with an insistence that the scope of the NASD rule had not been broadened. The Association of Mutual Plan Sponsors urged its members to undertake "reasonable measures designed to prevent the rise of [undesirable] sales practice[s]" by making certain inquiries of contractual plan applicants. A standard form to be filled out by the applicant was suggested:
1. Date of birth.
2. Are you presently employed? If so, give name of employer and position held.
3. If not employed, specify other sources from which you have an assured income.
4. Do you have a bank account? Life insurance? Other investments?
5. Are you making monthly installment payments on an automobile or appliances purchased on time, including periodic payments for amortizing a mortgage on your home or on property you own?
6. UPON CAREFUL CONSIDERATION, ARE YOU SATISFIED THAT AFTER MEETING ALL YOUR OTHER PRESENT AND ANTICIPATED COMMITMENTS YOU WILL HAVE AVAILABLE MONTHLY THE AMOUNT OF THE PERIODIC PAYMENT TO BE MADE UNDER THIS PLAN, [$]__________?

Roach, Contractual Plans: The Front-End Load; Suitability Requirements and Present Status, in CONFERENCE ON MUTUAL FUNDS 135, 147-49 (Fed. Bar Ass'n, Sec. Law Comm., ed. 1966). It is hard to resist the conclusion that the Association's voluntary "suitability" campaign was aimed primarily at protecting its members' pocketbooks.
tion considered, but did not adopt, an amendment to its suitability rule that would deal specifically with "hot issues." It recently proposed suitability rules that address the peculiar problems that frequently arise in the area of tax sheltered investments. Both of these proposals, made with the SEC's urging, are discussed below together with other SEC initiatives.39

The SECO Suitability Rule

The Securities Acts Amendments of 196440 empowered the SEC to issue regulations governing registered brokers who are not members of a national securities association such as the NASD. In particular, the Commission was empowered to adopt rules for such brokers "designed to promote just and equitable principles of trade."41 Such nonmember brokers represent a not insignificant portion of


The NASD has adopted one additional suitability provision that, while of limited application, has interesting variations from the basic rule. In 1972 the Association approved rules governing the offering and sale by NASD members of securities in their own firms. See NASD News, Sept. 1971, at 3; NASD News, May 1971, at 1 (such transactions pose "inherent conflict of interest problems, such as . . . the question whether such securities are suitable for specific accounts"); see generally O'Boyle, Broker-Dealer Conflict of Interest Problems, in PLI THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION 457, 462-70 (R. Mundheim & A. Fleischer, Jr. eds. 1972). The suitability section reads: "Every member underwriting an issue of its own securities . . . who recommends to a customer the purchase of a security of such an issue shall have reasonable grounds to believe that the recommendation is suitable for such customer on the basis of information furnished by such customer concerning the customer's investment objectives, financial situation, and needs, and any other information known by such member. In connection with all such determinations, the member must maintain in its files the basis for and reasons upon which it reached its determination." NASD By-laws, art. IV, § 2(c), sched. E, § 5, NASD MANUAL (CCH) ¶ 1402, at 1101-11 (1977). The absence of the "if any" language of the basic rule, the references to "investment objectives" and "other information," and the requirement of documentation all indicate greater stringency. The NASD carefully noted: "Such detailed record-keeping for suitability purposes is not required in connection with transactions in securities of other offerings and would be required in connection with those offerings only because of the significantly different nature thereof." NASD Notice to Members 4 (May 8, 1971).


41. Section 15(b)(9) of the Exchange Act, 15 U.S.C. § 78o(b)(9) (Supp. V 1975). On the legislative history of this section, see Phillips & Shipman, An Analysis of the Securities Acts Amendments of 1964, 1964 DUKE L.J. 706, 822-28, who argue: "Apparently, as long as the NASD does a good job the Commission's rules . . . are not to go substantially beyond the NASD counterparts." Id. at 824. The Commission has addressed the relationship of NASD and SEC fair practice standards in a release that concludes, with certain qualifications, "the standards of conduct and general interpretive principles which have been prescribed by the NASD for its members . . .
registered brokers, eleven percent in 1962 and seventeen percent in 1974.\textsuperscript{42} Before 1964, they were not subject to rules of the fair practice variety.

Under the 1964 amendments the Commission has promulgated its 15b10 series of rules. This regulatory structure is known as the SECO (SEC-registered Only) program. In 1967, the SEC adopted Exchange Act rule 15b10-3, the SECO suitability rule, and announced\textsuperscript{43} that it was intended to implement the recommendation of the \textit{Special Study}.\textsuperscript{44} The SECO suitability rule provides:

Every nonmember broker \ldots who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker \ldots .\textsuperscript{45}

Although this rule resembles the NASD's suitability rule in some respects, the references to "reasonable inquiry," "investment objectives," and "other information" are more far-reaching. The most significant difference between the two rules is the SECO requirement that a "reasonable inquiry" be made concerning a customer's situation and needs. The NASD rule, by contrast, refers only to "the facts, if any" disclosed by the customer.\textsuperscript{46} Some have argued that the

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\textsuperscript{44} See text accompanying note 28 \textit{supra}.

\textsuperscript{45} 17 C.F.R. § 240.15b10-3 (1977).

\textsuperscript{46} Another difference is that the rule refers to "not unsuitable" recommendations, rather than "suitable" ones. As originally proposed, it required reasonable grounds to believe a recommendation to be "suitable." SEC Securities Exchange Act Release No. 7984, at 6 (1966). The change was not explained by the SEC, and would seem insignificant. However, one commentator predicted the difference might be seized upon by a court seeking a basis for a lenient construction of brokers' suitability duties. Lipton, \textit{supra} note 1, at 277-78 (prepared statement of M. Lipton). He was soon proved correct. \textit{See} Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1382 (N.D. Tex. 1976). \textit{Cf.} 53 \textit{ALI Proceedings} 648-49 (1976) (colloquy between L. Loss and R. Demmler on a similar linguistic distinction).
NASD rule can be read sensibly only as imposing "some responsibility for knowing not only the background of the securities [the broker] sells but also that of his customers."\(^47\) The SECO rule is nevertheless more explicit in imposing such a duty.\(^48\) The SEC commentary which accompanied the final promulgation of rule 15b10-3 further defines the broker's duties under this new regulation:

Under the rule the broker . . . , when recommending a transaction to a customer, [is] expected to make reasonable inquiry concerning the customer's investment objectives, and his financial situation and needs. Information concerning financial situation and needs would ordinarily include information concerning the customer's marital status, the number and age of his dependents, his earnings, the amount of his savings and life insurance, and his security holdings and other assets. The broker . . . may rely on the information furnished by the customer.

The nature and extent of the inquiry to be made by the broker-dealer will depend on all the facts and circumstances. Thus, depending on the length of the interval between recommendations, it might be sufficient simply to ask the customer whether there has been any material change in his circumstances since the previous inquiry. However, the broker-dealer is not precluded from making a recommendation because the customer after reasonable inquiry, declines to furnish the information.\(^49\)

Rule 15b10-3 was adopted over strong protests from the NASD, which argued that Congress had empowered the SEC only to issue rules comparable to those of the NASD and not to promulgate more far-reaching rules as an "indirect method of forcing changes in long-established rules of self-regulatory organizations."\(^50\) The NASD also argued that rule 15b10-3 would be "generally inhibitory" to business, imposing a rigid requirement that a broker have a file of financial information on a customer prior to making any recommendation. Such a requirement, the Association contended, would effectively terminate general mailings to potential customers and the opening of new accounts by telephone. The NASD restated its position that


\(^{48}\) See Lipton, supra note 1, at 278 & n.16 (prepared statement of M. Lipton).


\(^{50}\) NASD News, Mar. 1967, at 4. See note 41 supra.
Fair Dealing with Customers, issued with the Commission’s approval in 1964, was specifically designed to outline unfair practices in making recommendations without creating a broker’s absolute duty of inquiry.\textsuperscript{51} The Association hinted, however, that its position that member brokers had no duty to inquire into their customers’ circumstances might not be entirely inflexible: “The Association’s present suitability rule recognizes that in certain instances more information might well be necessary and a broker/dealer member of the NASD might be called upon to demonstrate that he had made reasonable inquiries to obtain this additional information.”\textsuperscript{52}

The difference between the “if any” language of the NASD rule,\textsuperscript{53} which implies the absence of any general duty to inquire, and rule 15b10-3’s more ambiguous “reasonable inquiry” language has precipitated considerable commentary.\textsuperscript{54} Remarkably, however, in the decade marking the coexistence of the two rules, only one case has taken note of their difference in wording.\textsuperscript{55} Not a single decision has rested squarely on rule 15b10-3.

\textit{New York Stock Exchange Rules}

In order to be registered, securities exchanges, like national securities associations, must have rules designed, \textit{inter alia}, “to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade.”\textsuperscript{56} Suitability rules might appear to be required; however, the New York Stock Exchange (NYSE) does not have an express suitability rule. Some have found\textsuperscript{57} an implicit suitability requirement by construing the NYSE’s know-your-

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\textsuperscript{52} Id. Two years later, Professor Loss wrote that the adoption of rule 15b10-3 indicated that the compromise over the policy statement had not “ended the controversy over whether the [broker] should have an affirmative obligation to seek out the information relevant to a determination of suitability.” 6 Loss (1969), \textit{supra} note 18, at 3718 (emphasis in original). Thus, the NASD was correct to fear that the rule would reopen the debate. On the instability of the NASD policy statement compromise, see O'Boyle, \textit{supra} note 23, at 99 (prepared statement of T. O'Boyle).
\textsuperscript{53} See text accompanyng note 19 \textit{supra}.
\textsuperscript{54} See, e.g., 1 A. Bromberg, \textit{supra} note 6, at 100 n.34.2; Fishman, \textit{Broker-Dealer Obligations to Customers — The NASD Suitability Rule}, 51 MINN. L. REV. 233, 234-35 (1966).
\textsuperscript{55} See note 46 \textit{supra}.
\end{flushleft}
customer rule, rule 405, sometimes in conjunction with its general rule of fair dealing, rule 401, or other provisions. Rule 405 provides in pertinent part: "Every member organization is required . . . to . . . use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."568

Rule 401 reads: "Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs."59

Commentators have differed over the existence of an implicit NYSE suitability rule, but the majority agree that rule 405 imposes at least some suitability obligation.60 The most extreme view is taken

58. 2 NYSE Guide (CCH) ¶ 2405 (1978).
60. Compare 6 Loss (1969), supra note 18, at 3715-16 (rule 405 "seems more designed to protect the member firm than the customer"); Gates, The Developing Options Market: Regulatory Issues and New Investor Interest, 25 U. Fla. L. Rev. 421, 449 (1973) (NYSE has not "clearly recognized" suitability; rule 405 "more designed to protect member firms"); Rediker, supra note 47, at 66 n.208 (rule 405 serves only a housekeeping function; contrary court decision "extend[s] the NYSE's rule beyond the purposes evidently intended by its framers"); Comment, Current Problems in Securities Regulation, 62 Mich. L. Rev. 680, 741 n.319 (1964) (no requirement comparable to that of the NASD); and O'Boyle, supra note 23, at 94 n.1 (prepared statement of T. O'Boyle) (same; rule 405 "is intended primarily for the protection of members, not customers"), with E. Brodsky, Guide to Securities Litigation 156 (1974) (rule 405 establishes "firm's responsibility to its customers who trade in securities 'unsuitable' for them"); Nichols, The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards, 26 Buff. L. Rev. 435, 436 (1977) (suitability "may be derived from" rule 405); Sotos & Bowen, The Proposed Suitability Standards for the Commodity Industry: "Right Church, Wrong Pew," 53 Chi-Kent L. Rev. 289, 302 n.41 (1976) ("Rule 405(1) has now expanded in scope to include the suitability doctrine."); R. Jennings & H. Marsh, supra note 42, at 693 ("Obviously implicit . . . is the requirement that the broker's recommendations be responsibly related to the investment objectives and financial situation of the customer discovered by the investigation."); Lipton, supra note 1, at 275-76 (prepared statement of M. Lipton) (rule 405 is a "customer suitability — know your customer — rule"); Fishman, supra note 54, at 239 n.39 (suitability has been "interpreted into" rule 405); Hed-Hofmann, supra note 20, at 201 (rule 405 is "the same" as NASD suitability rule); Jacobs, supra note 6, at 897 n.124 (rule 405 "was originally designed to protect member firms but has been developing as a suitability rule as well"); Leavell, Investment Advice and the Fraud Rules, 65 Mich. L. Rev. 1569, 1576-77 & n.48 (1967) (rule 405 is a suitability
by David I. Faust, who has written that the rule imposes "[a]ffirmative obligations to obtain information for the purpose of making suitability judgments" which are far broader than brokers' obligations under the NASD and SECO rules, because the NYSE rule neither distinguishes between orders executed on the basis of broker recommendations and other orders nor between orders and accounts.\textsuperscript{61} Faust, however, is alone in espousing this view.

It is somewhat incongruous that a suitability requirement has been inferred from the NYSE know-your-customer and fair dealing provisions, because both the NASD and the SEC, through the SECO program, have promulgated know-your-customer rules\textsuperscript{62} and general rules of fair dealing,\textsuperscript{63} while also adopting separate suitability canons. Notwithstanding this incongruity, the Special Study, which had directed its recommendation for the clarification and enforcement of suitability duties to the NYSE as well as the SEC,\textsuperscript{64} reported that, beginning in 1962, the Exchange was prepared to read suitability...
into rule 405 even though the rule was originally promulgated "to protect member firms against irresponsible customers."65

The 1962 NYSE guide to supervision and control of sales practices, which predated the Special Study, contained a detailed specification of the information to be elicited from customers. These guidelines were apparently designed, however, to protect member brokerage firms from unscrupulous investors. The word "suitability" did not appear in the text of the guide, and only two brief allusions to the concept were discernible. The first reference drew a dichotomy between those customers who do not seek investment advice and those who do. As to the former, the guide merely observed that brokers should advise against the purchase of stock where "the risks of failure appear to him to be far greater than the chances of success."66 Having given such advice, a broker was free to execute the transaction if the customer still insisted on the purchase. As to customers seeking investment advice, the guide stated:

To advise an investor properly [the broker] obviously needs to know his client's investment objective. At the extreme where an investor wants advice on fitting investments into his personal financial plan, [the broker] will need to help his customer define his investment objective through consideration of (a) financial resources and obligations, (b) background and knowledge, (c) other investments held in his portfolio, (d) cash resources, and (e) other major assets such as real estate and insurance. On the other hand, an investor . . . with the objective of buying shares in a particular industry may want only the [broker's] opinion on the most promising companies in that industry. Only with the investment objective clearly understood will a [broker] be able to give a satisfactory opinion on a security held by a client or make a proper recommendation for his portfolio. Like a doctor or a lawyer, the [broker] should determine pertinent facts concerning his client's situation prior to giving advice. . . .

The wholesale recommendation of a single security . . . without thought to each individual's overall investment situation is certainly not a proper approach. It is also important that a [broker] realize that his responsibility is greatest when he recommends the purchase of highly volatile securities or the stock of a little known company.67

The guide also recognizes a potential suitability problem when "[a] widowed client of limited resources, professing that her objec-

65. Id. at 315-16, at 320.
66. NYSE, SUPERVISION AND MANAGEMENT OF REGISTERED REPRESENTATIVES AND CUSTOMER ACCOUNTS 7 (1962 ed.).
67. Id. at 7-8 (emphasis added).
tive is safety of capital and income, expresses keen interest in purchasing a highly volatile, low yielding stock which is the glamour stock of the moment." 68 A broker may recommend against such a transaction, but the customer may still wish to place the order. The guide notes that there may be "major difficulties" in proceeding to execute such an order even though the order was unsolicited. 69

The 1967 and 1973 editions of the same NYSE guide, although updated in several respects, contained no new material on suitability despite the Special Study's directive to clarify the area. Except for the deletion of the phrase, "like a doctor or a lawyer," the above-quoted language from the guide was repeated almost verbatim. 70 The deletion of the analogy to doctors and lawyers suggests, if anything, a retreat from strict suitability principles by the deemphasis of fiduciary overtones. 71

Recently, the NYSE proposed for SEC approval several amendments to rule 405. These proposals include the deletion of the reference to inquiry in the case of "every order," which appears together with references to "every customer" and "every account" in the present rule; the substitution of the words "reasonable effort" for "due diligence"; the addition of an exemption from compliance for up to five $2000 transactions per year per customer; and the exemption of "carrying" brokers, who perform the financial, operational, and bookkeeping functions for those brokers who actually open and service a customer account. 72 The Commission responded by initiating a formal disapproval proceeding, expressing its concern that one effect of the proposal might be to "sanction a less thorough evaluation of . . . the financial condition and investment objectives of the customer and the suitability of particular transactions." 73 After

68. Id. at 16.
69. Id.
70. Id. at 5, 9 (1967 ed.); id. at 4, 5, 9 (1973 ed.). The 1973 guide adds to the statement that if a customer insists on a speculative purchase "the decision is his," the qualification that "it may be advisable for the manager to document his files with a written acknowledgement from the customer as to the non-solicitation of the order." Id. at 4.
71. Recall the investment bankers' rejection of the physician-patient analogy, supra note 31.
an unsuccessful effort to compromise with the SEC, the NYSE applied
to withdraw its proposed amendments on February 10, 1978. The
SEC permitted the withdrawal and discontinued the disapproval pro-
cedure.

Rules of the Other Stock Exchanges

There are nine registered exchanges in addition to the NYSE. These exchanges have rules similar to the NYSE rules examined above. American Stock Exchange (Amex) Rule 411, which has been termed a suitability rule, phrases the know-your-customer requirement similarly to the NYSE rule: “Every member, member firm or member corporation shall use due diligence to learn the essential facts relative to every customer and to every order or account accepted.” Amex Rule 411 is reinforced by Amex Rule 16, which concerns fair dealing and which also closely tracks the NYSE phraseology: “Every member, member firm and member corporation shall at all times adhere to the principles of good business practice in the conduct of his business affairs.”

The texts of the remaining exchanges’ rules demonstrate several formulations of know-your-customer and fair-dealing duties, none

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74. See, e.g., Letter from Agnes M. Gautier, Director, NYSE Member Firm Policy Development, to Nelson Kibler, Assistant Director, SEC Division of Market Regulation (Oct. 14, 1977); Letter from James E. Buck, NYSE Secretary, to Secretary of the SEC (Dec. 7, 1977); Letter from James E. Buck, NYSE Secretary, to George A. Fitzsimmons, SEC Secretary (Feb. 10, 1978) (Copies on file with the author).


76. 2 FED. SEC. L. REP. (CCH) § 21,310.10 (1977). Only the American Stock Exchange is a national exchange; its volume is about a quarter that of the NYSE. STAFF OF SENATE Comm. ON Banking, Housing & Urban Affairs, Subcomm. ON Securities, 93d Cong., 1st Sess., Securities Industry Study 89 (Comm. Print 1973) [hereinafter cited as Industry Study]. The other exchanges are regional or specialized. They had only 6.9% of total trading volume in dollars in 1962. SPECIAL STUDY, supra note 18, pt. 2, at 912. But see Liang, Problems Multiply at Midwest Exchange, But Chief Is Optimistic, Wall St. J., Apr. 4, 1978, at 1, col. 6.

77. 2 AM. STOCK Ex. GUIDE (CCH) § 9431 (1970).

78. See, e.g., Faust, supra note 61, at 899 & n.3; Lipton, supra note 1, at 275-76 (prepared statement of M. Lipton); Jacobs, supra note 5, at 897 n.124.

79. [1970] 2 AM. STOCK Ex. GUIDE (CCH) § 9236.

80. See also Boston Stock Ex. Rules, ch. VII, § 2 BOSTON Stock Ex. GUIDE (CCH) § 2091 (1975) (know your customer); Boston Stock Ex. Rules, ch. II, § 14, id. § 2027 (1973) (fair dealing). Some exchanges were less circumspect in their reaction to the Special Study than were the NASD and NYSE, and openly attacked the suitability recommendation. See Investor Protection, supra note 30, pt. 1, at 394 (Midwest Stock Exchange), 471 (Amex).
significantly departing from the NYSE rules. In 1963 the Special Study reported that no exchange had an express suitability rule,\(^{81}\) and with the exception of special suitability rules governing options transactions,\(^{82}\) this remains true.

**Exchange Act Rule 15c2-5 and the “Shingle Theory”**

The SEC has adopted one special purpose suitability rule, which seems to impose greater obligations on brokers than does the NASD\(^{83}\) or even the SECO rule. Adopted in 1962,\(^{84}\) Exchange Act rule 15c2-5\(^{85}\) was actually the first SEC suitability rule. The rule applies to customer borrowing other than routine margin borrowing subject to Regulation T.\(^{86}\) It provides in relevant part:

> (a) It shall constitute a “fraudulent, deceptive, or manipulative act or practice” as used in section 15(c)(2) of the Act for any broker . . . to offer or sell any security to, or to attempt to induce the purchase of any security by, any person, in connection with which such broker . . . directly or indirectly offers to extend any credit to or to arrange any loan for such person, or extends to or participates in arranging any loan for such person, unless such broker . . . , before any purchase, loan or other related element of the transaction is entered into:

> (1) [Makes full advance disclosure of the customer’s obligations, of the risks, and of the costs]; and

> (2) Obtains from such person information concerning his financial situation and needs, reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person, and retains in his files a written statement setting forth the basis upon which the broker . . . made such determination; Provided, however, That the written statement referred to in this paragraph must be made available to the customer on request.\(^{87}\)

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82. See text accompanying notes 140-48 infra.

83. *But cf.* NASD Manual (CCH) § 5267 (1973) (NASD guideline stating that “the arranging of loans or granting of credit appears to result in excessive activity or churning of accounts of those customers who borrow money to purchase investment company shares, using such shares as collateral for the loan; and such churning or other over-activity raises questions under” the suitability rule).


87. The requirement that the broker retain a written suitability statement in his files was adopted in 1975. SEC Securities Exchange Act Release No. 11220, 6 SEC
This suitability requirement applies to all transactions, not just those accompanied by broker recommendations. The rule seems to adopt an objective conception of suitability to which the broker must adhere even when a highly sophisticated investor is entirely satisfied that the transaction is suitable. According to the SEC, rule 15c2-5 was promulgated in response to abuses arising out of the proliferation of so-called "equity funding" programs, "in which securities sold to a customer by a broker or dealer are used as collateral for a loan whose proceeds are in turn used for payment of premiums on a life insurance policy sold to the customer as an integral part of the program." The abuses included programs that were being offered indiscriminately to many persons for whom they were not suitable. The application of rule 15c2-5 is not limited to "equity funding" programs, however, and it applies to arrangements which involve borrowing of funds by customers from brokers in any form except conventional margin securities transactions.

Unlike the SECO suitability rule, rule 15c2-5 is a direct interpretation of the antifraud language of section 15(c)(2). Despite its authority to recommend rules designed "to insure fair dealing in securities . . . or to insure fair administration of [a national securities] exchange," the SEC imposed the rule, a very stringent suitability requirement, under the antifraud rubric of section 15(c)

Docket 342, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,096 (1975). Before 1975, the rule required the statement to be delivered to the customer. No explanation was offered for the change.

88. See, e.g., Fishman, supra note 54, at 234.
91. See text accompanying note 49 supra.

As yet, however, no commentator has recognized clearly the doctrinal difficulties posed by subsuming suitability under "fraud" through rule 15c2-5.95

Section 15(c)(2) does give the Commission broad authority to adopt rules that "define and prescribe means reasonably designed to prevent, such acts and practices [by brokers] as are fraudulent, deceptive, or manipulative."96 By requiring both full disclosure of risk and an independent determination by the broker that the transaction is suitable for the customer, rule 15c2-5 apparently rejects the idea that a suitability requirement should be directed at allowing a customer to determine for himself the appropriateness of the transaction after full disclosure of the risks involved by the broker.97

94. The SEC can impose fair practice rules on the exchanges and the NASD under § 19(c) of the Exchange Act, 15 U.S.C. § 78s(c) (Supp. V 1975) (formerly § 19(b), 15 U.S.C. § 78s(b) (1970)). Until 1975, the SEC had the power to override exchange rules concerning twelve enumerated subjects, as well as other "similar matters." Although at least one commentator assumed this power did not reach suitability, see Rediker, supra note 47, at 52, the question was certainly debatable. See Gordon v. New York Stock Exchange, 422 U.S. 659, 667, 687 (1975); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 129-31, 134-36 (1973). Since 1975, the SEC has had undisputed power to impose suitability rules on the NASD and the exchanges.

95. See 6 Loss (1969), supra note 18, at 3681, 3725; Jacobs, supra note 6, at 903; Mundheim, supra note 60, at 454-55, 460 n.39; Rediker, supra note 47, at 53 & nn.170-71. But see Fishman, supra note 54, at 234-35, 247; Mundheim, supra note 60, at 472 n.81.

96. See generally 2 Loss (1961), supra note 18, at 1192-200, 1361-62; 3 id. at 1425-26; 5 Loss (1969), supra note 18, at 3202-05; 6 id. at 3680-81.

97. This may be as appropriate a point as any to record the author's view on the relationship between disclosure requirements and true suitability rules. This view is best illustrated by his conclusion that Securities Act rule 146, 17 C.F.R. § 230.146 (1977), the "safe harbor" rule recently adopted under the private offering exemption, is not, although embodying certain suitability principles, properly conceived of as a suitability rule.

Rule 146, adopted in 1974, see SEC Securities Act Release No. 5407, 4 SEC Docket 154, 1 Fed. Sec. L. Rep. (CCH) ¶ 2710 (1974); see also SEC Securities Act Release No. 5913, 14 SEC Docket 310, [Current] Fed. Sec. L. Rep. (CCH) ¶ 81,532 (1978) (proposed amendments), is a nonexclusive interpretation of the exemption from registration of securities provided by § 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (1970). In addition to imposing restrictions on the number of purchasers, on resale, and on the access to issuer data by or the furnishing of data to offerees, the rule requires offerees and purchasers to satisfy certain criteria. The issuer (or anyone acting on its behalf) must have reasonable grounds to believe, and shall believe, one of two things about offerees and purchasers. Immediately prior to the offer, he must believe either that "the offeree has such knowledge and experience in financial and business matters that he is capable of valuating the merits and risks of the prospective investment," rule 146(d)(1)(i), or that "the offeree is a person who is able
In view of the traditional principle that fraud is a kind of decep-
to bear the economic risk of the investment," rule 146(d)(1)(ii). Immediately
prior to sale, he must also believe, "after making reasonable inquiry," rule 146(d)(2),
one of the same two things about the purchaser. If the second alternative (ability to
bear the risk) is taken, however, he must also believe that the "offeree and his offeree
representative(s) together" satisfy the first alternative (ability to evaluate the risk).
The ALI Code's "limited offering" exemption would not impose any such criteria on
offerees or purchasers, although the imposition of such criteria was initially considered.
See ALI FED. SEC. CODE (Proposed Official Draft, 1978) § 242(b); 49 ALI PRO-
CEEDINGS 376-77 (1972) (remarks of L. Loss). Indeed subsection (b)(3) suggests
the Commission would have the power to do so if the Code were adopted.

Some commentators have seen rule 146 as a suitability rule. See Cook & Levenson,
SEC Staff Views on Continental Tobacco and the Need for Regulatory Guidelines in
the Private Offering Area, in PLI FOURTH ANNUAL INSTITUTE ON SECURITIES REGULA-
tion 49, 55 & n.17 (R. Mundheim, A. Fleischer, Jr. & J. Schupper eds. 1973); Lipton,
supra note 1, at 273, 287, 289 & n.35 (prepared statement of M. Lipton); id. at 289 &
n.35 (address by SEC Chairman M. Cohen); Bines, Investment Objectives, supra note 18, at 279 n.8, 284, 419 n.2, 424 n.11, 428 & n.27, 431, 455-56 (1976 & 1977); Borton
& Rifkind, Private Placement and Proposed Rule 146, 25 HASTINGS L.J. 287, 304-05
(1974); Faust, supra note 61, at 901; Flint, SEC and FRB Treatment of Options: An
Experiment in Market Regulation, 53 TEx. L. Rev. 1243, 1281, 1283 (1975). However,
this view fails to distinguish the underlying purposes of rule 146 and suitability rules.

Ultimately, all of the securities laws aimed at ensuring disclosure could be thought
of as suitability laws, because their goal is to facilitate informed judgments by pur-
chasers and sellers as to the desirability, or suitability, to them of transactions — the
suitability in their eyes, which is referred to in this Article as subjective suitability.
So could the states' blue sky laws, which, by interposing the judgment of the state be-
tween issuers and investors as to the fairness of investments, assure the suitability
of transactions for customers in the state's eyes. That concept of suitability which
involves its being decided for the investor by someone else is referred to in this Article
as objective suitability.

Suitability rules can also be divided along these subjective-objective lines. As
we shall see at text accompanying notes 260-62 & 342-385 infra, the SEC initially in-
terpreted the suitability obligation, and the courts have also tended to interpret it
as a requirement that the broker not frustrate the process of informed investor judg-
ment that the disclosure philosophy was meant to promote by recommending a security
he knew the customer would not find appropriate, at least if the customer were fully
sophisticated and autonomous. They thus took a clearly subjective view of suitability.
See also Geerlings, Suitability Requirements for Non-Member Broker-Dealers Under
Proposed Rule 15b10-3, in CONFERENCE ON MUTUAL FUNDS 13, 14-15 (P. Geerlings
ed. 1967) (arguing that the suitability rules should be faithful to the concern with
disclosure of the SPECIAL STUDY and the securities acts). On the other hand, some
suitability rules, rule 15c2-5 for example, embody a clearly objective view. They can-
not be reconciled with the disclosure philosophy because they make it the broker's duty
to determine himself the suitability of a transaction rather than to facilitate the cus-
tomer's determination of suitability. In some cases they also impose specific guidelines
as to the characteristics of customers for whom given transactions are presumed suitable
or unsuitable.

But what all suitability rules have in common is that they are specifically and ex-
clusively directed at ensuring a desired matching between investments and customers'
tion, the rule's imposition of a dual obligation under the doctrinal heading of fraud must rest on the fiction that brokers, by "hanging out their shingles," implicitly represent that they will independently determine the "objective" suitability of all transactions for their customers. This assumption seems entirely implausible, except in the circular sense that Rule 15c2-5 itself now makes such an implicit representation a part of doing business as a broker.

The fiction of brokers' implicit representations to their customers is the cornerstone of the "shingle theory," which emerged as a means of justifying rules and proceedings under the fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. The shingle theory was employed in cases in which acts of actual

investment goals, finances, and needs. Rule 146 is not a suitability rule because while, like objective suitability rules, it imposes guidelines as to the characteristics of investors, it does so not directly to the end of objective suitability, but as an instrumental step in the larger regulatory scheme of general disclosure. The alternative to compliance with rule 146 is disclosure, whereas there is no alternative provided to compliance with true suitability rules. Rule 146 limits private offerings to certain purchasers neither because private-offering securities are objectively suitable only for such purchasers, nor because only such purchasers can make the informed, autonomous judgments underpinning the subjective view of suitability: at least as far as the Securities Act is concerned, if the securities were registered, they could be sold to anyone. The basic reason that rule 146 requires offerees and purchasers to meet sophistication or risk-bearing criteria is that only by so limiting the universe of purchasers can the protections afforded by the general disclosure mechanism (and the effect it has through the interpretation of public information in the marketplace) be approximated. As the SEC said on adopting the rule: "Such a rule should deter reliance on [the section 4(2)] exemption for offerings of securities to persons who are unable to fend for themselves in terms of obtaining and evaluating information about the issuer and in certain situations of assuming the risk of investment. These persons need the protections afforded by the registration process." SEC Securities Act Release No. 5487, 4 SEC DOCKET 154, 158, 1 Fed. Sec. L. Rep. (CCH) ¶ 2710, at p. 2907-3 (1974). See also SEC v. Ralston Purina Co., 346 U.S. 119, 124-27 (1953); SEC v. Continental Tobacco Co., 463 F.2d 137, 158-61 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680, 687-91 (5th Cir. 1971).

98. This principle was most recently reaffirmed by the Supreme Court in Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471-74 (1977).


deception could not be specified but which involved the calculated enrichment of brokers at the expense of their customers.\textsuperscript{102} The theory was first applied to dealers who profited by consummating transactions at prices not reasonably related to the market.\textsuperscript{103} More recently the theory has been applied to hold brokers liable for conduct not in keeping with, for example, these implied representations or “implied warrant[ies]”:\textsuperscript{104} that the broker will execute only authorized orders,\textsuperscript{105} that orders will be executed promptly,\textsuperscript{106} that customer securities purchased for cash will not be pledged without authority,\textsuperscript{107} that the broker is solvent,\textsuperscript{108} that the broker has no interest such as a substantial long or short position which could cloud his recommendation\textsuperscript{109} and that there is a reasonable basis in fact for a favorable recommendation of a security.\textsuperscript{110}


One significant feature of the shingle theory is that, because it relies on a warranty concept, proof of reliance or of a lack of sophistication on the part of an investor apparently are not necessary elements in establishing a violation. On the other hand, there is considerable authority that in the case of other suitability rules reliance must be shown, and that experienced or sophisticated investors have a greater burden in directly proving a violation.

Although the shingle theory has been said to hold "the seed" of the suitability doctrine, the foregoing applications of the shingle theory fail to support an extension of the theory to suitability for two reasons. First, the representations that have been inferred in most

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111. See, e.g., SEC v. Dolnick, 501 F.2d 1279, 1283 (7th Cir. 1974); Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963); S. Jaffe, supra note 110, § 7.03; 5A A. Jacobs, supra note 6, § 211.01[b], at p. 9-39; Brudney, Origins and Applicability of the "Reasonable Basis" or "Know Your Merchandise" Doctrine, in PLI Fourth Annual Institute on Securities Regulation 239, 249 & n.34 (R. Mundheim, A. Fleischer, Jr. & J. Schupper eds. 1973) (prepared statement of V. Brudney); William Harrison Keller, Jr., 38 S.E.C. 900, 906 (1959). Reliance and lack of sophistication may, however, be required in private civil actions, as distinguished from SEC enforcement actions. See SEC v. North American Research & Dev. Corp., 424 F.2d 63, 84-85 (2d Cir. 1970); Hanly v. SEC, 415 F.2d 589, 596-97 & nn. 9 & 13 (2d Cir. 1969); see also A. Jacobs, supra note 6, § 211.04, at p. 9-83 & n.15. Recently, however, this qualification to the strict warranty approach may have been abandoned. See Franklin Sav. Bank v. Levy, 551 F.2d 521, 530 (2d Cir. 1977) (Van Graafeiland, J., dissenting in part); see also Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir.), cert. denied, 98 S. Ct. 312 (1977).

112. See, e.g., text accompanying notes 293-94, 380-88 & 444-46 infra.

113. See, e.g., text accompanying notes 363-69 infra. See also note 369 infra. But see Lipton, supra note 1, at 280 (prepared statement of M. Lipton) (treats as open question).

114. 6 Loss (1969), supra note 18, at 3685. See also Lipton, supra note 1, at 275 (prepared statement of M. Lipton) ("suitability can be traced to the Commission's shingle theory"); Loss, Book Review, 18 J. LEGAL EDUC. 238, 239 (1965) (suitability requirement has "been emerging out of the old 'shingle' theory").

115. See Bickel, supra note 23, at 17 (denying "that the recommendation of an unsuitable security in itself is tantamount to fraud or deceit"). One court has expressed misgivings about the wisdom of treating suitability under the shingle theory. See Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 430-31 (N.D. Cal. 1968), modified, 430 F.2d 1202 (9th Cir. 1970). But see E. Weiss, Registration and Regulation of Brokers and Dealers 184 (1965) ("representation as to suiting the client's needs . . . appears to be implicit in the recommendations made by a broker-dealer to his customer"); note 295 infra. The NASD policy statement, Fair Dealing with Customers, concludes with a cryptic reference to the shingle theory which appears to signal no view as to its relevance to suitability. See NASD, Special Report to NASD Members (Oct. 9, 1964), NASD Manual (CCH) § 2152, at 2053.
of the shingle theory cases have some basis in common sense; they are aspects of "trade custom"\textsuperscript{116} to which the average customer would probably expect a broker to adhere. On the other hand, it is considerably less likely that the average customer expects a broker to make an extensive effort, before recommending a security, to assure himself that the customer would find it appropriate to his investment objectives, portfolio, and financial needs. It is even less plausible that the average customer expects the broker to make an independent, objective calculation of appropriateness, satisfying himself that the security is suitable for the customer according to certain absolute criteria, notwithstanding the customer's own opinions, before making any recommendation. Because the shingle theory has developed from the application of fraud principles to the broker-customer relationship, a cause of action under the theory must ultimately be based on some type of misrepresentation, which may be implied. There can be no misrepresentation, even impliedly, as to the suitability of a security, however, if the customer does not expect the broker to satisfy himself of the security's appropriateness. Thus, to include suitability doctrine, particularly an objective version of suitability, within the shingle theory stretches the theory farther than it will reach.

Second, most of the practices to which the shingle theory has been applied involve substantial conflicts of interest; they are practices which would constitute a breach of a broker's fiduciary duty if he had entered into a fiduciary relationship with his customer. The usefulness of the shingle theory is that it allows brokers to be disciplined for these practices without a case-by-case finding that a fiduciary relationship existed with the customer.\textsuperscript{117} It is less evident whether a broker's recommendation of an unsuitable security, absent misrepresentations or other clearly fraudulent acts,\textsuperscript{118} may be reason-

\begin{itemize}
  \item[116.] 3 Loss (1961), supra note 18, at 1488.
  \item[117.] See id. at 1500-08; 6 Loss (1969), supra note 18, at 3702-08. But see Rice, Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis, 25 MercER L. REV. 537, 553-54 (1974).
  \item[118.] Churning is also an exception. "Even a broker, who acts solely as an agent for his customers, is compensated on a commission basis and thus has an interest in generating transactions. His interest in this respect obviously may conflict with those of his customer. And when this conflict is resolved in the broker’s favor, trouble may ensue in the form of, for example, a ‘suitability’ or ‘churning’ case.” O’Boyle, supra note 39, at 459. See text accompanying notes 284-94 infra; see also V. Brudney & M. Chirelstein, Cases and Materials on Corporate Finance 1064 n.0 (1972) (“unloading” excess inventory).
\end{itemize}
ably viewed as conduct constituting a conflict of interest and a breach of fiduciary principles. A broker in this situation at most secures business he might otherwise lose, and may simply save the time and expense of a thorough investigation of security and customer. The substantial unjust enrichment or self-dealing present in most shingle theory violations is absent from "pure" suitability violations.

Of course, the SEC and the courts may choose simply to abandon the doctrinal underpinnings of the shingle theory in favor of a formula that makes it fraudulent to act "unfairly" or inconsistently with "standards of the profession." But such a formula would be almost infinitely elastic.

Options Trading: SEC Proposals and Exchange Rules

During the past five years, there has been a rapid emergence of exchange trading in options, which previously had been traded over the counter in much lower volume. The SEC has permitted this trading, the first trading of options on the exchanges since the years before 1934, on an experimental basis on the Chicago Board Options Exchange (CBOE), the Amex, and the Philadelphia, Pacific, and Midwest Exchanges. The Commission has repeatedly expressed

119. See, e.g., Leavell, supra note 60, at 1581-83.

120. See Loss (1969), supra note 114, at 240 (danger that inferring representations is "question-begging"); Jacobs, supra note 6, at 880. See also Hearing on Municipal Securities Regulation before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess. 60 (1975) (testimony of SEC Commissioner J. Evans that use of a fraud theory would be a much more difficult approach to upgrading standards than fair practice rulemaking).

121. Options are contracts in which the seller ("writer") conveys to the buyer the right to buy ("calls") or sell ("puts") an underlying security at a specified price within a specified period. In exchange trading, the Options Clearing Corporation intervenes between seller and buyer, becoming the party with which each contracts. On the mechanics of options trading, see S. JAFFE, supra note 110, § 10.11; Poser & Brodsky, Amex Options Regulation, 8 Rev. Sec. Reg. 959, 959-60 (1975); Flint, supra note 97, at 1244-47; Gates, supra note 60, at 421-37.

concern, however, not only with the potential impact of such trading on capital markets but also with the higher risks and greater complexity of trading in options rather than in the underlying securities. Accordingly, the Commission adopted Exchange Act rule 9b-1, requiring SEC approval of exchange options trading plans. This rule was later superseded by Exchange Act rule 19b-4, which governs all rule changes by self-regulatory organizations.

On October 17, 1977, the SEC announced the initiation of a formal investigation of all options trading and the initiation of formal disapproval proceedings directed at plans to expand options trading. Among the abuses that precipitated this major policy shift were suitability violations. Thus, the suitability performance of options brokers may have an important impact on the future of options trading.

The Commission's proposed Exchange Act rule 9b-2, outstanding since early 1973, would impose stringent disclosure requirements and a three-part suitability requirement on all brokers dealing in options.

The first part of the rule's suitability scheme is a general options suitability provision that tracks the language of rule 15b10-3, but also

requires a broker to have reasonable grounds to believe that “the entire recommended transaction is not unsuitable.”

The second suitability requirement in rule 9b-2 would apply to “limited price” options, also known as “down-and-out” and “up-and-out” options. The Commission has been considering since 1973 whether to prohibit these options.

Limited price options expire if the market price of the underlying securities falls below, in the case of calls, or rises above, in the case of puts, a given price. Under the proposed rule, no transaction in a limited price option could be recommended unless the broker also obtained “from the customer such information in addition to any other information known by such broker . . . , as to have reasonable grounds to believe, at the time of making the recommendation, that the customer understands the special characteristics of such option.”

According to the Commission, this additional suitability requirement is necessary because “limited price options are fraught with special hazards which require a customer to have a high degree of sophistication and understanding in order for such options to be recommended as a suitable investment.”

The third part of rule 9b-2 would apply to “uncovered” or “naked” calls and “offsetting” puts. These are calls whose writer neither owns nor is long in the underlying security, and puts whose writer is short in the underlying security. They are not subject to the same risk limits as other options because the writer faces unbounded losses on the call or the short position. A broker could effect such transactions only if

on the basis of information obtained . . . , after reasonable inquiry, and in addition to any other information known by such

133. Proposed rule 9b-2(b)(2), 2 Fed. Sec. L. Rep. (CCH) ¶ 22,623 (1977). One commentator has observed that it is unclear whether this provision would bar executing a transaction with a customer who refused to provide information, but takes the view that it probably would. Frankhouser, Options Regulation, 7 Rev. Sec. Reg. 903, 908 (1974).
broker . . , he has a reasonable basis for believing that the customer, at the time of the transaction, is capable of evaluating the additional risks in such transactions, and has the financial capability to meet reasonably foreseeable margin calls . . . .

This suitability provision would apply to all transactions conducted by the broker, whether or not he recommended them. The SEC explained that the broad scope of the provision was necessary "in view of the dangers to customers and endorsing brokers inherent in this more complex form of option writing."\textsuperscript{137}

The Commission noted with respect to both the second and third parts of the suitability scheme of rule 9b-2 that the information the broker should obtain would generally "include the nature and extent of the customer's knowledge and experience in financial matters."\textsuperscript{138} The Commission added that, unlike the general suitability requirement, these parts do "not call merely for a reasonable inquiry of the customer," but "would require the broker . . . to obtain the information relative to the customer's sophistication that is needed in order for . . . the broker . . . to make a reasonable judgment."\textsuperscript{139}

Exchange trading of options began on the CBOE in 1973 and on the Amex in 1975\textsuperscript{140} and is presently underway on three smaller exchanges, as already noted. The rules\textsuperscript{141} adopted by these exchanges

\textsuperscript{136} Proposed rule 9b-2(c) 2 FED. SEC. L. REP. (CCH) ¶ 22,623 (1977).
\textsuperscript{139} Id.
\textsuperscript{140} Poser & Brodsky, supra note 121, at 959; Brodsky, Rules of the CBOE, 6 REV. SEC. REG. 897 (1973).
as part of their statutorily-required options trading plans\footnote{142}{See note 122 supra.} include suitability rules very similar to those of proposed rule 9b-2, except that limited price options, which are not now traded, are not addressed and the more stringent requirements of the third part of proposed rule 9b-2 are applied to all puts rather than to offsetting puts only. The exchanges also require periodic review of options accounts from the standpoint of suitability.\footnote{143}{See, e.g., Brodsky, \textit{supra} note 140, at 897 (CBOE); Poser \& Brodsky, \textit{supra} note 121, at 963 (Amex).}

A number of brokerage firms have established minimum requirements in terms of net worth or account equity for “covered” and “uncovered” transactions.\footnote{144}{Poser \& Brodsky, \textit{supra} note 121, at 983; \textit{AmEx, Regulatory Guidelines For Conducting A Public Business In AmEx Listed Options (Puts And Calls) 4} (1977) [hereinafter cited as \textit{AmEx Guidelines}].} The Amex has established as a guideline the requirement that except for recommendations limited to the particular series of options where the customer himself has determined the amount of the investment to be made, “recommendations should not be made for the investment of more than 15% to 20% of a customer’s investment assets in the purchase of options.”\footnote{145}{\textit{AmEx Guidelines}, \textit{supra} note 144, at 10.}

One important side effect of the establishment of this new realm of suitability regulation by the exchanges is that it substantially undercuts the already uncertain argument that exchange know-your-customer rules are \textit{de facto} suitability rules.\footnote{146}{See, e.g., note 147 \textit{supra}.} For, in their options regulation schemes, the exchanges have included separate know-your-customer rules side by side with options suitability rules. These options know-your-customer rules not only repeat the language of the basic know-your-customer rules as to learning “the essential facts relative to the customer,” but go on to require that the broker learn the customer’s “financial situation and investment objectives.”\footnote{147}{CBOE rule 9.7(b), \textit{CBOE Guide} (CCH) § 2307 (1976), (also refers to “needs”); Amex rule 921(b), 2 \textit{Am. Stock Ex. Guide} (CCH) § 9721 (1977); Philadelphia Stock Ex. rule 1024(b)(ii), \textit{Philadelphia Stock Ex. Guide} (CCH) § 3024 (1977), Pacific Stock Ex. rule X, § 18(b)(1), \textit{Pacific Stock Ex. Guide} (CCH) § 4993 (1977); Midwest Stock Ex. rules art. XLVII, rule 3(b), \textit{Midwest Stock Ex. Guide} (CCH) § 2113 (1977).}

The Amex commentary on the rule states: “In connection with approving the account of a customer for options trading, members and member organizations should seek information in particular as to whether the customer has had prior experience in trading options, whether he is aware of the nature and extent of the obligations as
NYSE proposal for options rules follows the other exchanges in this regard.\textsuperscript{148} The adoption or proposed adoption of these rules creates a powerful negative inference as to the suitability content of the basic know-your-customer rules.

\textit{Other SEC Proposals and Statements Concerning Suitability}

In the past several years, the SEC has made several interesting proposals and statements concerning suitability.\textsuperscript{149}

Unsecured Short-Term Debt Securities

On April 12, 1971, the Commission released a statement expressing its concern over proposals to offer unsecured short-term debt securities in the guise of substitutes for savings accounts or certificates of deposit. The SEC drew attention to the risk factors associated with these securities and reminded those “engaged in the offer and sale” of such investments of their obligation under the SECO suitability rule, as well as under various fraud sections and rules “to consider as to each prospective investor all adverse risk factors, taking into account, among other relevant considerations, his investment needs and objectives in light of his personal and financial situation.”\textsuperscript{150} Apparently this instance is the only one in which the Commission has issued a warning under the general SECO suitability rule as to a particular category of investments.\textsuperscript{151}

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well as the risks attendant to options trading, whether he has account with other brokerage firms and the extent of any positions or commitments therein, and whether the customer has financial resources adequate to cover option positions he may intend to establish in such account.” 2 AM. STOCK EX. GUIDE (CCH) \S 9721.02 (1977). For similar comments, see PHILADELPHIA STOCK EX. GUIDE (CCH) \S 3024.02 (1977); PACIFIC STOCK EX. GUIDE (CCH) \S 4993.02; MIDWEST STOCK EX. GUIDE (CCH) \S 2113.02 (1977).


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Future Structure of Securities Markets

On February 2, 1972, the Commission issued to Congress its Statement on the Future Structure of the Securities Markets.152 The statement addressed the possibility that competitive brokerage commission rates would deprive the small investor of the benefit of research financed by the minimum commission scheme in effect at that time. A broker's adequate knowledge concerning the securities he recommends has not only been required independently under fraud principles,153 but is a logical prerequisite to his discharging his suitability obligations. In the SEC's statement to Congress, it observed that a competitive rate structure would not relieve brokers of their obligations under the NASD and SECO suitability rules and continued with this interesting comment:

It should be noted that the suitability rules are cast in terms of the needs of the customer based on information he furnishes to the broker. Unarticulated but implicit in such rules is also the broker's obligation to obtain current basic information regarding the security and then to make an evaluation as to the suitability of a recommendation for a particular customer in view of both the information concerning the security and the customer's needs.

The Commission recognizes that some customers will independently determine to purchase or sell specific securities and will not request or desire the advice of a broker and that in these circumstances it is impractical to require rigid adherence to the suitability rules. Even in such cases, however, the broker would appear to be obliged to reveal to the customer information known to him about the security which might reasonably be expected to affect the customer's decision, apart from his other duties under applicable provisions of the securities laws.154

The second paragraph seems to indicate that even in arm's length order clerk situations, the broker must make full disclosure of potential unsuitability. Such disclosure, by definition, would require some knowledge of the customer's situation. Apparently, the broker is free to effect the transaction if the customer so desires, once such disclosure is made.155

153. See note 110 supra.
155. Accord, Faust, supra note 61, at 900. See also Bines, Investment Objectives, supra note 18, at 432 (Future Structure statement raises "the question of how intensely
The *Future Structure* statement also identified the creation of a composite network of securities price quotations as an important step toward the ultimate goal of an integrated, national securities market.\(^{156}\) After considerable analysis and debate of alternative means to pursue a composite quotation system,\(^{157}\) the Commission finally adopted Exchange Act rule 11Ac1-1.\(^{158}\) This rule requires the exchanges and the NASD to make available to electronic quotation vendors their members' current bids, offers, and quotations sizes about every security for which trading data are regularly reported. These quotations are to be firm"; that is, each member broker will be required, with certain exceptions, to execute transactions at terms at least as favorable as his latest published quotations, with any other broker "or any other person belonging to a category of persons with whom [he] customarily deals."\(^{159}\) The SEC was careful to stress that the new rule does not abrogate brokers' suitability obligations: a broker still "should not engage in a transaction with a customer when the broker's fiduciary responsibility, including principles of suitability . . . , would otherwise prohibit such a transaction."\(^{160}\)

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\(^{159}\) Rule 11Ac1-1(c)(2).

Hot Issues

On July 26, 1972, during hearings on "hot issues," which "result where the price of a new offering of securities rises to a substantial premium over the initial offering price immediately or very soon after the securities are first distributed to the public," the SEC issued statements in which it noted a greater need for "due diligence" by the underwriters of such securities. The Commission also found a "definite need for specific suitability standards" as to these high-risk securities. It noted that there was precedent for the "tailoring of suitability standards for a specific problem," citing rule 15c2-5, and requested the NASD and the exchanges to "consider developing suitability standards for the guidance of their members in selling" such securities. These standards should take into account both the customer's "investment objectives, financial situation and needs" and his "experience and sophistication in securities transactions." The Commission stated that, if "an appropriate response" were not forthcoming, it would "consider rule making to accomplish the necessary results for the protection of investors and in the public interest."161

The NASD circulated its proposed "hot issue" rules in early 1973.162 The suitability section provided:

In recommending to a customer the purchase, sale or exchange of any security which is part of the initial public offering of a company in the promotional, exploratory or developmental stage, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of information furnished by the customer concerning the customer's investment objectives, financial situation and needs, and any other information known by the member. In connection with all such determinations, the member must maintain in its files the basis for and the reasons upon which it reached its determination.163

The "hot issue" proposal was withdrawn to redraft the "due diligence" sections and to add other provisions.164 It was resubmitted to the membership in April 1975,165 but has not been pursued. Un-

162. NASD, Notice to Members No. 73-17 (Mar. 14, 1973).
163. Id. at 13-14. Notice the similarity of this proposed rule to the NASD rule governing members' recommendations of securities in their own firms, set forth in note 39 supra.
doubtedly other matters were regarded as more pressing in the con-
text of a bear market from which "hot issues" had all but disappeared.

Tax-Sheltered Programs

On July 2, 1973, the Commission requested public comment on proposed NASD rules for comprehensive regulation of the distribution by NASD members of securities of tax-sheltered programs. These programs frequently involve exceptional levels of risk. At the same time the NASD circulated these proposals, which had already been revised following a year's consideration within the Association, to its own members for the second time.

The proposed suitability provision would have governed all sales, not merely recommendations. It was summarized by the SEC as follows:

[A tax sheltered] program would be required to establish and disclose in the prospectus its suitability standards for program participants. In order to determine the suitability of a program for a particular investor, the rules would establish certain minimum guidelines, among which are that the customer should be reasonably anticipated to be in at least a 50% tax bracket in certain high risk situations, and that the customer have a net worth sufficient to sustain the risk inherent in the program, including the loss of his investment.

Departures from presumptive suitability standards would have been permitted, but the burden would have been on the broker to prove that such aberrations were appropriate. Full disclosure to the customer would not fulfill the suitability obligation. The provision also


169. See NASD, Press Release No. NSD 1672, at 2 (June 4, 1972) (proposal would
included a requirement that the broker "maintain in the files the basis for and reasons upon which the determination of suitability was reached as to that customer."\textsuperscript{170}

The SEC, noting that several states had regulated such investments and that proposed California rules, now in effect,\textsuperscript{171} would govern their suitability,\textsuperscript{172} stated it was "inclined to the view that the implementation [of the suitability provisions and certain of the other provisions of the proposed rules] should proceed."\textsuperscript{173} The Commission expressed misgivings, however, as to the breadth of the overall NASD proposals; it was concerned that some of the provisions, such as those governing issuer net worth, investor assessments, liquidation of program interests, and sponsor compensation, might entail regulation of issuers which would be more appropriate for legislative action.\textsuperscript{174} Several months later, the Commission also released for comment a proposed guideline requiring that specific suitability standards be prominently displayed in real estate prospectuses.\textsuperscript{175}

In a May 1974 letter to the NASD, the SEC expressed continued misgivings over the breadth of the NASD's proposed regulation of tax-sheltered offerings. The SEC concluded that, although it "would welcome the prompt submission" of proposed NASD suitability rules for tax-sheltered investments insofar as suitability was within "the traditional areas of [NASD] regulation," the NASD should not, "at this time," undertake to regulate "the operation, structure and management" of tax-sheltered programs.

The Commission then suggested that the NASD could salvage "much of the thought behind" the disapproved rules in the form of

\textsuperscript{170} NASD, Notice to Members, 73-50, at 32 (July 13, 1973).
\textsuperscript{171} See note 5 supra.
"general guidelines in the area of suitability." In suggesting how such guidelines might be developed, the letter continued with a fascinating and illuminating effort by the Commission to mark out a line between acceptable suitability regulation and illegitimate issuer regulation. As an example of the use of issuer-oriented criteria in developing suitability guidelines, the SEC cited the NASD’s proposed experience and net worth criteria for sponsors of tax shelter programs. Under the Commission’s approach, such criteria would not be mandatory. Since these criteria are risk indicators, programs whose sponsors failed to satisfy them would be suitable for fewer customers. The Commission took the following position with respect to such a program:

> While suitability guidelines would not absolutely preclude a member from deciding (and, if necessary, subsequently demonstrating) that offsetting factors made a program sufficiently attractive to justify recommending it to selected customers, a member so deciding will obviously wish to document that the selected customers had, for example, an ability to comprehend fully the extra risk involved and greater capital or income than the average customer to whom it recommended tax shelter programs generally.

On July 7, 1977, three years after the SEC letter, the NASD renewed its efforts in this area by submitting for SEC approval an enabling provision that delegates to the Association’s Board of Governors broad power to set the conditions under which NASD members may distribute, sponsor, or underwrite investments in “direct participation programs.” The Board’s powers would include authority to set “the standards of suitability for investment in such programs by investors.” A direct participation program is defined, in essence, as an investment vehicle “which provides for flow-through tax consequences.”

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177. Id. at 84,194. As to the events of 1972 to 1974, see Comment, supra note 5, at 486-88.
179. Proposed art. III, § 35(b)(3) of the Rules of Fair Practice. See NASD, Notice to Members No. 77-3, at 33 (Jan. 21, 1977). This provision had been approved by the NASD membership in January and February 1977, after it was circulated together with a first draft of detailed Board rules to govern such programs.
180. Proposed art. III, § 35(d)(2) of the Rules of Fair Practice. Id. at 34.
earlier concerns by limiting the Board's power to establish substantive standards concerning issuers to those cases in which an NASD member actually sponsored the program.\textsuperscript{181}

On March 10, 1978, while the enabling provision remained pending with the SEC, the Board of Governors circulated a second draft of detailed rules for direct participation programs,\textsuperscript{182} including, as had the first draft, a suggested suitability rule. The SEC may well be awaiting a final draft of these rules before passing on the enabling provision. In both the 1977 and 1978 drafts, the suitability rule is identical.\textsuperscript{183} The rule substantially repeats the 1973 suitability proposal. It requires suitability standards to appear in program prospectuses.\textsuperscript{184} A broker may neither recommend nor sell units in such programs unless he satisfies a three-part suitability requirement.\textsuperscript{185} This obligation is separate and apart from the broker's duty to "inform the customer of all pertinent facts relating to the liquidity and marketability of the program, or lack thereof, the tax aspects of the program during the term of the investment and the tax consequences upon dissolution of the program."\textsuperscript{186}

The first facet of the suitability requirement is an obligation to make a general suitability determination. The broker must "have reasonable grounds for believing that the purchase of the program is suitable for the customer on the basis of information furnished by him concerning his investment objectives, financial situation and needs and any other information known" to the broker.\textsuperscript{187} Unlike the general NASD suitability rule, this part of the proposal leaves no doubt that the broker must obtain detailed information from the customer about the customer's finances and investment goals.\textsuperscript{188}

\textsuperscript{181} Proposed art. III, § 35(b)(2) of the Rules of Fair Practice. \textit{Id.} at 32-33.

\textsuperscript{182} NASD, Notice to Members No. 78-12 (Mar. 10, 1978).


\textsuperscript{184} \textit{Id.} at 53 (subsection (a)).

\textsuperscript{185} \textit{Id.} (subsection (b)).

\textsuperscript{186} NASD, Notice to Members No. 77-3, at 55 (Jan. 21, 1977) (proposed subsection (b)(3)). Some of the language of this subsection was omitted from the 1978 version by a typographical error. \textit{See} NASD, Notice to Members No. 78-12, at 53 (Mar. 10, 1978).

\textsuperscript{187} \textit{Id.} at 54 (subsection (b)(4)).

\textsuperscript{188} \textit{See also} note 39 \textit{supra} (NASD rule governing self-underwriting); text accompanying note 163 \textit{supra} (NASD hot issue proposal); note 141 \textit{supra} (NASD options proposal).
The second part of the suitability requirement mandates a specific determination that the investment is appropriate for the customer's tax situation. The broker must

be assured on the basis of information obtained that the customer, after giving effect to all of his direct participation investments, is reasonably anticipated to be in a tax bracket appropriate to enable him to obtain the tax benefit described in the prospectus; provided, however, that in the case of an oil and gas program, other than a program formed to acquire producing properties, the customer shall be reasonably anticipated to be in at least a 50 percent tax bracket prior to giving effect to all of his direct participation investments . . . .

Thus, a mechanical presumptive suitability standard — that the customer be in at least the fifty percent tax bracket — is adopted for certain high-risk ventures in oil and gas.

The third part requires a specific determination that the investment is appropriate in light of the customer's net worth. The duty imposed by this third part has at least three aspects. The broker must conclude that the customer's net worth is high enough that (a) he can bear the risk of losing the investment, (b) he can bear the risk of loss of liquidity posed by the investment, and (c) his overall investment in such programs is a "reasonable" proportion (whatever that may mean) of net worth.

A broker must keep on file "the basis for and reasons upon which the determination of suitability was reached." The broker is also forbidden from underwriting or distributing investments in any direct participation program which does not apply the rule's suitability standards to all its purchasers.

The stringency of the specific suitability standards outlined above is diluted, however, by the availability of an alternative means of compliance. In the event the requirements are not "entirely satisfied," (a) "the burden of proving justification for the determination" of suitability shall be on the broker, and (b) the broker "shall document in writing the basis therefor with particular references to its departure from the standards." The Board of Governors ex-

189. NASD, Notice to Members No. 78-12, at 53-54 (Mar. 10, 1978) (subsection (b)(2)).
190. Id. at 54 (subsection (b)(3)).
191. Id. (subsection (b)(5)).
192. Id. (subsection (c)).
193. Id. (subsection (c)(1) and (c)(2)).
plained that while suitability standards for such investments "should be higher than those for investment in general securities, it does not believe they should be so rigid that exceptions could not be made in appropriate circumstances or that discretion to make a suitability determination should be taken completely" from the broker.

The Proposed MSRB Suitability Rule

Municipal securities brokers, including bank departments, were required to register by section 15B(a)(1) of the Exchange Act, effective December 1, 1975. To facilitate extending the scheme of the securities acts to municipal securities professionals, Congress created the Municipal Securities Rulemaking Board (MSRB). The MSRB is something of a hybrid between an administrative agency and a self-regulatory association. It received the familiar command to adopt rules designed, inter alia, "to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade." Among the reasons cited in congressional hearings for conferring fair-practice rulemaking power on the MSRB was the existence of suitability abuses in the marketing of municipal securities. Recent evidence indicates that these abuses continue. Pending MSRB action, transactions in municipal securities were exempted by Congress from NASD rules and by the SEC from SECO rules and rule 15c2-5.

194. Id. at 18.
201. Exchange Act rules 15b10-12 (exemption from SECO suitability rule) and 15c2-5(c) (exemption from rule 15c2-5), 17 C.F.R. §§ 240.15b10-12, 240.15c2-5(c) (1977). The initial SEC proposal for the exemption of municipal securities from rule 15c2-5 was accompanied by a comment implying that such a suitability rule was re-
In April 1977, after considerable study, the MSRB proposed its own set of fair practice rules, including a suitability rule, rule G-19. Following a period of public comment, these rules were submitted to the SEC for approval in September 1977, as required by sections 3(a)(26) and 19(b) of the Exchange Act. The suitability rule was substantially revised between the time of submission of the exposure draft and the SEC filing.

The MSRB explained that in formulating its fair practice rules, it "carefully reviewed comparable NASD and SECO rules, and proposals from industry representatives and others." Although proposed rule G-19 does draw on the language of other suitability rules, it also contains new material which would make it among the least ambiguous and most sophisticated of all suitability provisions. The proposed rule reads:

(a) Customer Information. No broker . . . shall recommend the purchase, sale, or exchange of a municipal security to a customer unless such broker . . . , after reasonable inquiry, (i) has reasonable grounds to believe that the recommendation is suitable for such customer on the basis of information furnished by such customer concerning the customer's financial background, tax status, and investment objectives and any other similar information concerning the customer known by such broker . . . or (ii) has no reasonable grounds to believe that the recommendation is unsuitable for such customer if all of such information is not furnished or known. Notwithstanding the foregoing, if a broker . . . determines that a transaction in specific municipal securities would not be suitable for a customer and so informs such customer, such broker . . . may thereafter respond to the customer's requests for advice concerning such securities and may execute transactions in such securities at the direction of the customer.

202. MSRB, Notice of Filing of Fair Practice Rules (Sept. 20, 1977), MSRB MANUAL (CCH) ¶ 10,030.
205. Unfortunately, the Board's commentary does not explain the reasons for the various adoptions of, and departures from, other suitability rules.
(c) Discretionary Transactions. No broker . . . shall effect a transaction in a municipal security or cause such transaction to be effected with or for a discretionary account, unless the broker . . . first determines that the transaction is suitable for the customer as set forth in paragraph (a)(i) of this rule or unless the transaction is specifically authorized by the customer.206

Rule G-19 resolves several ambiguities in the NASD and SECO rules. Like the SECO rule, it would impose a duty of reasonable inquiry into the customer's finances and investment objectives, but it would also require inquiry into "tax status," while omitting the reference to the customer's "needs" which appears in both the NASD and SECO rules. The rule also narrows the SECO rule's reference to "other information known" by the broker by specifying "other similar information." Rule G-19 would allow a broker, under certain conditions, to make a recommendation to a customer who refused to provide relevant information207 but would not allow him to engage in discretionary transactions for such a customer unless each transaction was specifically authorized.

Rule G-19 demonstrates that the MSRB sees a significant difference between the requirement in the NASD rule that a broker believe a recommendation is "suitable" and the SECO rule's requirement that he believe it "not unsuitable." The Board's rule would apply the latter language only to the special case of the reticent customer.

Because the "not unsuitable" phraseology applies to the reticent customer, it becomes crucial to know when the broker's lack of information about a customer itself compels the broker to conclude that an investment would be unsuitable for that customer. The MSRB exposure draft offered the following example of a situation

206. MSRB, Notice of Filing of Fair Practice Rules (Sept. 20, 1977), MR SB MANUAL (CCH) ¶ 10,030, at 10,369.

207. "Although the proposal would not prohibit making recommendations to customers who, after reasonable inquiry by the broker, do not disclose relevant personal and financial information other than the customer account information required by the Board's rule G-8(a)(xi), the [broker] would not be permitted to make a recommendation unless the [broker] had no reasonable grounds to believe that the recommendation would be unsuitable for the customer." MSRB, Exposure Draft: Fair Practice Rules (Apr. 7, 1977), MSRB MANUAL (CCH) ¶ 10,003, at 10,321. Only this comment makes it clear that the provision is aimed at a refusal or failure on the part of the customer to provide information. The language in subsection (a)(ii) itself—"if all of such information is not furnished or known"—might suggest that a mere delay or other problem in communication between broker and customer could be sufficient to permit a "not unsuitable" recommendation to be made.
in which a broker could not reasonably believe a recommendation "not unsuitable":

[A] municipal securities professional could not recommend the purchase of tax-exempt securities to a retired person who indicates to the professional that the proceeds of a savings account are to be used to make the purchase, if the professional has no knowledge that the customer has any other liquid assets. 208

This statement suggests that the absence of information about the customer's other assets would preclude a reasonable broker from determining that tax-exempt securities would be "not unsuitable" for the customer. After the comment period, however, the Board greatly diluted this statement by adding the following qualification:

If, after further inquiry, the customer is unwilling to reveal any further information to the professional, the Board believes that the provisions of paragraph (a)(ii), as redrafted, would permit recommendations to be made, provided the professional had no reasonable grounds to believe that the recommendations were unsuitable for such customer. 209

The only interpretation of this addition that does not render the analysis circular is that an absence of crucial data about a customer does not, in itself, require a broker to conclude that any particular recommendation is unsuitable, if the customer is responsible for withholding the data.

Perhaps the most important feature of the proposed rule is its authorization for brokers to give advice upon request to customers who have first been warned that the securities they desire are unsuitable. By this language of authorization, the MSRB rule embraces a conception of suitability as a matter determined not by the customer but by someone else applying objective standards to the customer's situation. Under the proposed rule, the customer's persistence in desiring a transaction after he has been informed it is unsuitable frees the broker from any further suitability obligations. It does not, however, render the transaction suitable. The customer's preferences, therefore, are apparently irrelevant to suitability under the MSRB rule.

208. Id.
Manual (CCH) ¶ 10,003, at 10,321.

Commodity Futures and Commodity Options

The trading of commodity futures, contracts for the future delivery of commodities, and commodity options, rights to buy or sell such contracts at a specified price at a future time, has generally been excluded from the regulatory scheme administered by the SEC. For a long period, such trading was instead subject to relatively minimal controls under the Commodity Exchange Act. Although such transactions can be used by actual buyers and sellers of commodities, such as meat processors and ranchers, to minimize risks of loss from adverse price movements in the future ("hedging"), they can also be a vehicle for speculation on price movements by investors who never participate in actual commodity transactions. Depending on the overall structure of the investor's transactions, such speculation may involve exceptionally high risks.

In response to serious abuses and regulatory inadequacies, Congress enacted the Commodity Futures Trading Commission Act of 1974. This statute established the Commodity Futures Trading Commission (CFTC) as a single, central regulatory agency for this field and greatly expanded the regulation of commodities trading. The commodities trading markets are rapidly growing in importance. Although the intricacies of commodity futures and com-


211. Ch. 545, 49 Stat. 1491 (1936).


Commodity options regulation are beyond the scope of this Article, it is important to examine the recent proposal by the CFTC of a highly sophisticated, and in several respects novel, suitability rule to govern commodity trading brokers.

The proposed rule, which was established for comment in September 1977, reads as follows:

216. Under section 4c(a)(3)(B) of the Commodity Exchange Act, 7 U.S.C. § 6c (Supp. V 1975), only certain commodities may legally be the subject of options. Gross suitability abuses in commodity options trading have recently been reported. See, e.g., Kelley v. Carr, COMM. FUT. L. REP. (CCH) ¶ 20,517, at 22,139 (1977) (commodity options brokerage firm preliminarily enjoined from any sale unless customer is first told both orally and in writing that "because of the volatile nature of the commodities markets, the purchase of commodities options is not suitable for many members of the public"); British Am. Commodity Options Corp., Nos. 76-15 & 77-3 (CFTC Dec. 2, 1977) (summarized in COMM. FUT. L. REP. (CCH) ¶ 20,556); Commodity Futures Trading Comm’n v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911 (S.D.N.Y. 1977); Field, Cadden & Koblenz, Summary of the Division of Enforcement’s Experience to Date in Regulating Options Transactions (CFTC Staff Memorandum, Mar. 11, 1978); Lynch, How a Flim-Flam Man Causes a Big Shake-Up in Commodity Options, Wall St. J., Feb. 14, 1978, at 1, col. 1; Mysterious James A. Carr — Options, Alias and Wealth, N.Y. Times, Jan. 29, 1978, at D1, col. 2; Kwitny, Commodity Options Sold By Phone Often Fail To Ring True, Wall St. J., Nov. 18, 1977, at 1, col. 4; Maidenberg, When the Commodity Pitchman Calls, Hang Up, N.Y. Times, May 22, 1977, ¶ 3, at 3, col. 1; COMM. FUT. L. REP. (CCH), Report No. 68, at 5 (Mar. 13, 1978); Comment, Federal Regulation of Commodity Option Trading — Is the Customer Protected? 9 ST. MAR’S L.J. 53 (1977). In response, the CFTC has imposed a suspension as of June 1, 1978 of all commodity options trading. See Suspension of the Offer and Sale of Commodity Options, 43 FED. REG. 16,153, COMM. FUT. L. REP. (CCH) ¶ 20,588 (1978); Buxbaum, Proposed Suspension of Trading in London Commodity Options, N.Y.L.J., Feb. 8, 1978, at 1, col. 1. This decision was reached because the Commission’s comprehensive program to regulate options trading failed to halt customer abuses. For the development of this regulatory program, see 41 FED. REG. 44560 (1976); id. at 51808; 42 id. at 18246 (1977); id. at 23614; id. at 55538; id. at 61831; CFTC Advisory Comm. on the Definition and Regulation of Market Instruments, Recommended Policies on Commodity Options Transactions, reprinted in COMM. FUT. L. REP. (CCH), Report No. 26 (July 15, 1976). The CFTC still expects to implement by the end of 1978 its plans for pilot programs of commodity options trading on registered exchanges. CFTC, Release No. 385-78, at 3 (Apr. 5, 1978).

217. For example, this Article does not consider the rules of the various commodity exchanges. On the regulation of commodity trading generally, see COMM. FUT. L. REP. (CCH) ¶¶ 100-911 (1977-1978); CFTC, ANNUAL REPORT 1976 (1977).

(a) No [broker] . . . may, directly or indirectly make any recommendation to any customer concerning the purchase, sale or continued holding of any commodity interest, or may effect, directly or indirectly, any transaction in a commodity interest for a customer pursuant to discretionary power . . . , unless the [broker] . . .

(1) Within a reasonable period of time before the recommendation or transaction,
   (i) Obtained from the customer the essential facts about the customer's financial condition and trading objectives, and
   (ii) Verified with the customer the accuracy of that information if previously obtained and
(2) At the time of the recommendation or transaction, had reason to believe that the recommendation or transaction was suitable for the customer in light of
   (i) The information obtained from the customer and otherwise known about the customer . . . , and
   (ii) The risk of loss involved therein.

(b) For purposes of this section, the term "recommendation" means any advice, suggestion or other statement that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a commodity interest, but does not include any statement that merely describes in an objective fashion the commodity interest, the manner in which it is traded or the services of the [broker] . . . .

(c) This section does not apply to recommendations furnished solely through—
   (1) Uniform publications distributed to subscribers thereto,
   (2) Books,
   (3) Television or radio communications, or
   (4) Seminar or lecture presentations.210

The need for, and appropriate contours of, a suitability rule for commodities trading were hotly debated before the release of the CFTC proposal.220 The Commission justified its proposal by citing

398-78 (May 2, 1978). However, the Commission did decide that brokers "should be required to disclose to prospective customers — by way of the risk disclosure statement — that the customers should consider whether futures trading is suitable for them in light of their financial condition and needs." Id. at 3.


220. See, e.g., [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,266 (1977). This is a summary of a workshop of an American Bar Association subcommittee, at which concern was expressed over the "potential for litigation" threatened by any CFTC suitability rule, and opinions were expressed such as the following: "[P]ersons who trade commodity futures contracts are not investors, but speculators,
the high risk that commodity trading can involve and noting that "customers are often unaware of, or inattentive to,"²²¹ this risk. The Commission declared that it

is considering the adoption of a suitability rule precisely because disclosure alone does not sufficiently protect some customers from high-pressure sales tactics. For example, commodity option salesmen have been able to induce customers on small fixed incomes to make clearly unsuitable purchases of speculative options notwithstanding the salesman's disclosure in some instances of all material facts.²²²

Indeed, a separate proposed rule would require that every customer be furnished with a detailed, written statement disclosing the possible risk of loss from commodities trading.²²³

The proposed suitability rule has several distinctive features. First, as in the NASD tax shelter proposal,²²⁴ the concept of suitability is expressed not only in the familiar general terms of the consistency of a recommendation with the customer's investment objectives and financial situation but also in an additional, particularized requirement concerning the appropriateness for the customer of the risk of loss from the transaction. The accompanying commentary makes clear that the assessment of suitability, in both senses, is to be made by the broker, not the customer. This adoption of an objective no-

²²⁴. See text accompanying notes 182-90 supra.
tion of suitability is made clear with comments that it would be "inconsistent with the purpose of the rule to permit the professional to shift completely to the customer the responsibility for assessing the risks of a trade" and that the broker would be held to the suitability requirement "regardless of the degree to which the customer relied" on him.225

Second, this strongly paternalistic quality of the rule is reinforced by a Commission request for comments on the possibility of imposing presumptive suitability standards, "such as a requirement that commodity customers have a minimum net worth (e.g., $50,000), annual gross income (e.g., $25,000), account equity (e.g., $10,000) or some combination of those factors."226 The Commission’s skepticism about imposing such standards resulted not from basic doubts about the imposition of external, objective suitability criteria on the customer but rather from concern regarding the imperfections of any presumptive standards as measures of "true" ability to bear risk.227 The CFTC expressed its confidence that once the broker had complied with his obligations to inquire into the customer’s situation228 and had obtained information as to such matters as the customer’s net worth, income, dependents, financial obligations, and other investments,229 he would "be able to determine whether commodity trading

226. Id. Some brokers, and many “commodity pools” (which are akin to mutual funds in the securities markets) already impose income and net worth standards on investors. Hudson, supra note 218, at 16 n.104, 17 n.110.
228. The proposed rule contains no specific requirement for regular updating of customer information, and no requirement of the verification by other sources of information supplied by the customer. However, the Commission requested comments on the possibility of including such express requirements. Id., 42 Fed. Reg. at 44749, Comm. Fut. L. Rep. (CCH) at 21,937. Proposed 17 C.F.R. § 1.37 would require the broker to “keep a record in permanent form which shall show for each person for whom a commodity futures or commodity option account is carried all information concerning the person’s financial condition and trading objectives . . . considered in recommending any transaction for the account or in effecting any transaction for the account pursuant to discretionary power.” Id., 42 Fed. Reg. at 44749, Comm. Fut. L. Rep. (CCH) at 21,939.
229. Id., 42 Fed. Reg. at 44744, Comm. Fut. L. Rep. (CCH) at 21,928-29. The Commission announced that it would recognize a special exception for information concerning a customer’s commodity trading activities with other brokerage firms. If a broker made a “good faith attempt” to secure such information, he would not be barred from making recommendations to, or discretionary trades for, a customer who
is suitable for the customer and, if so, the amount of risk-taking that will be appropriate." 230

Third, the CFTC's endorsement of an objective theory of suitability is completed by the rule's prohibition of any recommendations to, or discretionary trading for, customers who decline to provide all information necessary to a suitability determination by the broker. The Commission explained that order clerk transactions were excluded from this prohibition because "the application of the rule in this area might unduly restrict the activities of financially responsible customers who do not receive trading advice . . . and who decline to furnish suitability information." Basic financial information about such customers would have to be obtained in any event, in the Commission's view, to satisfy the know-your-customer component of the rule. 231 The Commission requested comments on the wisdom of its proposed prohibition of recommendations to, and discretionary trading for, reticent customers and suggested that a broker might instead be permitted to deal with a customer who refuses to provide information when the broker makes a "good faith attempt" to obtain it. 232

The CFTC proposal supplies a detailed, and very broad, definition of "recommendation." In this connection, the Commission requested comments on the advisability of "requiring wide-spread communications that contain commodity recommendations to include a conspicuous warning that commodities trading is not suitable for many individuals." 233 The CFTC also requested comments on whether the various commodities exchanges, and any NASD-type commodities association which may become registered, should be required to adopt self-regulatory suitability rules equivalent to or stricter than the CFTC rule, which would be a departure from the SEC approach to suitability regulation. 234

Even before the CFTC proposed its suitability rule, another source of suitability doctrine had emerged in the field of commodities. In sharp contrast to the approach of the Securities Exchange Act of 1934 declined to provide it. 235

to conventional securities, the Commodity Futures Trading Commission Act of 1974 created an administrative mechanism through which an aggrieved customer can recover money damages from a broker for the broker's misdeeds. This "reparations" procedure is authorized by section 14 of the 1974 Act.\textsuperscript{235} On the complaint of a customer, the CFTC may proceed against a broker. When more than $2500 is claimed, a hearing must be held before an administrative law judge. In several reported decisions, administrative judges have imported suitability principles from legal sources outside the area of commodities regulation in order to dispose of customers' claims that unsuitable recommendations were violations of the antifraud section and rules governing commodities.\textsuperscript{236} Generally, these decisions have denied the customers' suitability claims because the administrative judges have taken the position that even highly risky commodities transactions are suitable for any customer who has some investment experience and even the most modest of liquid assets.\textsuperscript{237}

B. The Present Sources Applied

Routes to Enforcement\textsuperscript{238}

The suitability obligations of brokers and dealers may be enforced by regulatory action of the NASD, an exchange, or the SEC or by judicial decision invoked by an individual complaint. The following


\textsuperscript{236} See section 4b of the Commodity Exchange Act, 7 U.S.C. § 6b (Supp. V 1975); 17 C.F.R. §§ 30.02, 30.03, 32.9 (1977). The CFTC proposal of customer protection rules, including the suitability rule, cautioned that "it should be clearly understood that the inclusion of a standard in the proposed rules does not mean that a commodity professional's failure to adhere to that standard would not presently be actionable." Proposed Rulemaking, supra note 218, 42 Fed. Reg. at 44743, COMM. FUT. L. REP. (CCH) at 21,927.


\textsuperscript{238} For a discussion of the separate scheme for the regulation of commodity futures and commodity options, see notes 235-37 & accompanying text supra.
discussion will analyze various aspects of each of these methods of enforcement.\textsuperscript{239}

NASD disciplinary decisions are not reported in any detail.\textsuperscript{240} The Special Study found that from 1959 to 1961, only 35 of 1,506 NASD rule violations involved suitability but noted that "charges of violations of net capital or of keeping improper books and records are frequently brought when the NASD believes that improper selling practices are being carried on [because] cases on that ground would be more difficult to develop and prove."\textsuperscript{241} Individual complainants have rarely initiated NASD discipline because the disciplinary mechanism has not been publicized and does not yield rescission or damages to the customer.\textsuperscript{242}

\textsuperscript{239} For surveys (in some respects outdated) of the range of possible sanctions against brokers for selling practice abuses, including some not discussed here such as injunctive and criminal proceedings, see S. Jaffe, supra note 110, at chs. 4-5; Special Study, supra note 18, pt. 1, at 302-22; Comment, supra note 60, at 743-47. For discussions of possible state common law liability, see Mundheim, supra note 60, at 469 n.77; Rediker, supra note 47, at 39-40; see also Jackson, \textit{Stock Broker's Liability Under Customs, Usages, and Rules}, 12 \textit{Clev.-Mar. L. Rev.} 111 (1963). For an excellent analysis and critique of self-regulation in relation to SEC authority, see \textit{Industry Study}, supra note 76, at 135-221.


\textsuperscript{241} Special Study, supra note 18, pt. 1, at 165, 314; see also Rediker, supra note 47, at 25-26.


The Special Study found that exchange actions, which are also not reported, had led to discipline for violation of a suitability standard in only one of ninety-two disciplinary proceedings against members and registered representatives involving "selling abuses" from 1957 to 1962. Other NYSE Rule 405 cases "involved the possibility of financial loss to the firm rather than the customer." These data, collected during a bull market characterized by high-pressure selling, may be similar to present figures, which would be based on a higher volume but bearish market. Because damages are not available to customers through exchange disciplinary proceedings, there is little incentive for customers to lodge complaints.

Reported cases involving suitability rules originate from both SEC proceedings and federal court actions. Reported SEC decisions may arise in two ways: (a) on appeal from NASD proceedings against members or their associates and (b) directly as Commission proceedings to discipline brokers either in their capacity as NASD members or in their capacity as registrants. The NASD may act against member brokers for violations of the Exchange Act and SEC rules thereunder as well as for violations of its own rules and rules of the Municipal Securities Rulemaking Board. The SEC's


244. Special Study, supra note 18, pt. 1, at 320-21; see also id. at 319, as to the single instance of a suitability violation in which the salesman was merely censured, and was later hired by another member firm.

245. Recently, a few suitability decisions have also been published by administrative law judges administering the separate regulatory scheme for commodity futures and commodity options. See notes 235-37 & accompanying text supra. The judges administering the separate regulatory scheme for commodity futures and commodity options. See notes 235-37 & accompanying text supra.


power to initiate actions, on the other hand, does not extend to NASD rule violations. In 1974, the SEC’s authority to hear appeals and initiate its own proceedings was extended beyond NASD members to reach members of registered securities exchanges, but this greater authority does not seem to have produced any reported cases concerning suitability.

Federal court decisions may arise through circuit court review of an SEC decision or via a federal district court proceeding instituted by a plaintiff who alleges a direct federal civil cause of action under a particular suitability rule. In several recent suits claiming an implied cause of action for suitability violations, plaintiffs have alleged violations of both the NASD suitability rule and NYSE Rule 405. Thus, the commentators’ argument that NYSE Rule 405 car-

250. See note 247 supra.


ries implicit suitability content\textsuperscript{254} seems to be growing increasingly popular with litigants.

The scope of suitability rules in practice is very difficult to determine, as they have rarely been relied upon to dispose of reported cases. There have been very few SEC decisions in which a suitability issue was even arguably dispositive. It has been suggested that "[m]ost NASD proceedings are not reviewed because no appeal is taken and those cases that are appealed rarely involve the question of the suitability doctrine."\textsuperscript{255} In some thirty federal court cases\textsuperscript{256} suitability claims under the various rules have been reported. Generally, the courts have avoided deciding whether a cause of action under the rules was available, and only a few have addressed the issue of what elements are necessary to establish a suitability cause of action or have specified defenses that would be available if the cause of action did exist.\textsuperscript{257}

\textit{SEC Decisions}

The Commission has upheld the NASD suitability rule against the claim that it is unconstitutionally vague. In \textit{Boren & Co.}\textsuperscript{258} the Commission found the rule "sufficiently specific" to "provide an adequate standard of compliance," characterizing it as an obligation "to consider the financial situation and security holdings of the customer"\textsuperscript{259} when making a recommendation. A review of the SEC decisions in which suitability violations have been found or suitability principles have been discussed, however, reveals several fundamental ambiguities in the doctrine.

Knowing Sale of an Unsuitable Security: From the "Subjectively" to the "Objectively" Unsuitable?

A first major category of SEC suitability decisions is comprised of those cases in which a broker, handling a discretionary account or

\textsuperscript{254} See note 60 \textit{supra}.
\textsuperscript{255} Fishman, \textit{supra} note 54, at 239 (footnote omitted).
\textsuperscript{256} See notes 342-422 & accompanying text \textit{infra}.
\textsuperscript{257} This is not to deny that unreported suitability claims, perhaps many of them, have been settled. Instances are reported in O'Boyle, \textit{supra} note 23, at 101-02 (prepared statement of T. O'Boyle), Comment, \textit{supra} note 5, at 530-32 (two SEC settlements in federal court of suitability claims involving real estate syndications, one involving $2.5 million), and Mundheim, \textit{supra} note 60, at 465.
\textsuperscript{258} 40 S.E.C. 217 (1960).
\textsuperscript{259} \textit{Id.} at 227-28.
executing transactions with the customer's complete reliance, either purchases speculative securities for a customer whom the broker knows cannot bear the risk of loss or else recommends securities directly counter to the customer's expressed needs. Characteristic suitability statements from decisions spanning the past thirty years place emphasis on the totally inappropriate nature of the offending broker's recommendations in view of the known investment objectives of the client:

Additional violations of the anti-fraud provisions were committed . . . in conjunction with . . . sales to certain customers of . . . unseasoned and highly speculative stocks . . . [The] companies . . . had operating losses, and information concerning such losses was supplied to registrant's sales staff. The customers in question disclosed their financial situations and needs and investment objectives to the salesmen who falsely represented, expressly or impliedly, that the securities they recommended met those needs and objectives.

. . . . It was incumbent on the salesmen in these circumstances, as a part of their basic obligation to deal fairly with the investing public, to make only such recommendations as they had reasonable grounds to believe met the customers' expressed needs and objectives.260

[1]n many instances, (the broker) recommended and sold the stock to uninformed customers whose trust and confidence he cultivated and who indicated to him their need for non-speculative investments which would produce a reasonable income. Instead, by fraudulent misrepresentations and omissions, [he] induced them to purchase a highly speculative security of doubtful value, which had little prospect of any income and which he knew was not adapted to their needs.261

The suitability principle has been viewed, by those focusing their attention on decisions in this category of "knowingly unsuitable" recommendations as essentially aimed at discouraging the merchandising of speculative securities to customers for whom they are plainly in-

appropriate by brokers aware of the inappropriateness. The concept of suitability reflected in these decisions is a subjective one—suitability to the customer in the customer's own eyes. The gravamen of this type of violation is that the broker knowingly misleads the customer as to subjective suitability. More recent decisions in this first category of knowing suitability violations have contained overtones of an objective concept—suitability to the customer in the eyes of a third party, usually an administrative authority who is implementing some absolute notion of suitability.

Perhaps the most interesting of the cases is Philips & Co., the only case in the first category to review a specific finding that the NASD suitability rule had been violated rather than articulating suitability principles in the context of a fraud finding. Three customers of the brokerage firm—a head porter, a garment factory foreman, and a cab driver—had complained to the NASD that the firm's salesperson, "knowing their limited financial circumstances," had strongly urged the purchase of a highly speculative oil stock, accompanying his solicitations with "extravagant representations and glowing promises" of profit. The salesperson thus allegedly knew the purchases by these customers were "not suitable on the basis of their financial situations." The NASD had found violations of the suitability rule and the general rule of fair dealing, holding that "the statements made led the customers beyond their means and induced them to make purchases, perhaps through their own greed, which good judgment would not otherwise have led them to do."

The Commission affirmed with an opinion that suggested that the voluntariness of the customers' decisions to purchase was of no importance. The SEC acknowledged that the customers were "mature and intelligent persons," that they made additional speculative purchases from "their own independent judgment and desire," and, indeed, that they had recommended speculative purchases to others. The Commission reasoned, however, that the broker was aware of

262. See, e.g., O'Boyle, supra note 23, at 104 (remarks of P. Loomis, Jr., SEC General Counsel). Cf. Lipton, supra note 1 at 284 (remarks of T. O'Boyle) (suggestion that suitability doctrine is aimed at brokers who have "induced and encouraged" shift from long-term investment to short-term trading as goal of customers).
263. 37 S.E.C. 66 (1956).
264. See notes 298-312 & accompanying text infra.
265. 37 S.E.C. 66, 67 (1956).
266. Id.
267. Id. at 68.
the modest financial situations of the three customers, as well as their earlier acquisitions of shares in the questionable venture, and yet he "engaged in a persistent and aggressive sales campaign" designed to convince his customers that the recommended transaction was financially safe. The Commission went on to announce the correct test of a suitability violation:

Whether or not customers Z and E considered a purchase of the stock . . . a suitable investment is not the test for determining the propriety of applicants' conduct in the situation before us. The test is whether [the broker] fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer's financial situation and needs. The record shows that [he] knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist.268

Both the NASD and the Commission here suggest that suitability is an objective concept which the broker is obliged to observe regardless of a customer's wishes,269 a view that the NASD, at least, had previously rejected.270 The NASD's statement that the customers' "own greed" may well have been their motivation reinforces the idea that the customer is not sovereign for suitability purposes.271

268. Id. at 70.
269. Accord, Fishman, supra note 54, at 243 n.61; Mundheim, supra note 60, at 453-54.
270. See, e.g., Bickel, supra note 23, at 27-28 (NASD rejection of charge of suitability violation where the board of the aggrieved charity had made an informed choice to adopt a policy of aggressive trading).
271. Accord, Mundheim, supra note 60, at 449-50 & n.11. Actually, the roots of the notion that a customer's genuine desire to speculate is somehow illegitimate, and that securities bought for this reason are necessarily unsuitable, can be found in the Special Study, with its pejorative use of the terms "speculative impulses" and "gambling instincts" in its characterization of the appeals of certain securities advertisements. See Special Study, supra note 18, pt. 1, at 248, 322.

There are other hints in the cases that the customer's choice to speculate, however free and genuine, cannot ipso facto confer suitability on the sale of a high-risk security. See, e.g., Century Sec. Co., 43 S.E.C. 371, 373 (1967), aff'd sub nom. Nees v. SEC, 414 F.2d 211, 219 (9th Cir. 1969) (one suitability "victim" wanted to double her money in nine months); J. Logan & Co., 41 S.E.C. 88, 98 (1962), aff'd sub nom. Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), cert. denied, 377 U.S. 937 (1964) (broker played on "speculative instincts").

The implication, of course, is that insofar as the customer's judgment is not sovereign, no amount of disclosure can discharge the broker's suitability obligation. Among the commentators, at least, this has increasingly been seen as a basic tenet of suitability doctrine. See, e.g., Lipton, supra note 1, at 273 (remarks of R. Mundheim) (growth of suitability doctrine "reflects a judgment that disclosure has not been a successful regulatory technique and that, at least in some areas, it is necessary to shift
It is possible that this holding cannot be read separately from the fraud aspects of the case, although the Commission makes no reference to fraud in its opinion. Perhaps a customer who was accurately appraised of the risks of a speculative security and whose dependence on the salesperson's recommendation was not so great as to interfere with his independent judgment could make an informed judgment that he did not feel the security was unsuitable. The salesperson would then be absolved from liability on any objective theory of unsuitability.\footnote{272}

In at least one later case, however, in which a highly speculative investment was recommended, the SEC held explicitly that no amount of disclosure to the customer could have cured the violation. In \textit{Powell & McGowan, Inc.},\footnote{273} the broker had recommended that a customer, seventy-nine years of age, "retired and living alone," whose physical condition "had deteriorated to such an extent that at times it was doubtful whether he was capable of understanding or making decisions with respect to his investments or financial matters,"\footnote{274} enter into a subordination agreement to supply the broker with capital. The broker knew of the customer's poor health and did not fully disclose the risks of the transaction. In holding that the broker had violated several antifraud sections and rules, the Commission went beyond the failure to disclose and held: "In the context of the

\begin{itemize}
  \item the responsibility for making the ultimate investment judgment from the customer to the broker'''); \textit{id.} at 273-74 (prepared statement of M. Lipton) ("There has been a growing awareness that full disclosure and the anti-fraud provisions are not sufficient for the protection of investors in today's securities markets. It is now quite clear that a new doctrine -- customer suitability -- is evolving to fit the need.''); Fishman, \textit{supra} note 54, at 239 ("[One reason] why a suitability rule is needed in the securities business [is that] disclosure requirements and practices have not protected the investor completely. In fact, there can be situations where disclosure is not enough to protect the investor even from his own greed.''); Faust; \textit{supra} note 61, at 900 ("Must the broker tell the investor on a fixed income with limited assets that speculative securities are off limits? Can such an individual be welcomed at a racetrack betting window but be banned from the Chicago Board Options Exchange?" Faust concludes disclosure to such a customer may not suffice).
\end{itemize}
circumstances here and the facts concerning this customer known to it and the special risks involved, registrant had an obligation not to recommend a course of action clearly contrary to the best interests of the customer, whether or not there was full disclosure. This holding clashes sharply with the SEC's initial purely disclosure-oriented expression of suitability principles. Although the emphasis on the customer's condition might suggest that disclosure to a fully competent customer would have been adequate, there are two indications to

275. *Id.* at 935. The Special Study came to a similar conclusion as to contractual mutual fund plans with heavy “front-end load,” that is, in which sales commissions made up a major part of the early periodic payments by the customer: “[T]he combined factors of the incentive to high-pressure selling which the front-end load provides to salesmen, the essentially unsupervised nature of home selling of plans, the complexity of the security sold and the lack of financial sophistication of so many of the purchasers of plans create a problem of a fundamental nature which cannot be solved through the mere application of the doctrines of disclosure.” Special Study, *supra* note 18, pt. 4, at 211.


277. This seems to be the view of Faust, *supra* note 61, at 900, who doubts, however, that disclosure is ever a “sure defense.” In Lipton, *supra* note 1, at 281-83, Thomas A. O'Boyle put a similar case (an eighty-year-old widow who wishes to open a clearly improvident trading account) to test the issue of competence. Martin Lipton responded by pointing to Powers v. Francis I. DuPont & Co., 344 F. Supp. 429 (E.D. Pa. 1972), in which the court, although refusing to hold the defendant liable for excessive trading where the rate of trading was clearly desired by the plaintiff and the trading was ultimately stopped on the broker's initiative, expressed the following concerns: “The question brought to mind by the evidence in this case is, should the broker permit a compulsive investor to continue to trade through its facilities when it has become clear that his speculative activity has crossed the line between intelligent risk taking and irrational gambling? We are reminded of the established body of law which limits the bartender's discretion in selling to an obviously inebriated alcoholic. . . . This is a clear example of a case in which governmental scrutiny and control are necessary to prevent the unfortunate waste of financial resources such as plaintiffs have brought upon themselves here.” *Id.* at 433; *see also* Bines, Investment Objectives, *supra* note 18, at 279-80 & n.10, 419 n.1, 451.

But if the *Powers* court were seeking guidance in state common law or statutory law on the question of competence, one would have thought the more likely analogy would be the law of contractual or testamentary capacity. Both involve a determination of the threshold competence to be required before permitting an individual to dispose of his property — and both plainly set a lower threshold than is required by those who would have the suitability doctrine effectively protect customers against themselves. *See* 2 S. Williston, A Treatise on the Law of Contracts §§ 222-272 (3d ed. W. Jaeger 1959 & Supp. 1977); 1 W. Page, Law of Wills §§ 12.1-.48 (rev. ed. W. Bowe & D. Parker 1960 & Supp. 1977-1978).

The sale of alcoholic beverages to inebriates obviously involves factors of physical danger to the user and to others that make for a considerably different resolution of the competing values of personal freedom, on the one hand, and protection of the self and third parties, on the other, than is appropriate with regard to the sale of securities. Indeed, even given these more compelling factors, the dominant rule at common law
the contrary. First, the Commission carefully avoided actually finding that the customer’s competency was impaired, and second, a later Commission decision cited Powell & McGowan as support for an assertion that even with disclosure, a sale of subordinated notes “might well have been fraudulent,” even though the “elderly widow” who made the purchase in the latter case was inquisitive, knowledgeable, and apparently healthy.

A recent decision that also suggests an objective view of suitability is Harold R. Fenocchio. Again, the extent of the customer’s reliance on the salesperson’s recommendations or the degree to which the customer may have been affirmatively misled is not clear, but the Commission’s language in affirming a holding that the NASD suitability rule was violated strongly suggests a duty to refuse transactions that are objectively unsuitable, as well as an affirmative duty to investigate the customer’s finances and needs. The customer in Fenocchio was in his eighties, resided at a rest home, and had an investment history indicating an emphasis on growth rather than income. The broker admitted having detailed knowledge of the customer’s experience, financial needs, and objectives and asserted that the customer was “a sophisticated investor who had been engaging in securities transactions for over 50 years, and that all transactions were made with the customer’s full knowledge and approval.” The Commission replied:

Even if we were to accept without qualification applicant’s contentions, we believe the instant circumstances, particularly the customer’s advanced age and the fact that he resided in a rest home, placed a duty on Fenocchio . . . to make a serious inquiry

278. Rice, supra note 117, at 577 & n.213, reads Powell & McGowan as making disclosure “no defense” to a suitability charge, at least in administrative proceedings. See also Lipton, supra note 1, at 283 (remarks of M. Lipton) (broker “cannot satisfy the obligation by disclosure alone”); Fishman, supra note 54, at 240.

279. Fishman, supra note 54, at 243, and Mundheim, supra note 60, at 453, simply assume that the customer was “senile” and that the decision established a duty to determine whether the customer can utilize any information disclosed.


282. Id. at 148.
into the suitability of the customer’s investments and to prevent the dissipation of the customer’s capital by successive turn-

overs.\textsuperscript{283}

One Variant on the Objectively Unsuitable: “Per Se Unsuitable” Transactions Such as Churning

The second major category of suitability decisions concerns transactions that might be called “per se unsuitable.” These transactions, which are specifically singled out in the NASD policy statement,\textsuperscript{284} are almost surely fraudulent, aside from the invocation of suitability by the NASD or SEC. These practices include churning, short-term trading in mutual funds, and executing transactions near dividend dates, thereby creating for the unsophisticated a false impression of gain.\textsuperscript{285} Another example, discussed in the \textit{Special Study}, is the sale to elderly persons of long-term contracts to purchase mutual fund shares.\textsuperscript{286} In line with the NASD’s generally restrictive reading of the suitability obligation, the NASD continues to treat such per se unsuitable transactions as the paradigmatic violations of the NASD suitability rule.\textsuperscript{287}

\textsuperscript{283} \textit{Id.} at 148. Note that excessive turnover was viewed as a \textit{separate} violation from the unsuitability of individual investments.

\textsuperscript{284} See notes 29-36 & accompanying text \textit{supra}.


\textsuperscript{286} \textit{See} \textit{Special Study}, \textit{supra} note 18, pt. 4, at 151 (“might in many cases violate” the NASD suitability rule).

\textsuperscript{287} For example, a recent compilation of reports from District Committees on violations began with this general introduction to the suitability rule: “Unsuitable recommendations, when discovered, include sales to elderly clients of long-term growth funds with sales loads, excessive transactions in discretionary accounts, switching of mutual
"Churning" is excessive trading in a customer's account, which has the effect of increasing commissions to the broker without any valid goal of economic gain to the customer. Short-term trading in mutual funds might be thought of as a special case of churning, because mutual fund shares are generally held for longer terms and are "not proper trading vehicles." Thus, any short-term trading in mutual funds constitutes excessive trading because it cannot lead to economic gain and such transactions often involve substantial sales commissions and tax disadvantages. The inherent unsuitability of shifting a customer's assets from one security into another that will soon yield a dividend lies in the fact that the "ex-dividend" price mechanism of which the customer is presumably ignorant offsets the dividend and forecloses the possibility of real economic gain. In addition, there may be significant tax disadvantages. Analysis of these abuses is not a simple problem. When does aggressive trading become excessive trading? What about trading in reaction to news developments between growth-oriented mutual funds specializing in particular industries? When does a transaction near a dividend date demonstrably have no purpose other than to create a false impression of gain? These questions, however, are ones of definition and proof rather than fundamental concept. All would agree that,

funds shares in customer accounts, the execution of unauthorized transactions in customer accounts, and unauthorized sharing in customer accounts by registered representatives." NASD Newsletter, Sept. 1976, at 4.

288. See Special Study, supra note 18, pt. 4, at 151.


290. Even if churning, mutual fund "switching," or selling near dividend dates are clearly identified, whether they are necessarily suitability violations also turns on a question equally relevant to other transactions: What place do the customer's wishes have in determining suitability? Is the customer's choice to conduct the transactions irrelevant, even if he is "fully informed" as to its implications? Because the NASD has not recognized any general duty of inquiry, its view as to transactions in general seems to be that customer choice, even if not fully forewarned and tutored, automatically confers suitability on a transaction. As to mutual fund transactions, however, the NASD has vacillated on whether signed customer ratifications alone can create suitability. After a series of pronouncements indicating that written suitability statements had value but were not conclusive and did not free the broker of a further obligation to assure himself that a mutual fund switch was appropriate, see Special Study, supra note 18, pt. 4, at 152; NASD News, April 1968, at 5-6; NASD News, Nov. 1969, at 4, the Association reported the discipline of a member for transactions the customers had apparently desired: "[A]lthough the customers cheerfully and willingly paid unnecessary sales commissions and also signed statements signifying their intention to do so, this did not in any way excuse the conduct of the principal." NASD News, Jan. 1970, at 6. Shortly thereafter, the NASD unceremoniously retreated from this position, and explained that
in unambiguous cases, such transactions are suitable for no one.\textsuperscript{291}

The SEC tends to buttress its position in per se unsuitability cases with evidence that customers were unsophisticated and relied on their brokers. Furthermore, in churning cases the broker's control of account transactions has become an invariable prerequisite to a violation.\textsuperscript{292} At the same time, the decisions generally suggest that sophistication, reliance, and even the customer's opinion that the transaction is suitable\textsuperscript{293} are not defenses to such per se suitability violations. While the SEC may discuss the needs of the particular client, his lack of investment knowledge, and his reliance on the

other factors were present in the reported disciplinary action, and no clear-cut rule as to the relevance of signed customer ratifications was appropriate. NASD News, Mar. 1970, at 3-4.

\textsuperscript{291} See Rice, supra note 117, at 537-38 n.3 ("a transaction in some situations may be so inherently bad that a broker-dealer could not recommend it as 'suitable' for anyone").


\textsuperscript{293} See Thomas Arthur Stewart, 20 S.E.C. 196, 208 n.12 (1945) (dividend dates).
SUITABILITY OBLIGATIONS OF BROKERS

The Difficulty of Isolating the Suitability Rationale

The very fact that the cases in these two major categories of suitability decisions are those closest to the realm of fraud, if indeed not within it, makes them uncertain guides to the scope of the suitability rules. The knowing recommendation of an unsuitable transaction involves just the sort of intentional deception which is easily viewed as fraud within the meaning of federal securities law—a material misrepresentation made with sciente. It has already been noted that per se unsuitability violations, such as churning, probably violate fraud provisions, either because of the broker's knowing failure to disclose the absence of any economic benefit to the customer or because, under the shingle theory, there is an implied representation that the broker will not enter into transactions which are undesirable for customers.

Furthermore, most of the decisions in both categories of cases—those involving recommendations that were clearly inconsistent with the customer's expressed investment objectives and those involving per se unsuitable transactions—also found independent violations of several antifraud sections and rules. For example, in Century Securities Co., which falls into the first category, violations of section 17(a) of the Securities Act, sections 10(b) and 15(c)(1) of the

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295. One observer has written that the recommendation of a “hot issue” with knowledge that such an investment is inconsistent with the customer's investment goals “could easily be considered a 'scheme to defraud,' a 'misleading statement,' or be otherwise encompassed as a fraudulent activity.” Comment, Securities Regulation: Legislative and Administrative Treatment of the “Hot Issue” Phenomenon, 1968 Duke L.J. 1137, 1151 (footnote omitted).
297. See, e.g., sources cited in note 290 supra. Churning may also violate various specific fraud rules, see, e.g., Exchange Act rules 15c1-2, 15c1-7, 17 C.F.R. §§ 240.15c1-2, and 240.15c1-7 (1977). See also note 34 supra.
the Exchange Act, and Exchange Act rules 10b-5\(^2\) and 15c1-2\(^3\) were found, including the sale of unregistered securities, market manipulation, the charging of excessive prices, and the making of overt misrepresentations. Indeed, one commentator observed in 1965 that "[i]n every case in which suitability concepts have been articulated there have also been fraud grounds for disposing of the case."\(^4\)

Often in cases on appeal from the NASD, the reviewing Commission discusses suitability concepts even though no express finding of violation of suitability rules was made by the NASD. In the SEC's own fraud proceedings, the Commission has carefully avoided clear explanation of whether the suitability comments are intended as integral to the fraud holding or whether they are merely dicta.\(^5\) These opinions thus give no indication of the outer reaches of the suitability obligation. If the suitability discussions are intended as part and parcel of the fraud findings,\(^6\) perhaps they are conservative relative to the ultimate scope of the suitability obligation. On the other hand, if the discussions are simply dicta, perhaps they articulate general ethical principles broader than the suitability duty that the Commission would be willing to enforce in proceedings under even the SECO suitability rule. One SEC decision implies that the latter interpretation may be the correct one. In *Haight & Co.*,\(^7\) after a detailed description of the eight respondent salesmens' failures to observe the investment objectives of their customers and of their


\(^{303}\) 17 C.F.R. § 240.15c1-2 (1977).


\(^{305}\) For example, in Richard N. Cea, 44 S.E.C. 8 (1969), "where numerous instances of unsuitable recommendations were found to have occurred, the Commission almost pointedly avoided referring to either its own or the NASD's suitability rule." Rediker, *supra* note 62, at 38 n.103.

\(^{306}\) This is the unsupported assumption of most commentators, premature in the author's view, for at no point, despite ample opportunity, does the SEC make clear the significance of its discussion of suitability principles. See, e.g., 5 A. Jacobs, *supra* note 6, § 211.01[b], at 9-43, 9-44 & nn.25-26; Bines, *Investment Objectives*, *supra* note 18, at 426; Jacobs, *supra* note 6, at 899 n.134, 901-02 n.139, 903 & nn.147-48; Rediker, *supra* note 47, at 53 n.171; Comment, *supra* note 60, at 741; Leavell, *supra* note 60, at 1583 n.98 (Leavell does, however, express uncertainty as to the coverage of suitability by rule 10b-5); Rice, *supra* note 117, at 539 n.10 (seemly); Comment, *supra* note 5, at 530 & n.270, 538-39 n.312. See also note 334 infra. Only Mundheim, *supra* note 60, at 466-67, takes a more cautious view of the Commission's articulations of suitability principles in cases arising under the fraud provisions. But see id. at 471-72 n.81.

encouragement of the purchase of speculative securities, the Commission nevertheless expressly disclaimed reliance on suitability violations in arriving at its fraud holding. The SEC has noted that "in many situations, violations of the suitability rules may involve fact patterns which also would constitute violations of [the] securities acts." However, it also has taken the position that "[f]ailure to adhere to these rules may fall short of actual violation of the anti-fraud provisions of the federal securities acts and the rules thereunder."

The Commission usually initiates actions only against flagrant violators, when an antifraud violation may be in question, leaving other matters to the NASD. One commentator has characterized the SEC's approach as follows:

The SEC has been at great pains in its language and approach to keep "legal" (antifraud) considerations out of cases reviewing the application of NASD rules and, similarly, to exclude explicit reference to NASD "ethical" standards from its own proceedings under the antifraud provisions. This course is followed even though it seems clear that a violation of the antifraud provisions usually would also constitute a violation of a NASD rule. In rare instances, even the SEC acknowledges the congruency by its language in a particular case.
In short, both the SEC's practices in bringing cases and the studied ambiguity of its opinions have worked against the potential that "development of the suitability concept" could have had to clarify "the relation generally between the self-regulatory agencies' ethical strictures and the SEC's fraud concepts."³¹²

Expansion of the Idea of Knowing Sale of an Unsuitable Security: The "Boiler Room" and Beyond

A number of additional SEC decisions that articulate suitability concepts involved neither a recommendation that the broker knew was unsuitable for the particular customer nor a per se unsuitable transaction.³¹³ In several opinions in which brokers were sanctioned for aggressively selling securities that were more speculative than called for by their customers' circumstances or investment preferences, the SEC made statements suggesting that such behavior violated suit-

³¹² 6 Loss (1969), supra note 18, at 3727.
³¹³ See, e.g., Blyth, Eastman, Dillon & Co., SEC Securities Exchange Act Release No. 10565, 3 SEC Docket 255, 255 (1973) (salesmen "failed to obtain adequate information as to the financial resources of the shareholders contacted"); John P. Fleming, SEC Securities Exchange Act Release No. 8129, at 1 (1967) ("respondent . . . induced customers to purchase such speculative securities without regard for their financial needs, circumstances or objectives"); Amsbary, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 8111, at 2 (1967) (same fact situation); M.J. Merritt & Co., SEC Securities Exchange Act Release No. 7878, at 3 (1966) ("Prospects were induced to make hasty decisions to effect purchases or additional purchases of the stock and to sell securities they owned in order to pay for such purchases, and the salesmen did not inquire into the purchasers' financial position or investment needs and objectives."); Shearson, Hammill & Co., 42 S.E.C. 811, 834 (1985) ("Kaye, without inquiring into a 70-year-old widow's finances or investment objectives, induced her to invest $1,250 in USAMCO stock although she had limited financial means, earned a weekly salary of $65, and wanted safety of principal and some dividend income."); J. A. Winston & Co., 42 S.E.C. 62, 64 (1964) ("Customers were not questioned about their financial status or their particular investment objectives or needs."); Harold Grill, 41 S.E.C. 321, 324 (1963) ("Applicant was an active participant in this fraudulent, high-pressure operation for an extended period of time, selling only this admittedly promotional and speculative security . . . to persons whose financial condition he did not know or apparently consider relevant."); N. Pinsker & Co., 40 S.E.C. 285, 292 (1960) ("Registrant's technique of using numerous salesmen to sell a large block of securities of one issuer by wholesale and persistent telephone solicitations, in the course of which highly optimistic representations were made without disclosure of known or easily ascertainable adverse facts and customers were urged to sell other securities they owned and to use the proceeds to acquire Tyrex shares without knowledge of their individual investment needs and situations, violated the basic standards of fair and honest dealing."); Boren & Co., 40 S.E.C. 217, 222 (1960) ("Boren also admitted that if investment company shares were being sold, no inquiries were made concerning the customer and his needs because he 'assumed' that such shares are 'good for everyone.'").
ability principles even if the broker was unaware of the customers’ financial status and investment goals. All of these cases, however, involved indiscriminate sales efforts. They must therefore be considered in light of Gerald M. Greenberg, a decision which has been described as repealing the “if any” language in the NASD suitability rule but which in fact is probably more limited in its holding.

Greenberg involved a “boiler room,” a high pressure sales technique that is designed to sell speculative securities, usually through large-scale telephone solicitations. The appellant contended that a broker “is not guilty of any misconduct under the language of the [NASD suitability] Rule in making a recommendation unless facts concerning the customers’ financial condition and holdings making the recommendation unsuitable are volunteered by the customer or are already known” by the broker. The Commission disagreed. It held that the purpose of the rule, to restrain “the making of recommendations to customers under circumstances where there is no reasonable basis for considering the recommendation suitable to the customer,” would be defeated if a broker could “engage in a practice of recommending low price speculative securities to unknown customers.” This language, broad as it is, goes no further than prescribing indiscriminate recommendations when there is “a high probability that the recommendation will not be suitable to at least some of the persons solicited.”

315. That is, the requirement that the broker believe the security is suitable “upon the basis of the facts, if any, disclosed by” the customer. See text accompanying note 19 supra.
316. 6 Loss (1969), supra note 18, at 3714; Jacobs, supra note 6, at 899 n.132; O’Boyle, supra note 23, at 96-97 (prepared statement by T. O’Boyle).
318. 40 S.E.C. 133, 137 (1960).
319. Id. at 137-38 (footnotes omitted). See also, e.g., William Glanzman & Co., 43 S.E.C. 261, 262 (1967) (“Registrant and its salesmen made no reasonable inquiries to learn. . . . the financial circumstances or investment needs of their customers.”); William Glanzman & Co., 42 S.E.C. 365, 369 (1964) (“It must have been clear to all
standard as existing in those cases in which the broker (a) neither gives the customer an "opportunity to tell him the facts" about himself nor inquires after them and (b) "is forcing a decision." 320

Such a reading of Greenberg is consistent with the rationale of the first major category of decisions involving knowing sale of an unsuitable security. The only expansion is in the concept of knowl-

the participants that the [speculative] Gaslite stock was being recommended without any consideration to its investment merit or its suitability to the large number of persons being solicited.); Schmidt, Sharp, McCabe & Co., 42 S.E.C. 745, 747 (1965) (boiler rooms are characterized by "indifference to or lack of concern for . . . investors circumstances"); Norman Joseph Adams, SEC Securities Exchange Act Release No. 7073, at 3 (1963) ("Registrant used 'boiler-room' sales techniques involving high-pressure telephone solicitation of unknown persons by untrained salesmen without adequate supervision, reflecting a disregard of the basic standards of conduct of a broker-dealer toward his customers."); Mac Robbins & Co., 41 S.E.C. 116, 119-20 (1962), aff'd sub nom. Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) ("[Boiler rooms] involve a concerted, high-pressure effort — typically by telephone — to sell a large volume of one or several promotional or speculative low-priced securities to unknown persons without any concern for the suitability of such securities in light of the customers' investment needs or objectives and by the use of false and deceptive means. The sales techniques used are by their very nature not conducive to an unhurried, informed and careful consideration of the investment factors applicable to the securities involved."); Barnett & Co., 40 S.E.C. 1, 4 n.7 (1960) (citing Best Securities, Inc., 39 S.E.C. 931, 933 (1960)) ("Its wholesale solicitation of distant customers by telephone was by its very nature not conducive to an unhurried and careful presentation and disclosure of the facts and investment factors applicable to the security recommended and to a determination of its suitability for purchase by the customer in the light of his particular financial situation and investment objectives."); SPECIAL STUDY, supra note 18, pt. 1, at 311 (NASD decision holding in case of a recommendation of speculative securities that firm and salesmen had responsibility to know "(1) what they are recommending, and (2) to whom they are recommending it"); NASD News, Apr. 1958, at 1, 4; SEC v. R. J. Allen & Assoc., Inc., 386 F. Supp. 866, 874 (S.D. Fla. 1974) (boiler rooms involve intensive selling "without regard to the suitability to the needs of the customer, in such a manner as to induce a hasty decision"); Kelley v. Carr, COMM. Fut. L. REP. (CCH) ¶ 20,517, at 22,128 (W.D. Mich. 1977) (defendants preliminarily enjoined under Commodity Exchange Act from offering commodity options without regard to suitability, citing R. J. Allen); Commodity Futures Trading Comm'n v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911, 915 n.13 (S.D.N.Y. 1977) (same); Cohen, Broker-Dealer Regulation at the Federal Level, in CONFERENCE ON SECURITIES REGULATION 3, 8 (R. Mundheim ed. 1965) (statement of SEC Chairman M. Cohen). But cf. Alfred Bryant Tallman, Jr., 44 S.E.C. 230, 231 (1970) (discussed in Jacobs, supra note 6, at 903 n.148) (where even though there is no evidence cited of boiler room or high-pressure selling, nor of the broker's knowingly making unsuitable recommendations, the respondent is found to have "offered, recommended the purchase of, and sold the speculative and unseasoned securities . . . to customers for whom such securities were unsuitable in light of their investment needs and objectives").

320. O'Boyle, supra note 23, at 97 (prepared statement by T. O'Boyle); see Cohen & Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 LAW & CONTEMP. PROB. 691, 707 n.120 (1964).
edge\textsuperscript{321} — from actual knowledge to must-have-known or should-have-known forms of constructive knowledge. Thus, should the broker fail to make a reasonable inquiry of his customer’s finances and objectives, he would nevertheless be held to have constructive knowledge of what an inquiry directed to the type of customer with whom he dealt would have been very likely to disclose. Except for the fact that boiler room tactics represent perhaps the most egregious violations of the duty to deal fairly,\textsuperscript{322} there is no logical reason to restrict this expanded concept of knowledge to the boiler room context.\textsuperscript{323}

A broader reading of the boiler room cases would see them as standing for the proposition that a broker has an absolute duty to inquire into the customer’s finances and objectives to determine the suitability of a proposed investment, regardless of whether the broker can be said to have constructive knowledge of unsuitability. Some commentators have adopted this broader view but would limit it to the boiler room context,\textsuperscript{324} observing that boiler room practice constitutes a “segment of the industry” that “by [its] very nature [does] not conform to the requirement to deal fairly.”\textsuperscript{323} If, however, \textit{Greenberg} and its progeny are read as imposing a duty of inquiry independent-

\textsuperscript{321} See \textit{ALI Fed. Sec. Code} (Proposed Official Draft, 1978) § 287 (knowledge); \textit{id.} § 299.50 (scienter); \textit{id.} (Tent. Draft No. 2, 1973) § 251A (knowledge); \textit{id.} (Tent. Draft No. 3, 1974) § 251A and Comment; \textit{id.} § 296AA (scienter); \textit{id.} (Revised Tent. Draft Nos. 1-3, 1974) § 251A; \textit{id.} § 296AA and Note (2); 50 \textit{ALI Proceedings} 470-71, 473-76 (1973); 51 \textit{id.} 471-82 (1974 discussions of definition of knowledge); \textit{Restatement (Second) of Torts}, § 12(1) (reason to know) and (2) (should know) (1965). \textit{See also} Bines, \textit{Investment Objectives}, supra note 18, at 426 (“not a difficult step” from “know” to “ought to know”).

\textsuperscript{322} See, e.g., O’Boyle, \textit{supra} note 23, at 103 (remarks of SEC General Counsel P. Loomis, Jr.) (“The only instances where the Commission has carried [the concept of suitability] over into a rule of law is the context of a boiler room. In the boiler-room context suitability can be reduced to its lowest common denominator . . . .”).

\textsuperscript{323} Note that the language of paragraph 1 of the NASD policy statement (broker may not recommend “speculative low-priced securities” without inquiry because of “high probability” of unsuitability) is not restricted to boiler rooms. \textit{See} Bines, \textit{Portfolio Theory}, \textit{supra} note 18, at 725 n.20.

Application of an objective or per se unsuitability theory to boiler rooms might also be conceived of as a surrogate for disclosure. \textit{See} Lipton, \textit{supra} note 1, at 283 (remarks of A. Fleischer, Jr.); \textit{but see id.} (remarks of M. Lipton).

\textsuperscript{324} See, e.g., Fishman, \textit{supra} note 54, at 244-45; Mundheim, \textit{supra} note 60, at 457; Wilson, \textit{Interpretation of NASD’s Suitability Requirements in Sales of Mutual Fund Shares in Conference on Mutual Funds} 21, 26 (P. Geerlings ed. 1967); \textit{cf. Comment, A Symptomatic Approach to Securities Fraud}, \textit{supra} note 317, at 1429.

\textsuperscript{325} \textit{Special Study}, \textit{supra} note 18, pt. 1, at 268.
ent of any constructive knowledge of unsuitability which may be
imputed to a broker, there is no reasoned basis for limiting the duty
to boiler rooms. Boiler rooms are special precisely because, unless
the high-pressure salesperson assumes an affirmative duty to inquire
and assure suitability, unsuitable transactions are inevitable, and this
truth should be obvious to the salesperson. Because the SEC boiler
room decisions failed to express clearly this constructive knowledge
analysis, no rationale appeared for limiting their holding that there is
an independent duty to inquire in the boiler room context. Thus, in
a 1966 address, the SEC Chairman characterized Greenberg as stand-
ing for the general principle, embodied in the then proposed Rule
15b10-3, that "a broker-dealer could not avoid the impact of [the
NASDAQ] suitability rule by not making inquiry into the financial situa-
tion and needs of his customer."326 The Special Study saw Green-
berg as a rejection by "[b]oth the NASD and the Commission" of "the
contention that under the language of the [NASDAQ] rule, when a cus-
tomer does not volunteer his financial condition and holdings, the
broker-dealer and his salesmen have no duty to obtain such infor-
manation." 327

The observation previously made328 about the first two categories
of cases is true of the boiler room cases as well: the principal attack
by the NASD and SEC has been on fraud grounds.329 The main count
in NASD and SEC proceedings is typically a non-suitability fraud
count, occasionally accompanied by a count for selling unregistered
securities.330 At one time the Commission proposed an "anti-boiler
room" rule under antifraud section 15(c)(2) of the Exchange Act to
restrict selling of low priced, speculative securities.331 Indeed, in

326. Address by M. Cohen to 18th Annual Int'l Mutual Fund Dealers' Conference
327. SPECIAL STUDY, supra note 18, pt. 1, at 239 (footnote omitted).
328. See notes 295-312 & accompanying text supra.
329. Kroll, Fraud Problems in Connection with Broker-Dealer Selling, in SECURITIES
330. Boiler room cases "typically involved outright misrepresentation or material
nondisclosure." Bines, Investment Objectives, supra note 18, at 283 (footnote omitted).
Of the many cases cited in notes 313, 314, and 319 supra, only three, Boren & Co., supra
note 313, Gerald M. Greenberg, supra note 314, and C. Gilman Johnston, supra note 319,
involved the NASD suitability rule at all. The others only incidentally articulated suit-
ability principles. Even in Boren and Greenberg there were substantial nonsuitability
fraud grounds for discipline (such as the sale of securities at unfair mark-ups), and in
Boren the violation was in the nature of per se unsuitability.
6885, 1961-1964 Transfer Binder FED. SEC. L. REP. (CCH) ¶ 76,862 (1962). See
most of the boiler room cases, brokers were disciplined for clearly fraudulent conduct: misrepresentations about the companies whose securities were being sold, unfounded predictions of price increases, failure to conduct adequate investigation of the securities or to disclose known facts that undermined the attractiveness of the securities, or classical shingle theory violations, such as excessive markups. Many boiler room decisions did not offer even brief dicta as to suitability principles.332 Professor Alan Bromberg sees this primary reliance on fraud counts in the boiler room cases not as another sign of the elusiveness of pure suitability principles333 but rather as an indication of the expansion of fraud principles to cover suitability. He briefly notes in his text:

Except for "boiler-shop" cases, [the suitability requirement] presently lies outside 10b-5 and other fraud rules. However, it has already become a requirement for broker-dealers who are SEC-registered without being members of the NASD, and it takes no great prophet to foresee a closer connection between suitability and the fraud rules.334

No-Action Letters

An indication from the SEC that suitability duties may not be limited to express recommendations is the response to a 1971 request for a no-action letter.335 On March 27, 1972, the SEC responded to a request from New York Securities Co. and three coparticipant firms, seeking the Commission's imprimatur for a payroll deduction scheme,


333. See notes 306-09 & accompanying text supra.

334. 1 A. Bromberg, supra note 6, at 100 (footnotes omitted). The same assumption that any suitability principles articulated in boiler room cases were intended to be incorporated in the theory of the fraud violation is made in 6 Loss (1969), supra note 18, at 3708; Kroll, supra note 329, at 39, Jacobs, supra note 5, at 898 n.131, and Mundheim, supra note 60, at 466 n.39. See also note 306 supra.

which they would manage and which was to be offered to the employees of client companies. Existing schemes managed by one of the firms provided companies’ employees the option of purchasing insurance, mutual fund shares, or both through payroll deductions. The firms proposed to add an additional element, the shares of client companies. Employees would be given the option of investing one-fourth of each payroll deduction in their employer’s stock. No recommendations would have been made, except whatever recommendation could be read into the very availability of the stock under the deduction plan. Nevertheless, the firms had affirmatively represented that

New York Securities would make sufficient investigation of each proposed company to make certain that the stock of the corporation would be a suitable investment for employees prior to any presentation being made. . . .

. . . [N]o sale of funds or stock would be permitted to any individual for whom such an investment would be unsuitable, taking into consideration the wage level of the employee and the amounts of money withheld for investment. 336

The SEC responded that a guarantee of suitability precautions would have to be substantiated by submission of a detailed procedure. 337 Clearly, the SEC staff either found the absence of recommendations irrelevant under rule 15b10-3 or found the scheme carried enough of an implicit recommendation to trigger the rule.

The idea persisted that suitability rules are inappropriate when no overt recommendation is made. 338 In a 1974 request for a no-action letter concerning another employee-investment scheme in which about thirty stocks would have been available, attorneys for Standard & Poor’s took the position that rule 15b10-3, the SECO suitability rule, was inapplicable to the proposed plan because the securities would be recommended on the basis of investment merit, so that the employee would be allowed to decide personally whether the security would

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337. Id., Letter from Albert D. Sturtevant to Francis P. King, March 27, 1972 (available on LEXIS; copy on file with author).

"meet his needs."

The response advised that suitability questions should be taken up with a different division of the SEC but also included the following remarks regarding the degree of discretion to be retained by investors under the plan:

A fundamental problem, in our view, is that in providing a list limited to approximately 30 securities eligible for investment, the Service greatly restricts an investor's ability to exercise a significant degree of discretion in purchasing securities. Although participants in the Service would be able to exercise some choice in selecting securities, that choice would be quite limited in relation to the broad range of available investments which might otherwise be suitable.

Why the SEC staff focused on the breadth of choice among securities to be offered by the plan, rather than on the discretion that every employee would of course retain to buy securities elsewhere, or not to buy them at all, is unclear.

These no-action responses suggest a retreat from the position that an overt recommendation is required before suitability obligations attach or, alternatively, an expansion of the definition of recommendation to include statements that carry implicit recommendations. In adopting this new attitude, the SEC is ignoring the evidence in favor of the "order clerk" exemption to the suitability rules provided by "recommendation" language in the rules themselves. Additionally, the Commission is forgetting that the Special Study's seminal analysis of the suitability problem revolved exclusively, aside from the special problem of churning, around inappropriate recommendations.

Court Decisions
The Elements of a Violation

Reported federal and state court cases do little to clarify the many ambiguities and inconsistencies that emerge from the materials discussed above. No SEC decision on suitability has been reviewed on the merits in a circuit court. Most court decisions deal with


341. See, e.g., Special Study, supra note 18, pt. 1, at 269-70, 278, 308.
whether a federal cause of action will lie under the exchange and NASD rules. Three recent cases, however, address in detail the merits of suitability claims. One case construes the doctrine liberally, while the other two take restrictive views. Two older cases, though less clear, also seem to embrace a restrictive view.

In *Rolf v. Blyth Eastman Dillon & Co.*, the plaintiff Rolf brought suit alleging fraud and violations of the NASD suitability rule and NYSE Rule 405 as a result of trading that reduced the worth of his stock portfolio from $1,423,000 in May of 1969 to $225,000 by January of 1971. The court found that plaintiff was a sophisticated investor with long experience in growth-oriented trading. He had actively managed his own account from 1950 to 1962 when he switched to a discretionary account because he did not have enough time to devote to his portfolio. In 1963, he engaged defendant BEDCO, a brokerage house, seeking to double his equity as quickly as possible. In 1969, plaintiff's account manager left BEDCO, and the account was reassigned to defendant Stott, who recommended that plaintiff turn his account over to an independent investment adviser, defendant Yamada. Stott was unaware of plaintiff's investment objectives when he recommended Yamada to the plaintiff, and he remained ignorant of those objectives throughout the ensuing period while he participated in managing the account.

Plaintiff met with Yamada, whom he found to be a bright, aggressive young adviser known for his great success with highly speculative securities. He advised Yamada that he was interested in rapidly increasing his equity but that he also sought to preserve his capital, which would largely finance his retirement. Plaintiff executed a blanket trading authorization to Yamada but requested he trade through BEDCO and Stott in order "to balance Yamada's youth and zeal with BEDCO and Stott's reliability and supervision."

Yamada took over plaintiff's account and began trading in low quality securities that greatly reduced the value of the account. A number of the investments were being used by Yamada as part of fraudulent manipulation schemes or were the subject of fraudulent misrepresentations. The court held that Stott knew these securities were highly speculative but not that they were fraudulent.

342. See notes 496-540 & accompanying text infra.
344. Id. at 1028.
Both Stott and BEDCO contended that a brokerage firm has no obligation to prevent unsuitability "if an investment adviser [is] in the picture" and that the firm was therefore justified in dispensing with its normal policy of special approvals for transactions involving stocks with low ratings. The court began by rejecting this theory. In what was technically dictum because of a finding that Stott actually had engaged in managing the account, the court held that an intervening agency does not relieve the broker of his obligations under NYSE and NASD rules to the customer. It cited as persuasive authority two SEC decisions which held that a broker may not remain passive while knowing that an investment adviser was defrauding customers. The court's holding went well beyond these SEC decisions, however, because Stott was ignorant of any actual fraud by Yamada and because the court required Stott not merely to act on known unsuitability but also to investigate the suitability of transactions.

The court began its discussion of the law by referring to brokers' duties both as fiduciaries and under the shingle theory, clearly implying that suitability violations are within the realm of the fraud sections and rules. It determined that Stott, and BEDCO on a theory of respondeat superior, were liable for violations of the rules by Stott that were "tantamount to fraud" and committed with scienter. First, the court held, without any discussion of Rolf's speculative investment goals, his investment sophistication, or the fact that he was fully aware of the nature and value of his holdings throughout, that Yamada's acquisitions of manipulated securities were unsuitable for Rolf and that the total management of Rolf's account was tantamount to fraud. Second, the court found that Stott's recommendation of Yamada as an investment adviser, without knowing or investigating Rolf's investment objectives or "every essential fact relative to Yamada," violated the rules because Stott "did not learn whether Yamada would be a suitable adviser." This holding stretches enormously the language of the suitability rules, which say nothing

345. *Id.* at 1035. This was regarded as an open question in Lipton, *supra* note 1, at 280 (prepared statement by M. Lipton).


347. 424 F. Supp. at 1036-37. The court's reference to liability under NYSE and NASD rules for violations "tantamount to fraud" creates some doubt as to the holding. *Id.*

348. *Id.* at 1042.
about recommending investment advisers. Third, the court held that Stott's reassurances to Rolf as to Yamada's competence and failures to suggest that Rolf "reconsider any transaction," to recommend against any investment, or to suggest "that perhaps Yamada was too speculative for the plaintiff's investment needs" were tantamount to fraud. The court then concluded:

Even had Stott never assured the plaintiff with respect to Yamada, Stott's total failure to speak out nevertheless would suffice to render him liable for violations of the rules. Stott not only failed to learn about Rolf, but he totally failed to investigate the stocks in the account or to tell Rolf what he now claims — that he really didn't know anything about those stocks. If a broker acts only as an order-taker, he must not offer advice. If he begins to offer advice, he must not fail to make full disclosure. . . .

A broker must not allow his silence to be taken as a recommendation. If he cannot or will not investigate the security being purchased, he must disclose the fact to the customer and warn the customer of the risks of making investments without full knowledge of the issuer. He must satisfy himself that not only the security but also the type of transaction is suitable for the customer.349

Finally, the court held that the appropriate measure of damages was determined by the amount of commissions that the defendants had earned from plaintiff's account, plus interest. Rolf thus recovered only $55,790 of his $1,198,000 loss.

On appeal, the Second Circuit sustained the finding of liability, but on fraud grounds only. The court put off for another day whether a cause of action is available under the NASD and NYSE rules.350 The court reversed on the question of damages, holding that in addition to the amount awarded above, Rolf was entitled to his gross losses during the period of the fraud, reduced to reflect the decline that had been occurring in the market as a whole.351

349. Id. at 1042-43 (citations omitted).
350. 570 F.2d 38, 41, 48 n.19 (2d Cir. 1978).
351. Id. at 48-50. The court was rather inscrutable as to the mechanics of the required market-factor correction. However, it seemed to hold that the decline in value of Rolf's portfolio during the relevant period, his gross losses, should be reduced by the percentage decline of the market as a whole (as measured by some recognized index or a composite of such indices) in order to arrive at net losses. It would appear more logical to reduce Rolf's portfolio at the beginning of the relevant period by such a market-decline percentage, and then to arrive at net losses by subtracting from the result Rolf's portfolio at the end of the period. This would of course yield a lower damage measure than the court's suggested approach.
Clearly, the district court's suitability ruling in *Rolf* is extremely broad. As the circuit court recognized, the trial court went out of its way to expand liabilities where narrower holdings were available. *Rolf* is the only decision allowing a knowledgeable, sophisticated investor to recover for unsuitable investments despite his speculative investment goals. There is also a troubling air of *ex post facto* judgment as to the unsuitable nature of the entire portfolio, and indeed the court does not analyze all of Rolf's assets. The logic of applying suitability rules to the recommendation of an investment adviser is also highly questionable. Despite the equivocal evidence concerning the plaintiff's reliance on the broker for reassurance, and the almost total lack of evidence that the broker's security recommendations were unsuitable, a strict affirmative suitability duty is imposed. Finally, the need for any evidence of express advice is cast in question by the admonition that the "broker must not allow silence to be taken as a recommendation."

After *Rolf*, *Gleit v. Shearson, Hammill & Co.* seems cruelly narrow in its rejection of plaintiffs' suitability claims. Mr. and Mrs. Gleit, having returned a postcard inviting them to request further information as to Shearson's investment services, met in April 1972 with Loeser, a Shearson account solicitor. They discussed with Loeser, their finances and investment goals. The Gleits earned $25,000 per year, had an unspecified amount of life insurance, owned a mortgaged home, and wanted to invest half of their $20,000 savings in order to realize "sufficient capital appreciation to assist in meeting college costs for their three children." 

The defendants have petitioned for rehearing or rehearing *en banc*, with the support of *amicis curiae* which include the NYSE and several major brokerage firms. While the petition remains pending, the Second Circuit took the unusual step of issuing an amendment to its original opinion. The court added a footnote to make clear that rule 10b-5, at least, was not being construed to "impose liability on a broker-dealer who merely executes orders for 'unsuitable' securities made by an investment advisor vested with sole discretionary authority to control the account." The court noted that Stott, "although charged with supervisory authority over the advisor and aware that the advisor was purchasing 'junk,' actively lulled the investor by expressing confidence in the advisor without bothering to investigate whether these assurances were well-founded." *Rolf v. Blyth, Eastman Dillon & Co., Nos. 77-7104 & 77-7124* (2d Cir. June 22, 1978). See Rustin, *Court Amends Ruling on Broker Duties to Client*, Wall St. J., June 23, 1978, at 5, col. 1.

352. See 570 F.2d at 55 (Mansfield, J., dissenting).
354. Id. at 90,887.
Loeser told the Gleits that he would depend on Shearson research and receive the firm's approval for transactions. The Gleits explained they were ignorant in securities matters and would rely entirely on Loeser and Shearson. A margin account was opened for them the next day.

By March 1973, the Gleits had realized $624.06 in gains and $16,475.77 in losses on purchases and sales of nine securities. Two of the biggest losers, accounting for 56% of total portfolio losses, were new issues. The Gleits alleged that unsuitable purchases were made in violation of NYSE Rule 405, "and that such violation constitutes a manipulative or deceptive practice within the meaning of section 10(b) and Rule 10b-5."335

The court held that, even assuming arguendo that a violation of Rule 405 gives rise to a civil cause of action, the plaintiffs had not proven the securities purchased were poorly suited to their objectives. The evidence summarized in the opinion, however, had little or nothing to do with the risk levels of the securities purchased or the appropriate risk levels of the plaintiff's portfolio. Rather, the court concluded that the evidence demonstrated that (a) the securities were generally regarded by brokers as "good" investments (for whom not being specified), and (b) plaintiffs would have fared even worse if defendants had not sold when they did. The only clear reference to risk levels was in connection with a purchase of warrants, and that discussion begs the question of appropriateness at the time of purchase:

Because warrants are by their nature speculative, they might be considered inconsistent with the Gleits' investment objectives. However, they were the only securities in plaintiffs' portfolio sold at a profit. This Court therefore finds it difficult to fault defendants for having made this particular recommendation. Nor can the Court criticize their sale shortly after their purchase even though so fast a turnover indicates a non-investment objective. Had the warrants been held longer, they too would have been sold at a loss . . . .356

In sum, Gleit is very unclear concerning the requisite elements in finding a suitability violation. Generally, the opinion applies a very lenient "malpractice" standard which differentiates little, if at all, among the appropriate risk levels of different investors.

355. Id. at 90,888.
356. Id. at 90,890.
In Parsons v. Hornblower & Weeks-Hemphill Noyes, the court was similarly conservative but much clearer about its reasons. After first holding that no private right of action existed under the NASD suitability rule, the court went on in dicta to construe the rule very restrictively in two important respects. The court stated that the rule imposes no duty to investigate the customer's finances and also held, squarely contradicting the Rolf court, that the rule applies only to express recommendations. The court easily concluded that even if a cause of action were available, the rule had not been violated.

Had the rule been given a broader reading, the facts might well have supported a finding of violation. The plaintiff was a wealthy woman whose husband, Smith, had traded her account on her behalf. She prayed for the recovery of $1,983,125, a 100% loss on the purchase of 50,000 shares of the common stock of Cartridge Television, Inc., which had developed and was promoting a home video tape system.

After selling an initial acquisition of 13,000 shares of the stock at a profit, the dealer, Ward, telephoned Smith and reported that he had "information which had not been available to him" when he had counselled sale two days earlier. Based on the information conveyed by Ward, Smith decided to purchase 50,000 shares of the stock. At that time plaintiff was having cash flow difficulties resulting from the failure of a speculative real estate venture. This fact, however, was not disclosed to Ward. Eighteen months later the company was bankrupt and the shares were suitable only for framing.

Apparently Ward sought to induce the purchase, even though he may not have made a formal recommendation. In the context of plaintiff's very recent, large profit in the stock, his phone call certainly could be construed as the recommendation of a renewed purchase. He also seems to have assumed that the plaintiff's account remained the rather free trading account it had been before plaintiff became pressed for cash. If he had been under an obligation to make the most minimal inquiry—for example, to ask, "Have your investment goals changed significantly?"—it probably would have been obvious

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357. [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,885 (M.D.N.C. 1977). Note that while Rolf concerned both the NYSE and NASD rules, the plaintiffs in Gleit based their suitability claim solely on NYSE rule 405, and the plaintiff in Parsons solely on NASD article III, § 2.

358. For example, the broker's communication would clearly be a "recommendation" as that term is defined in subsections (b) and (c) of the proposed CFTC suitability rule.
that the purchase of a stock which was still highly speculative despite its recent price gains was now unsuitable for the plaintiff.

The court dismissed the idea of a suitability violation by noting that there is "no affirmative duty on the broker to investigate or solicit facts." Since Ward had no reason to question Smith's purchase, it appeared to him that the purchase was a suitable one. In addition, the court held that an express recommendation is necessary before a rule violation may take place and that the evidence in the case revealed no such recommendation. Thus, the court decided that the transaction was not within the terms of the NASD suitability rule, and did not pursue the question of whether this very large, speculative purchase was suitable for plaintiff's portfolio. If anything, the court suggested that speculative securities are suitable for anyone who is "extremely wealthy with extensive securities and real estate holdings."

There are only two other federal cases that rule instructively on the substance of a suitability violation. Both rejected the allegations of a violation on the basis of a highly subjective view of suitability. In essence, these opinions adopted a presumption that sophisticated investors make their own assessment of suitability, thereby immunizing the broker from any potential liability.

In Phillips v. Reynolds & Co., three investors sued a broker for their losses on transactions in the stock of Strategic Materials Corporation. Their main claims were under rule 10b-5, but they also included a suitability claim. Two of the plaintiffs were of considerable means and had extensive trading experience. Little information was provided with respect to the third investor, a trucking

360. Id.
company vice president. The court rejected the suitability claims of all three. Though the reasoning is obscure, the court apparently favored a purely subjective, disclosure and free choice oriented, notion of suitability, notwithstanding the fact that the plaintiffs alleged the broker's actual knowledge of unsuitability.363

The other decision that denied liability under the suitability rules, Merrill Lynch, Pierce, Fenner & Smith. v. Bocock, Inc.364 was a diversity case in which the plaintiff brokerage firm sued for amounts the defendant owed on his personal and trust accounts after the defendant failed to meet a margin call. The defendant advanced a suitability counterclaim. The counterclaim was apparently based on a state law theory of common law deceit,365 although the court may also have interpreted the NASD suitability rule as giving rise to a direct federal claim.

The court, which apparently viewed the NASD rule as reaching both fraudulent and negligent conduct,366 rejected the counterclaim.367

363. It is possible, as the suitability claim was apparently not briefed in detail, that the court only decided that a suitability obligation is not imposed by the fraud sections of the securities laws.


365. 6 Loss (1969), supra note 18, at 3722.

366. But see Rediker, supra note 47, at 42.

367. In Jackson v. Bache & Co., 381 F. Supp. 71, 99 (N.D. Cal. 1974), the court held: "Although there exists a serious question of whether there can be a private action for violation of exchange [and NASD] rules, the court's determination that . . . the plaintiffs' investments were suitable disposers of this claim . . . ." One's best guess is that the court has used similar reasoning to that in the Phillips and Bocock decisions; in fact, the court did not determine that the investments were suitable and there is no discussion of the finances or needs of the many plaintiffs who lost money on a speculative stock, but the court does determine, in line with Phillips and Bocock, that plaintiffs were experienced speculators and were not deceived.

In Architectural League v. Bartos, 404 F. Supp. 304 (S.D.N.Y. 1975), the court denied that a cause of action lay under the NASD suitability rule, but held that in any event, the broker defendant "Bartos followed an investment course suited to the League's needs." Id. at 314 (footnote omitted). The League was a non-profit association of architects and other professionals; it had lost $87,000 of a $100,000 account in speculative trading by Bartos, who was given discretionary authority. The court found that Bartos had been instructed to pursue an "aggressive" trading policy and that the League knew of the speculative nature of his investments. Since the League "faced a chronic shortage of operating funds" and "was very anxious to have some profits," the investments were suited to its needs. Id. The court did not discuss the sophistication of the League's financial officers or the general finances of the League. See Bines, Investment Objectives, supra note 18, at 452-55.
Although the defendant had only a high school education, he had prospered in his own manufacturing business, had executed substantial stock transactions, and had consulted an attorney who advised against the short sales which were executed. The court concluded that considering Bocock's age, education, intelligence, business experience and familiarity with stock transactions, particularly in recent successful deals involving [the same] stock in similarly large amounts, . . . Bocock . . . was a "suitable person" considering his other security holdings and his financial situation and needs. See Section 2 of Article 3 of the Bylaws of the National Association of Security [sic] Dealers.\(^\text{368}\)

One commentator cites Bocock as one piece of evidence that fraud principles may be expanding to encompass suitability violations.\(^\text{369}\)

A final federal case of importance to the analysis of suitability principles is Anderson v. Knox,\(^\text{370}\) a 1961 diversity action in which the court allowed recovery in common law fraud for the recommendation and sale, by an insurance agent of an "equity-funded"\(^\text{371}\) insurance package to a customer unable to benefit from its tax advantages and, in fact, hardly able to afford it. The decision has been regarded by the SEC and commentators as a key source of the evolving suita-

Contrast Piper, Jaffray & Hopwood Inc. v. Ladin, 399 F. Supp. 292 (S.D. Iowa 1975), in which the plaintiff broker also sought in a diversity action to recover margin deficits — in that case, on accounts the defendant opened as trustee for his children's funds. In deciding a common law negligence counterclaim for recommending the margin purchase of low-rated bonds to the defendant, a "relatively unsophisticated" investor, the court held that the NASD suitability rule and NYSE rule 405 were admissible evidence of the standard of care of brokers. The court found the broker liable, but held the measure of damages to be not restitution, but only the cancellation of the accounts' deficits. The rule 405 violation was the result of the broker's "failing to inquire as to the amount of assets in the trusts" and the NASD suitability rule violation resulted from his failure "to advise the trustee of the risk of additional financial responsibilities incumbent on a purchaser of BB bonds on a margin account so that an informed decision could be made by the investor." \(^\text{Id. at 298-300.}\)

368. 247 F. Supp. at 376-77. The words "suitable person" of course do not appear in the NASD rule, nor is the rule part of the NASD By-laws.

369. 6 Loss (1969), supra note 18, at 3722.


371. On "equity funding," see notes 89-90 & accompanying text supra.
bility doctrine. The Ninth Circuit considered at length whether the insurance program was objectively suitable, given the plaintiff's income and future prospects, as well as whether the insurance agent's representations of suitability were ones of fact or opinion made in disregard of truth. The court sustained the trial court's award of actual and exemplary damages. The court was particularly influenced by the fact that the salesman had encouraged reliance on his judgment, and that the complex product involved defied analysis by the layman. The insurance package involved was one quite clearly tailored for the income and tax needs of someone in a position much different from that of the plaintiff. The Anderson case therefore fits well under the per se unsuitability rubric, where few of the difficult problems of the suitability doctrine are raised.

Common law fraud and breach of fiduciary duty were held to support recovery for a suitability violation in Twomey v. Mitchum, Jones & Templeton, Inc. The California court concluded that violation of suitability principles, as expressed in the NASD suitability rule, should result in civil liability because "[i]t would be inconsistent to suggest that a person should be defrocked as a member of his calling and yet not be liable for the injury which resulted from his acts or omissions." The court determined that suitability principles impose a duty on a broker when a customer who had previously expressed a desire for stability of principle and modest income makes

372. See, e.g., Richard N. Cea, 44 S.E.C. 8, 17 n.12, 18 n.13 (1969); 6 Loss (1969), supra note 18, at 3725; 1 A. Bromberg, supra note 6, at 100 n.35; E. Weiss, supra note 115, at 184-86; Flint, supra note 97, at 1261 n.131; Jacobs, supra note 6, at 899 n.133; Rediker, supra note 47, at 41; Fishman, supra note 54, at 246; Kroll, supra note 329, at 37; Mundheim, Professional Responsibilities, supra note 60, at 452 n.11, 454-55; Comment, supra note 5, at 518-19; Comment, supra note 317, at 1424 n.104.

373. But the case has also been viewed as a source of somewhat less per se rules. For example, according to one commentator, Anderson "should be a warning to a salesman who sells a prospect a 'package' of both [mutual] fund shares and life insurance where it is obvious that the investor's need is to invest all of his dollars in additional life insurance." Tepperman, Legal Problems in the Combined Sales of Life Insurance and Fund Shares, in CONFERENCE ON MUTUAL FUNDS 7, 12 (P. Geerlings ed. 1967).


375. Id. at 721-22, 69 Cal. Rptr. at 244. Pendent jurisdiction was assumed over another suitability claim under California law in Greitzer v. United States Nat'l Bank, 326 F. Supp. 762 (S.D. Cal. 1971). The claim alleged "liability under the National Association of Securities Dealers Rules [sic] which requires that a broker's recommendations be suitable." Id. at 762. Evidently the rule was being invoked, as in Twomey, which the court cited, as the standard of care in a state common law action for breach of fiduciary duty. Id. at 765.
a request for the recommendation of a rapid-growth security. In that situation the broker must advise the customer of the risks and may recommend specific speculative securities only if the customer persists in the request.\textsuperscript{376}

The broker contended that his lack of information concerning the plaintiff's financial position excused him from the need to warn her of the risks inherent in the purchase of speculative securities. The court held that the broker's obligation in this case extended further than to execute the "stated objectives of the customer." A duty to inquire into the plaintiff's "actual financial situation and needs" arose because the broker was more than a mere agent. A fiduciary relationship existed in this case because the broker's "recommendations, as invariably followed, were for all practical purposes the controlling factor in the transactions."\textsuperscript{377}

The plaintiff's acquiescence in the high rate of trading in her account and in the speculative nature of the recommended securities which were purchased was not enough to discharge the broker from any liability. The court stated:

Plaintiff acknowledged that she understood that there was a risk, that she knew securities could go down as well as up, and that she understood that defendants were not going to make good her losses, or guarantee her a profit. This, however, is not to say that she was competent to evaluate the extent of the risk she was taking or the propriety of one of her financial condition so doing. The fact that she had inherited money, that she had prior transactions with other brokers, and that she had improvidently invested in one speculative security on her own initiative might justify a finding of knowledgeableness and lack of reliance, but they do not compel that result when taken with her other testimony. The receipt of confirmation slips and accounts, and her ability to chart the cost and prices of her securities are facts of the same tenor. They may permit, but \textit{they do not compel}, findings that plaintiff knew she was engaged in a course of trading and purchasing securities of a type that were unsuitable for one of her financial situation and needs.\textsuperscript{378}

\textsuperscript{376} This approach was suggested in Mundheim,\textit{ supra} note 60, at 464-66.
\textsuperscript{377} 262 Cal. App. 2d at 719, 69 Cal. Rptr. at 242 (citations omitted).
\textsuperscript{378} \textit{Id.} at 722, 69 Cal. Rptr. at 244 (emphasis added). An analogous narrowing of the affirmative defense of customer ratification (or of proof of non-ratification as an element of a plaintiff's case) has occurred in some churning cases. \textit{See, e.g.,} Fortenberry v. Weber, 18 Cal. App. 3d 213, 95 Cal. Rptr. 834 (1971) which holds the defense available under California law, but requires the broker to prove actual notice to the customer of transactions, and charges the broker with notice of the customer's capacity to understand confirmation slips.
Here, the court clearly adopts an objective notion of suitability: even if plaintiff had fully understood the risks of the transactions and their potential impact on "her financial situation and needs" before choosing to enter into them, the transactions would still be unsuitable. A "finding of knowledgeableness and lack of reliance" would, however, be a good defense. In this view, suitability itself is not a function of customer choice at all, however well-informed the customer. Investment objectives are thus not relevant to the calculation of suitability for the Twomey court, at least to the extent that the risk or cost of the transaction exceeds some objective point of inappropriateness given one's particular "financial situation and needs."  

Possible Defenses

In some of the other reported federal cases in which suitability allegations have been made, courts have avoided deciding whether a cause of action is available under the rules and what elements constitute any such cause of action, by proceeding directly to find that an applicable defense was satisfied. The defenses relied upon have been (a) proximate cause, (b) estoppel or ratification, and (c) in pari delicto.

(a) In Van Alen v. Dominick & Dominick, Inc., the court sustained the dismissal of a Rule 405 claim because the plaintiff had "failed to establish a causal connection between the technical violations of the NYSE rules and the alleged losses sustained." Though it may be construed either as a defense or as a necessary element of liability, proximate cause is probably better conceived of as an aspect of proving damages.  

379. Perhaps the Twomey court would have found investment objective relevant, even though this "risk threshold" was not exceeded, in a case in which the broker clearly sold a different type of security than the customer desired. Of course, such an instance would generally be outright fraud. See text accompanying notes 295-97 supra.


381. See generally ALI FED. SEC. CODE (Tent. Draft No. 2, 1973) § 215A, Com-
fully distinguished from reliance. Though the two are indistinguishable in many securities actions, should suitability rules be construed so that no reliance on a broker’s recommendation need occur for a violation to take place, the law could deem any transaction which follows upon an unsuitable recommendation by a broker as legally caused by the recommendation.

(b) In *Pearl v. Shearson, Hammill & Co.*, where the plaintiff had made a “conscious decision . . . that business necessities required dealing in speculative securities in order to maintain a business in the selling of stock options,” the court granted summary judgment to defendant on an estoppel theory, “[e]ven assuming that violations of [the NYSE and NASD] rules [would] give rise to liability under Section 10(b) and Rule 10b-5.”

The court explained:

In this case, plaintiffs knew what their needs were and sought out the speculative aspect of the option business even before they brought their business to Shearson. Shearson . . . could only believe that plaintiffs’ needs would be served by trading in those stocks actively traded on the option market, the speculative issues. Defendants could have no knowledge beforehand that the stock market would sink into a substantial decline during 1969. And finally, defendants have relied upon the conduct of plaintiffs throughout the 1969-70 period by continuing to endorse stock options on the same type of stocks dealt with while plaintiffs’ accounts were at Bache & Company. In short, this is the situation where the investor has waited to see how his investments would turn out before invoking the rules concerning the suitability of those investments for his portfolio. Plaintiffs may not shift the blame for investment decisions made in great part by themselves on to the shoulders of the broker.

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382. See, e.g., Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1360-61 (8th Cir. 1977), cert. denied, 98 S. Ct. 1578 (1978). In *Garnatz*, the court held that where defendants fraudulently represented that a speculative investment was safe, losses resulting from a general market decline were appropriately treated as proximately caused by the misrepresentation. The opposite view was taken by the Second Circuit in the *Rolf* decision, see text & accompanying note 351 *supra*. Cf. *Moody v. Bache & Co.*, 570 F.2d 523, 527-28 (5th Cir. 1978) (discussing circumstances in which causation may be inferred from reliance and materiality in 10b-5 actions).


384. *Id.* at 8.

The underlying assumption is that unsuitability is an objective property. Otherwise, there would be no need for the dealer to plead estoppel as a defense in the case of a sophisticated investor, because such an investor would confer suitability on the transaction, just as was found by the Phillips and Bocock courts. Nevertheless, such an estoppel defense arrives at the same result, only possibly shifting the burden of proof.

(c) Similar arguments have been sustained under the theory of in pari delicto. In a suit based on the NYSE maintenance margin rules, for example, one court held that "there is no right of action that will allow a recovery to investors who know their accounts are inadvertently undermargined, maintain their silence for a substantial period of time, and take no corrective action." Some decisions suggest the in pari delicto defense might also be available against a suitability charge, though none squarely so hold. Were the estoppel defense limited to situations where the customer consciously sought to put himself in the pleasant position of either enjoying a successful speculation or pursuing the broker for a suitability violation (and Pearl seems to be so limited), the in pari delicto defense might be used to reach any situation where the customer knowingly purchased unsuitable securities. Again, the need for such a defense would turn on the prior question of the scope of the suitability rules themselves. Only if the rules were intended to protect the customer from his own knowing choice of objectively unsuitable securities would such a defense make sense, because under the subjective


388. But cf. ALI Fed. Sec. Code (Tent. Draft No. 2, 1973) § 1414, Comment (4), and cases cited (reluctance of courts to permit in pari delicto defense in cases concerning Federal Reserve Board margin rules).
theory, if the plaintiff voluntarily and knowingly purchased the securities, they would not be unsuitable securities at all, and no affirmative defense would be necessary. If, however, that was their purpose, the defense should probably not be allowed, as it would nullify an important part of the substantive liability.

C. Portfolio Theory

Recently, commentary has begun to focus on the potential of "portfolio theory" for translating the suitability doctrine "into a detailed code of conduct for brokers." Portfolio theory, which has spawned an enormous literature in recent years, seeks to solve, through economic analysis, the investor's problem of selecting an optimal portfolio. Its implications for suitability doctrine are really twofold. First, if one is willing to adopt all of its assumptions, the


doctrine offers a completely developed method, in principle at least, for arriving at the suitable investments for a given investor at any point in time. Second, even if one denies some of the assumptions of portfolio theory or questions its practicality, several of its principles refute basic assumptions regarding the suitability of particular transactions on which many of the authorities considered thus far have relied. Traditional assumptions concerning the diversification of a portfolio to minimize risk and the role of different types of securities are exposed as inadequate overgeneralizations.

The Pure Theory

In highly simplified terms, portfolio theory can be thought of as a formula for optimizing securities trading accounts which requires five ingredients.

(a) The first ingredient is knowledge of the investor’s subjective attitudes toward risk. More precisely, for each individual there exists at any particular moment in time a function that translates various possible changes in his wealth into units of relative satisfaction or dissatisfaction. These are called “units of utility” and the function, a “utility function.” Because almost everyone in almost every circumstance would value his first dollar more than his millionth, this relationship is demonstrated by the following graph:

![Graph showing units of utility vs. dollars]

Because a rational individual values the dollar gained less than the dollar lost, increasingly so as the numbers increase, he will expect a positive return for taking any risk. Greater and greater expected returns are therefore required to induce him to take greater and greater risks. 391

391. See, e.g., Note, Fiduciary Standards, supra note 389, at 970 n.57. This state-
Thus, there is a hypothetical set of potential investments, \( I_2 \), each one of which will satisfy him equally. A similar set, \( I_1 \), will give him a higher level of satisfaction. There exists an infinite number of these sets, known as indifference curves, each conforming to the same basic shape and each representing a particular level of satisfaction. In theory, every investor fits this model, though each curve will reflect his particular shape because it is a product of his particular utility function.

This entire picture is taken at an instant in time. At the next instant, when the individual's wealth, circumstances, and personality have changed, his utility and indifference functions will have changed as well.\(^{392}\)

This first ingredient of portfolio theory requires only knowledge of attitudes toward wealth and risk; nothing need be known about the factors that determine them. From this perspective, the familiar suitability formula — "investment objectives, financial situation, and

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The text is not fully visible. However, based on the visible portion, it discusses the concept of indifference curves and the notion of risk, where an investor's satisfaction is measured by the dispersion of possible outcomes around the expected return. The text also references works by J. Von Neumann & O. Morgenstern, Marschak, and others, discussing the significance of risk beyond the focus on loss.

\(^{392}\) Of course, an investor could simply hand a portfolio to a broker and instruct him to obtain a specified return for a given period, whatever the risk required or to maximize return within a specified risk ceiling. See Bines, Investment Objectives, supra note 18, at 277-80. But portfolio theory suggests this behavior would be irrational.
needs" — invokes extraneous elements. Everything relevant about "investment objectives" is portrayed in the indifference curves (it matters not that the goal is to send Johnny to college). All that is relevant about "financial situation" is how many dollars are available for investment. Everything relevant about "needs" has also been accounted for by the curves. The investor's hopes, dreams, fears, constraints, and responsibilities have all been combined by him into his orientation toward risk and return.

(b) The second ingredient is knowledge about the risk and return properties of all possible investments. Portfolio theory assumes that a security's prospects can be summarized in two statistics: a percentage mean expected return and an index of variance which expresses how widely possible outcomes are spread about the expected return. Once all possible investments have been described according to their "risks" and "returns," certain investment possibilities may be tentatively eliminated: all those that promise no greater return than some other investment with more risk and all those that promise no less risk than some other investment with less return. Those investment possibilities eliminated are said to be "dominated" by the others. Like the individual's risk preferences, this second ingredient, the risk-return properties of securities, changes literally from second to second.

(c) The third ingredient is knowledge about the covariance among investments. Some investments will carry very similar prospects in the sense that one will tend to do well when the other does well and poorly when the other does poorly. Their covariance will rarely if ever be perfect, but it may be substantial. The risks of all

393. A complete analysis would have to take account of differing attitudes toward wealth or consumption at various future times and toward various degrees of liquidity. See, e.g., Hirschleifer, Efficient Allocation of Capital in an Uncertain World, 54 AM. ECON. REV. 77 (1964); Tobin, supra note 390.

natural gas producers will covary to the extent that their prospects are dictated by governmental price regulation, for example. Some investments will tend to offset the risks of others (guns and butter), but because general market conditions tend to have an indiscriminate impact, their movements will rarely if ever be completely unrelated. Covariances also change constantly but perhaps less pervasively than the first two factors.

(d) Fourth, we must have complete knowledge of the costs of assembling possible portfolios. Commissions, volume discounts, liquidation costs, and other "transactions costs" make up this category. These costs may be relatively constant over time, though less so than when brokerage commissions were fixed.

(e) The final ingredient of portfolio theory is an assumption that risk-free, or nearly risk-free, investments are available. This assumption is not indispensable, but if it is true, it dictates a method of considerably greater flexibility and precision for assembling an optimal portfolio than if it is not true, as explained below.

These five ingredients are assembled through a two-step formula. First, an "efficiency frontier" of all the best portfolios for the particular investor is tailored by eliminating from further consideration those portfolios that are dominated by others.

Second, this efficiency frontier is matched against the array of the investor's indifference curves to ascertain the single portfolio that puts him on the very highest curve, that is, where the frontier is tangent to an indifference curve representing the highest level of the investor's satisfaction.

"X" marks the spot.
Arriving at the frontier is a complicated task, involving at least two and perhaps three distinct processes. First, all potential investments must be totally reassessed in terms of the particular investor's immutable financial characteristics. His particular tax situation, other necessary transactions costs, and all of his effectively fixed assets must be included in every hypothetical portfolio. Second, portfolio diversification should be implemented with a view to reducing covariance among the investments. Finally, to the extent that the purchase of totally risk-free assets ("disinvestment") and unrestricted borrowing ("leveraging") are possible, final selection from among the best portfolios should not be limited to selecting the one portfolio that corresponds to the highest indifference curve but rather should attempt to vary the mix between (a) the single portfolio on the frontier which has the highest overall return/risk ratio and (b) the risk-adjusting devices of disinvestment and leveraging.

Impracticalities of the Pure Theory

Of course, many objections to the workability of this strategy are apparent. Although some have argued with perfect seriousness that subjective risk preferences are ascertainable, there are many


396. Empirical research suggests that in most cases there is a relatively fixed point — between roughly 15 and 50 securities — beyond which diversification no longer pays for itself. The measurement of covariance and the rapidly diminishing effect of diversification are discussed in Markowitz, Markowitz Revisited, Fin. Anal. J., Sept.-Oct. 1976. On the empirical research, see Cohen, supra note 389, at 1613-14 & n.42; V. Brudney & M. Chirlestein, supra note 118, at 995-98; R. Jennings & H. Marsh, supra note 42, at 18 n.20. See also Nichols, supra note 60, at 437-38; Fozen, supra note 389, at 940-53.

397. This approach is called "the separation theorem." See e.g., Tobin, supra note 390; Lintner, The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, 47 Rev. Econ. & Stat. 13 (1965). In technical terms, disinvestment and leveraging allow the investor to move from a point on the frontier to a point on an even higher indifference curve than the highest one tangent to the frontier, by proceeding along a line whose slope is determined by the interest rate the investor faces in his disinvestment or leveraging. See, id.; cf. C. Kindleberger, International Economics 49, 51 (4th ed. 1968) (similar portrayals of gains from international trade). Economists disagree over whether low-risk assets, such as Treasury bills, can be considered risk-free assets for purposes of the separation theorem. See, e.g., Note, Fiduciary Standards, supra note 89, at 971 n.65.

obstacles to a broker's gaining any sort of picture of a customer, much less a comprehensive notion of the customer's internal utility calculus in coming to decisions about risk. Indeed, the actual behavior of customers may well be inconsistent with the notion of any continuous, rationally based, set of indifference curves. A broker will be strongly tempted to ascertain a customer's objectives and needs on the basis of shallow stereotypes. In times of increasing taxation and inflation, when individuals will differ in their willingness to accept greater risks in order to preserve their living standards, such stereotypes will be especially misleading.

Another obvious practical objection is that the theory requires of the broker herculean tasks of security analysis. These tasks would not be limited to the evaluation of the risk-return characteristics of

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399. See Comment, supra note 60, at 742; Bines, Investment Objectives, supra note 18, at 420.
400. See, e.g., Michelman, In Pursuit of Constitutional Welfare Rights: One Review of Rawls' Theory of Justice, 121 U. Pa. L. Rev. 962 (1973). In theory, it is possible to derive indifference curves without any "direct" experience of the subjective utilities of the customer, through an exhaustive process of exposing him to choices and recording his ordinal rankings. See J. Hicks, Value and Capital (2d ed. 1946); Samuelson, Consumption Theory in Terms of Revealed Preference, 15 Economica 243 (1948); Pareto, Mathematical Economics, 5 Int'l Econ. Papers 58 (J. Griffin trans. 1955). In practice, however, constraints of time alone preclude such a course, and the broker is thrown back on "direct" exploration of the customer's subjective preferences through the imperfect medium of language.
401. See, e.g., Geerlings, Suitability Requirements for Non-Member Broker-Dealers Under Proposed Rule 15b10-3, in Conference on Mutual Funds 13, 18 (P. Geerlings ed. 1967) (importance of investor's "psychological temperament"); Bickel, supra note 23, at 21 (arguing that even informed individual investors have irrational prejudices, such as refusing to purchase any railroad or insurance stocks and that customers have a natural urge to seek more than a reasonable rate of return - they want a stock sure to go up in price, but with no risk). Investor bias against short sales is an excellent example of widespread irrationality. See generally Lease, Lewellen & Schlarbaum, Market Segmentation: Evidence on the Individual Investor, Fin. Analysts J., Sept.-Oct. 1976, at 53.
402. Consider the following examples: "The contractual plan provides a method of investment in equities which fits the needs and way of going of the average and small investor . . . ." Roach, supra note 38, at 145. "[T]o the extent the law permits a manager to handle an account for a client who states his investment objectives in such general terms as "income," "balance," "growth," and "aggressive growth," the manager's responsibility for determining suitability is small. He needs to know little more than the range of values along the frontier of best portfolios to which those terms ordinarily apply. He has virtually no obligation to take into account the crucial suitability variables - the client's wealth and attitude toward changes in wealth - except perhaps those quantities are implied by the stated objectives." Bines, Investment Objectives, supra note 18, at 304-05.
403. See, e.g., Bickel, supra note 23, at 19-21.
nearly infinite numbers of securities. They would also include complex valuation of risky assets which are "securities" for purposes of portfolio theory but are hardly listed in Moody's—land, partnership interests, insurance, and even future earnings.

Even if reliable performance data could be obtained, there is no agreement among securities professionals or economists as to the correct method of security analysis. Because analysts will be unable to reach a consensus on the ranking of all alternative portfolios, they will necessarily disagree widely about which portfolio is, at a moment in time, optimal.

404. See, e.g., id. at 21 ("inconceivable" for "any security dealer, no matter how large his statistical staff"); but see MSRB Notice of Filing of Fair Practice Rules, MSRB Manual (CCH) ¶ 10,030 at 10,367 (1977), which rejects the suggestion of several commentators that rule G-19 should "apply only to recommendations made to engage in the purchase or sale of municipal securities generally," allowing a broker to "recommend specific securities to a customer who decided on his own to purchase municipal securities"; suggestion rejected in light of the "wide range of municipal securities with varying characteristics."

405. See, e.g., Cohen, supra note 389, at 1611 n.38; Comment, supra note 5, at 504-05, 508.

406. Consider, for example, the alarm sometimes expressed that suitability doctrine threatens "to completely preclude the use of a pure technical (chartist) approach to market interpretation." Investor Protection, supra note 30, pt. 2, at 821 (statement of R. Burnside). See also Rice, supra note 117, at 576-77; Brudney, supra note 111, at 254 (prepared statement of V. Brudney) ("To foresee a need for familiarity with primary sources immediately poses at least two challenges — what about the small retail broker who relies on market letters or reports and conversations with persons he considers reliable; and what about chartists, who predict their advice on market configurations?"). Cf. Mundheim, Professional Responsibilities, supra note 60, at 488 n.7 (suitability doctrine does not "attempt to provide a standard for evaluating various systems of analyzing securities or the decisions made as a result of such analysis"). In one response to a request for a no-action letter, the SEC did at least hint that a "technical" or "chartist" investment approach would be looked upon unfavorably with regard to suitability. See SEC Investment Company Act No-Action Letter, § 3(a), John G. Kinnard & Co., Oct. 30, 1973, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,662 (1973). A broker requested a no-action letter concerning a plan to solicit customers' investments in margin accounts of $15,000 or more which would be managed primarily according to various market indices, with an emphasis on short selling. The broker represented that customers would "be selected on the basis of present investment activities and will be immediately screened to determine the suitability of the service to their investment capabilities and objectives." Id. at 83,793. The SEC responded that "the use of margin accounts and short selling would not be suitable for clients who are not financially able to sustain the risks inherent in their use," and that "very thorough screening" was required because many customers "willing and able" to invest $15,000 "may nevertheless be unsuitable prospects." Id. at 83,789.

A third difficulty is the radically time-bounded nature of every complex calculation of optimality. At the next instant, the customer, the securities, and the transaction costs will all have changed, and in theory, the calculation will have to be undertaken anew.

Two final objections which may be raised are the great complexity of the calculations needed to derive the optimal portfolio, and the uncertainty expressed in the relevant literature as to the value of simplified methodologies.408

**Useful Insights**

If portfolio theory seems woefully impractical as an ideal, it nevertheless conveys important insights for suitability judgments. Its counsel that specific transactions cannot be assessed outside the context of the investor's entire portfolio seems incontestable. Portfolio theory serves to disprove the universal validity of statements that "[s]peculative securities . . . are obviously unsuitable for some customers" or that mutual funds meet "a demand for an equity instrument suitable for the investment of small and medium savings flows."409

Anyone with money to invest, however little he has to invest and however risk-averse he may be, may attain an optimal risk-return posture via a portfolio containing a highly speculative stock. Because of covariance, a single transaction exchanging a much lower-risk security for a highly speculative stock can decrease overall risk-per-unit-of-return. Conversely, such "safe," "well-diversified" holdings as mutual funds410 may be worse for a portfolio than a mix of speculative stocks and Treasury bills. These insights and the principles of optimal diversification undermine transaction-specific notions of suitability411 and any rules of thumb applied to the "timid

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409. Jacobs, *supra* note 6, at 898; *Spec. Study, supra* note 18, pt. 4, at 145. For a suggestion that "suboptimization" — the application of portfolio theory without strict adherence to all of its more costly or difficult steps — still offers a preferable means of selecting investments, see Note, *Fiduciary Standards, supra* note 389, at 971 n.66.

410. See *Special Study, supra* note 18, pt. 4, at 179.

411. "To the extent that ambiguity exists regarding the meaning of risk suitability, the suitability rule may have induced brokers to avoid the recommendation of efficient investments." Cohen, *supra* note 389, at 1611. The possible incoherence of "talking about the suitability of each individual purchase or sale" was adverted to in 1964 in O'Boyle, *supra* note 23, at 95 (prepared statement of T. O'Boyle).
widow" or the "aggressive young speculator." Similarly, they undermine the rationale of rules like proposed options rule 9b-2 that rest partly on the assumption that all unusually risky investments must be surrounded by government-imposed barriers to restrict them to the few who are risk-prone and rich enough to absorb losses.

It does not seem unfair to apply the less mechanical, less simplistic, and less inaccurate tests of portfolio theory to the securities industry. "Financial planning" services offered by industry members are guided by suitability rules containing references to "other security holdings" and imposing, in the view of some, an obligation to match transactions to the investment profile of the customer. Of course, it is no less fair to bar "the customer whose total portfolio

412. Cohen, supra note 389, at 1611.
413. See Bryant, Proposed SEC Option Rules, 6 REV. SEC. REG. 883, 886 (1973). See, e.g., Maidenberg, Commodities: A Role for Futures in a Managed Portfolio, N.Y. Times, July 25, 1977, at 33, col. 1. Rules of thumb carry errors of exclusion as well as inclusion. Although rule 9b-2 treats as highly risky transactions that in context may be risk-minimizing, the fact that a situation is not singled out by a special rule can also be misleading: "The fact that a client satisfies a presumptive standard may be taken as tantamount to a determination that the risk involved in an investment program is appropriate for the client. Yet such a conclusion does not automatically follow." Bines, Investment Objectives, supra note 18, at 282 n.16. Examples abound of the poor formulation of suitability rules when tested against portfolio theory. Rule 15c2-5, putting in the broker's hands the responsibility to pass, according to some notion of objective suitability, on the appropriateness of non-routine loan transactions, singles out borrowing from the broker as especially risky notwithstanding the fact that suitability theory suggests leveraging can be a vital step in attaining an optimal risk-return posture. Another irrationality from the vantage point of portfolio theory is the imposition of special suitability requirements on "speculative low-priced securities" in the NASD policy statement. See text accompanying note 35 supra. As noted in Mundheim, Professional Responsibilities, supra note 60, at 461 n.47, price has no necessary relation to risk.

Of course, such rules can always be defended on the ground that "unskilled use" of certain "tools of investment management" is especially hazardous. Bines, Investment Objectives, supra note 18, at 433. But the question is whether the various rules that have evolved are so overinclusive and underinclusive with respect to portfolio suitability as to call for their replacement by more accurate standards.


415. Letter from SEC Division of Market Regulation to NASD, [1973-1974 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 79,810, at 84,194 (1974). See also Kripke, supra note 389, at 306 ("The suitability of a particular investment should be considered not on its individual merits alone but on its contribution to the diversification and the risk of the total portfolio. There is no reflection of that kind of thinking in the securities legislation to date.").
is being managed [from] attack[ing] selectively only the loss transactions as unsuitable.”

Furthermore, the fact that a rigorous application of portfolio theory to every transaction subject to suitability scrutiny would be entirely unworkable does not weaken the possible relevance of portfolio theory as the source of a standard of care to which brokers must adhere. Little commentary on the suitability doctrine has been directed to the problem of standard of care. Of course, the “rules by their terms establish a reasonable basis standard — a negligence standard.” Those commentators who have remarked on the problem have tended to argue that a malpractice standard should be applied. A malpractice standard, however, would provide little incentive for the industry to move closer to the portfolio theory ideal.

416. Lipton, supra note 1, at 279 (footnote omitted) (prepared statement of M. Lipton) (discussing count in complaint in Trustees v. Donaldson, Lufkin & Jenrette, Inc., Civ. No. 71-C-686 (S.D. Ind. 1971), later withdrawn, which made such an attack); see also Bines, Portfolio Theory, supra note 18, at 763-67 (also discussing Trustees v. Donaldson); Nichols, supra note 60, at 438-39 n.24 (same); Belliveau, Discretion or Indiscretion, Institutional Investor, Aug. 1972, at 65 (same).

417. Jacobs, supra note 6, at 901 n.139.

418. See, e.g., Lipton, supra note 1, at 287 (remarks of M. Lipton); Leavell, supra note 60, at 1584; Rice, supra note 117, at 554, 556-61; cf. Comment, supra note 5, at 527 (liability should not be imposed if “every reasonable effort” made to insure suitability, but as there are “many ‘gray’ areas in the suitability concept it should “be imposed cautiously, on a case-by-case basis”). Recall, also, the very deferential malpractice standard applied in the Gleit case, see text accompanying notes 353-56 supra.

Other commentators have advocated “reasonableness” or “reasonable business judgment” standards which suggest greater leniency than a malpractice standard. See, e.g., Comment, Current Problems in Securities Regulation, 62 Mich. L. Rev. 680, 742 (1964) (standard would presumably be one of reasonableness and good faith); Mundheim, Professional Responsibilities, supra note 60, at 474-75 (“[A broker should] only be found to have violated his responsibility if no reasoning brokers would have recommended the particular security to the particular customer in light of information about the customer which the broker-dealer knew or should have known.”). Mundheim has particularly stressed the vital importance of encouraging more meaningful communication between broker and customer. Id. at 479; see also 5A A. Jacobs, supra note 6, § 211.01[b] at pp. 9-41 to 9-43, 9-45; Jacobs, supra note 6, at 905.

Another commentator has suggested that only recklessness along the lines of tort-law gross negligence ought to result in sanctions against a broker. Investor Protection, supra note 30, pt. 2, at 821 (statement of R. Burnside). Bickel takes a similar position, noting “mistakes in judgment must be distinguished from mistakes in motive.” He adds that “a committee of persons active in the securities business” is the appropriate disciplinary body because such persons “are best able to judge the actions and motives of other dealers and the seriousness of any guilt.” Bickel, supra note 23, at 30. He also suggests an additional barrier to liability: “[t]he entire pattern of a dealer’s recommendations and transactions must be judged and not an isolated
As Professor Victor Brudney has observed: "The customs or practices of the trade might be sufficient to define standards of appropriate — or non-negligent — behavior in many professions or established trades . . . . But the securities legislation contemplates alteration of those customs and practices in the securities industry in the interest of affording greater protection to investors."\(^{419}\)

Concededly, many of the underpinnings of portfolio theory are still in dispute. On the other hand, assume a broker, after careful inquiry into the customer's holdings and objectives, recommends and sells a conservative security to an investor with conservative holdings and conservative investment goals. Under present authority, the transaction seems beyond reproach. But should the broker be subject to no duty of care to consider the portfolio impact of the transaction? It is submitted that the principles of portfolio theory would serve the purposes of suitability doctrine by providing more accurate guidance in measuring inappropriate risk levels than any of the existing rules of thumb for special situations or particular categories of securities. In addition, portfolio theory principles would provide a greater measure of certainty for the application of suitability rules because, notwithstanding the admonition in 1963 that "what constitutes 'reasonable grounds' [for belief in suitability under the NASD rule] would remain uncertain until expounded by the Commission and courts in case-by-case adjudication,"\(^{420}\) little progress has since been made.\(^{421}\)
The economic analysis on which portfolio theory is based posits a fully subjective idea of suitability — the preferences to be served by selecting the optimal portfolio are those of the customer. Portfolio theory can also, however, provide the means of achieving risk/return levels dictated by an objective idea of suitability. For example, if there were a public anti-gambling policy prohibiting investors from bearing overall risk-per-unit-of-return above a certain level, application of the theory would establish when a portfolio exceeded the permitted level. Such an anti-gambling policy might be grounded purely in paternalistic motives or might rest on more sophisticated grounds. In either case, portfolio theory (with an adjustment to the index for measuring risk) would indicate when overall portfolio risk of loss exceeded the standard, even though the actual development of the theory was based on a conception of rational behavior which envisions all risks as potentially subject to compensation by sufficient expected returns. 422

D. A Recapitulation of Themes

Rather in the fashion of a cinéma-vérité documentary, the Article to this point essayed to depict as faithfully as possible the complex, fragmented and inconsistent development of the suitability doctrine. It sought to communicate the unfolding process of the doctrine’s development, difficult to describe adequately in direct generalizations. Whatever static suitability doctrine has existed at any particular time is best described as an unintegrated kaleidoscope of authorities having in common only the central, ill-defined word “suitability.”

tribute substantially to the standards below which the broker-dealer cannot safely fall. A major difficulty in applying this principle is that the industry standards are elusive.” Rice, supra note 117, at 560. “The SEC decisions have never articulated any explicit criteria for determining whether a recommendation involves a risk that is unsuitable for the customer in question.” Cohen, supra note 389, at 1628 n.77.

An attack on portfolio theory as a source of suitability doctrine should not be made on the ground that its rigorous application requires drawing distinctions beyond the competence of brokers and regulators. See, e.g., Lipton, supra note 1, at 287 (remarks of A. Fleischer, Jr.). The issue is whether it provides some standards for detecting inappropriate investments which are usable and enforceable and which are more accurate than those of present doctrine.

422. An argument that the various provisions of law governing risky investments should reflect this rationality axiom is advanced in Note, The Regulation of Risky Investments, supra note 389. Two commentators have already advanced detailed suggestions for practical rules incorporating insights of portfolio theory into suitability obligations. See Mundheim, Professional Responsibilities, supra note 60, at 448; Cohen, supra note 389.
Some major themes have emerged from the kaleidoscope of authorities. This section will demonstrate that they are the product of a single issue: how the law should define and how it should treat the customer’s voluntary investment decision. Even if, however, a certain coherence can thereby be imposed on these themes, a caveat should be entered. There is a certain amount of risk in proposing any structure designed to order these themes because any premature structuring may misconceive and divert attention from a natural evolution of suitability, a doctrine which has already asserted itself in a variety of contexts as “a major philosophical theme underlying the federal securities laws.” The student of legal change may well perform his or her most important service simply by placing evidences of change in a clear order and allowing them to speak undistorted.

Some of the issues encountered above are recapitulated below.

Recommendations' Only, or All Transactions?

A suitability requirement could be applied to only those broker recommendations that are followed by the customer. In the alternative it might be applied to all recommendations, to all transactions, or to both. It could even be applied to a broker’s failure to recommend transactions or to execute them in discretionary accounts. The language of the NASD rule by its terms applies only to recommendations, and the NASD has suggested that it is applicable whether or not the recommendation is followed. Several other suitability rules address only recommendations. Although the NASD has fought to restrict the application of its rule to recommen-

423. See text accompanying note 1 supra.
424. See M. HEIDEGGER, BEING AND TIME 49-63 (J. Macquarrie & E. Robinson trans. 1962); E. HUSSERL, PHENOMENOLOGY AND THE CRISIS OF PHILOSOPHY (Q. Lauer trans. 1965). These philosophers propound the phenomenological method of investigation whereby “expansion is accomplished by an accumulation of discoveries, not by an organic growth of scientific thinking as such.” Id. at 38.
425. Illustrative instances of each theme’s appearance will be given.
426. See Hed-Hofmann, supra note 20, at 202-03 & n.74. Contra, Comment, supra note 5, at 540 n.140.
427. See note 19 & accompanying text supra.
428. See note 51 & accompanying text supra.
429. E.g., The NASD rule on brokerage firm securities discussed at note 39 supra; the basic options rule at notes 124-26 & accompanying text; the proposed limited price options rules at notes 130-39 & accompanying text; and rule 15b10-3 at note 46 & accompanying text. See notes 39, 45, 124-39, and 202-07 & accompanying text supra.
...the options rules for uncovered calls and offsetting puts apply to all transactions, and rule 15c2-5, governing customer borrowing, applies to recommendations and transactions. NYSE materials also suggest that exchange members' suitability obligations extend beyond recommendations. The SEC has twice suggested that the law of suitability should eventually encompass nonrecommended executions.

Theoretically, the wider coverage of rule 15c2-5 and the special options rules for uncovered calls and offsetting puts can be justified by factors not universal to the suitability doctrine. Rule 15c2-5 concerns those transactions in which, because the broker is a lender, there is a special danger of overreaching. The options rules involve transactions with exceptionally high risk for the endorsing broker as well as the customer. As a general proposition, however, focusing on recommendations is sensible only if one assumes that the protection of the suitability doctrine is unnecessary when the broker acts as an order clerk. This assumption in turn must rest on the premise that a customer capable of independently deciding to initiate a specific transaction should have his decision honored. Under a fully objective concept of suitability, however, customer free choice is irrelevant, and it makes little sense to distinguish between recommendations and unsolicited orders; either activity could leave the customer with an objectively unsuitable security. An empirical argument might be made that the distinction is rational because, for some reason, customers initiating their own orders in fact tend to request transactions that are objectively suitable. There is, however, no reason to limit the protection of the objective version of the suitability doctrine to the customer who has had the benefit of a broker's advice.

The SEC has intimated that order clerk transactions should be subject to some, perhaps less stringent, suitability requirement than that applied to recommendations. The objective view of suitability is not the only theory consistent with this position, however. A sub-

430. See note 37 & accompanying text supra.
431. See notes 135-36, 143 & accompanying text supra.
432. See notes 84-87 & accompanying text supra.
433. See notes 70-71 & accompanying text supra.
435. See note 137 & accompanying text supra.
jective approach to suitability rules envisions their function as ensuring that the broker recommend a security suited to the customer's own preferences. The goal is that the broker (a) understand the customer's preferences and (b) recommend accordingly. The basic cases in the "knowingly unsuitable" category of SEC decisions were directed at the second point: the brokers had made recommendations contrary to the customers' expressed preferences. Cases like Greenberg were arguably directed at the first point: without some inquiry, the broker could not know the customer's desires. Beyond the question of whether there was any meaningful communication between customer and broker, the problem of understanding the customer's preferences may contain another element, depending on how one defines customer free choice. That element is whether the customer has fully understood his own preferences, in light of the alternatives offered by the market. Even with a subjective view of suitability, if the idea of free customer decisionmaking requires that the customer has understood reasonably well his own investment objectives and has appropriately matched those objectives to the "intricate merchandise" available for investment, then logically an order clerk broker should obtain assurances that the customer has gone through this process. Only empirical evidence which proves that customers who seek no investment advice have already made fully knowledgeable choices might refute the logic of imposing such a duty of inquiry.

Even if it were clear that only recommendations were covered by the suitability doctrine, the need to decide when a recommendation is legally present would still remain. Dramatic illustration

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436. See notes 260-83 & accompanying text supra.
437. See notes 314-19 & accompanying text supra.
439. See Piper, Jaffray & Hopwood, Inc. v. Ladin, 399 F. Supp. 292, 299 (S.D. Iowa 1975), where the court held: "Without disclosure of the facts essential to a margin purchase, a customer may express a preference for a risk which he does not really understand and which he, if fully informed, might not be willing to undertake. On the other hand, if an investor persisted in requesting an unsuitable margin investment, the broker could effectuate the sale provided he discloses the facts essential for the purchaser to make an informed decision." See note 369 supra.
440. For a comprehensive study of this question in the context of the know-your-security duty, see Rice, supra note 117, at 547-54. Note the SEC's statement that under rule 15b10-3, "it is not intended that a general distribution of a market letter, research report or other similar material would in itself constitute a recommendation." SEC Securities Exchange Act Release No. 8135 (July 27, 1967), [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,459 (1967).
of this issue is seen in the juxtaposition of the *Rolf* and *Parsons* decisions — the *Rolf* court declaring that the "broker must not allow his silence to be taken as a recommendation"\(^{441}\) and the *Parsons* court strictly limiting the NASD rule to express recommendations.\(^{442}\) SEC no-action letters suggest an ambiguous middle ground, as illustrated by the Commission's rejection of the argument that suitability obligations do not apply to proposals to make securities conveniently available on a payroll deduction plan but not to recommend them in terms.\(^{443}\)

The definition of recommendation should be shaped by the policies underlying the suitability obligation. We have seen that even under a subjective view, the recommendation/no recommendation line could be valid only (a) because it is based on an independent value accorded to free customer choice in the very narrow sense of autonomous action, or (b) because there is a well-grounded empirical sense that customer-initiated orders are suitable. Both of the above criteria would suggest, if the subjective view is adopted, that the SEC no-action letters correctly construed the payroll plans as recommendations, because the transactions under those plans would not have been truly customer-initiated.

*Is Reliance an Element?*

Silence may be a recommendation when, as in *Rolf*, the customer relies on the broker's judgment as a check on his own, or his agent's, investment choices. The uncertainty in the suitability doctrine as to whether reliance is an element is also related directly to the question of free choice. As noted above, the only reason to require genuine reliance as a prerequisite to a suitability violation is to vindicate the value of free choice as formal autonomy. Requiring genuine reliance denies protection in all cases in which the customer actually makes up his own mind. An objective notion of suitability, and any subjective theory that goes at all beyond purely formal autonomy, require some degree of intervention by the broker, if only to ensure that the customer is acting correctly to satisfy his own preferences. Both theories thus implicitly abandon reliance as an

\(^{441}\) See note 349 & accompanying text *supra*.

\(^{442}\) See notes 357-59 & accompanying text *supra*.

\(^{443}\) See notes 335-41 & accompanying text *supra*. 
element of a suitability violation or convert it into a partial or total fiction.\textsuperscript{444}

The latter course is advocated by Mundheim and Fishman. Fishman would erect a rebuttable presumption of reliance even in order clerk situations.\textsuperscript{445} This course may not go far enough, however, if the suitability rules are envisioned as assuring either objective suitability or a full exploration with the customer of the mechanics of his free choice.

Of course, there can be varying degrees of reliance. From a standpoint that looks beyond the surface indicia of autonomy, a paradox as to the importance of reliance should be noted. Some customers may be totally unable to make intelligent investment decisions, even with help in the form of factual information and assistance in analysis of that information.\textsuperscript{446} Presumably, under the subjective view of suitability a broker managing the discretionary account of such a customer must work with whatever imperfect knowledge he can obtain about the customer's preferences; but such a responsibility vindicates a customer's free choice only in the most abstract sense. On the other hand, when a customer is capable of selecting appro-

\textsuperscript{444}. This statement is subject to a caveat similar to that entered in the discussion of recommendations. It was noted there that delimiting the suitability obligation according to a recommendation — no recommendation line could be defended on empirical grounds as tending to isolate the cases where unsuitability is most likely. This, it was argued, could be true on either an objective or a subjective theory of suitability.

The reliance — no reliance line simply excludes one group given protection by the recommendation line: those who receive a recommendation, but ultimately make up their own mind. The argument seems strong that this group would be as or more likely to end up with suitable transactions (on either the objective or the subjective view) as those who receive no recommendation at all. Thus, the caveat applies with equal or greater force here.

\textsuperscript{445}. Both Mundheim and Fishman conclude that the suitability rules do not (and in their view should not) apply to the pure "order clerk" relationship. See Mundheim, supra note 60, at 450 (would apparently require broker to prove nonreliance, however, even in "order clerk" situation); Fishman, supra note 54, at 240 ("[t]he broker-dealer can, of course, rebut the presumption [of reliance] by showing that he was merely an order clerk"), 248 ("[b]eyond [Fishman's proposed] standards the broker-dealer would be no more than an order clerk to whom the suitability rule would not apply"). See also Lipton, supra note 1, at 280 n.24 (prepared statement of M. Lipton) (because NASD and SECO rules address recommendations, "one may contend that the suitability doctrine does not apply to the execution of unsolicited orders"); Brudney, supra note 111, at 271-72 ("[T]he litigation surrounding the suitability rule the notion that civil damages require reliance by the customer is clearly growing, notwithstanding the fact that the broker may well have violated the suitability norm."). But see Rediker, supra note 47, at 25 n.51; Cohen, supra note 389, at 1605.

\textsuperscript{446}. See note 401 supra.
priate investments and there is less reliance on the broker's own recommendations, it may be even more important, under a subjective theory of suitability, to enforce the broker's duty. That is, when a customer needs only technical assistance to realize his preferences or is missing only one or two pieces to complete the puzzle leading to fully informed choice, it is especially crucial, under the subjective view, that the broker competently assist him. The broader the customer's sphere of reliance, the less crucial broker suitability obligations become in the maintenance of meaningful customer choice.

Can the Customer Ratify Suitability?

In *Philips & Co.*, the customers' expressed beliefs that their purchases were suitable did not protect the broker against disciplinary action; yet, in *Phillips* and *Bocock*, an inferred belief in suitability was enough to bar liability. An apparent explanation is the differing in knowledge and sophistication of the customers involved. A sophisticated investor is presumed to have competently calculated suitability regardless of later protestations, while the novice can admit that he sincerely believed the investment was suitable at the time and yet still recover. This maxim is undermined, however, by the *Rolf* decision, in which a sophisticated investor who closely followed his account became the first plaintiff ever to recover civil damages in federal court for a suitability violation.

Mundheim would absolve the broker of culpability if he first advised against an unsuitable transaction and then made a specific recommendation only when the customer (a) persisted in requesting a recommendation and perhaps also (b) signed a statement to that effect. Cohen essentially agrees with that position, as do the *Twomey* decision and the proposed MSRB rule. Many regulators and commentators require or advise that customers sign ratifications of suitability. On the other hand, the commentators worry

448. See notes 362-63 & accompanying text *supra*.
449. See notes 364-69 & accompanying text *supra*.
450. See notes 343-52 & accompanying text *supra*.
453. See notes 374-79 & accompanying text *supra*.
454. See text accompanying notes 195-208 *supra*.
455. *See, e.g.*, NASD News, March 1970, at 4: "If the customer refuses to accept
that executing a transaction for a customer who refuses the broker's advice and insists that his desired transaction is suitable\textsuperscript{456} or who refuses to provide the suitability information the broker is required to obtain\textsuperscript{457} may expose the broker to liability.

Can order be brought to this chaos? Once again, a correct position depends on whether customer choice is relevant to suitability at all and, if so, how it should be defined. A purely objective theory gives no place to customer choice. Cohen attempts to explain his simultaneous advocacy of an objective, prudent-person risk threshold with which transactions must normally comply and investor freedom to disregard brokers' warnings, by arguing that, as most investors are prudent at heart, a warning will suffice and a prohibition is unnecessary.\textsuperscript{458} Aside from the fact that he offers no evidence that investors' actual preferences satisfy his ideal of prudence, Cohen fails to explain why even one investor should be allowed to act imprudently. "Consumer sovereignty" cannot, as he suggests, be the answer unless it is somehow inconsistent with consumer sovereignty to force investors to act against their preferences but consistent with it to encourage them to do so.

From the standpoint of a subjective theory, it is necessary to distinguish a signed statement from a sincere customer belief in suitability. A signed statement in itself ought to prove nothing. A broker's obligation to determine whether a transaction is subjectively suitable may be designed to cause the broker to make certain inquiries of his customers. Through these inquiries the broker would determine whether each customer's superficially free choices are consistent with the particular customer's own purposes. In addition, a subjective suitability obligation may be imposed to encourage customer communication with the broker that improves the customer's understanding of his goals and of the market alternatives. A difficult

the broker's advice, we suggest that the broker compose a statement containing his reasons for objecting to the investment and mentioning that his firm will not be responsible for the possible consequences of the customer's actions. He should then have the investor carefully read the statement and sign it in the presence of a notary public. This should be done prior to the transaction. The broker, of course, has the alternative of refusing the customer's business." See also notes 70 & 290 supra; Goodman, New Issues — SEC "Hot Issues" Releases: Areas of Concern and Impact Upon Underwriters of New OTC Issues, in THE OVER-THE-COUNTER MARKET PLACE: MYTHS, MYSTERIES AND MECHANICS 235, 242-43 (R. Kirschberg ed. 1974).

\textsuperscript{455} See for example note 455 supra.

\textsuperscript{457} See note 133 & accompanying text supra (limited price options proposal).

\textsuperscript{458} Cohen, supra note 389, at 1622 n.64.
problem is posed when, after these inquiries, the customer persists in a choice the broker views as inconsistent with the customer's own investment objectives. On one hand, to allow brokers to execute such an order will encourage them, whenever customers present orders, to perform only the most cursory investigation, if any, and then say, "I advise against this transaction, but sign here, and I am permitted to execute your order anyway." On the other hand, once a serious dialogue has occurred, to prohibit the transaction suggests that the broker understands the customer's subjective preferences better than the customer does. Of course, the problem may be that the customer has an opinion about the market with which the broker disagrees; but perhaps the law should be even more reluctant to enshrine brokers' concepts of the best investment strategy than to make controlling brokers' concepts of their customers' own preferences.

Unless the purpose of suitability doctrine is to protect mere formal autonomy, a customer who refuses to provide information about himself is a less appealing candidate for the protection of the doctrine than a customer who declines advice that his choice is irrational. If no constitutional barriers exist, the legislature or its regulatory delegates ought to be able to act in a citizen's own interests by compromising the value of strict confidentiality to the value of informed investor choice. One might argue that, if the goal of the suitability doctrine is to preserve free choice, an investor should be able to waive his own protection. Free investor choice is itself a matter of public policy, however. Many protective public policies may not be waived by their beneficiaries, in part to prevent coercion from taking place, and in part to avoid disputes as to the knowing and voluntary quality of waivers.459

Finally, it should be noted that the version of subjective suitability that would require the broker to have a reasonable conviction that the customer is achieving his own goals in a particular transaction might or might not allow the judgments of a sophisticated or knowledgeable customer to go unquestioned and to serve as a prima facie ratification of suitability, as did the Phillips and Bocock courts. Even these customers would surely sometimes benefit from discussing their decisionmaking processes with brokers, but as their need for

459. Some commentators have voiced concern as to the possible legal consequences to a broker who refused to deal with a customer demanding service despite suitability warnings. See, e.g., Goodman, supra note 455, at 342; Buxbaum, supra note 218, at 3, col. 1 & n.2.
the protection of the suitability doctrine is less than that of other customers, their exclusion could be justified as an accommodation to the industry’s interest in minimizing burdensome regulation.

**Duty to Inquire**

The single most bruited issue of suitability doctrine is whether the broker has a duty to inquire into the customer’s situation. In the event of an affirmative answer, a corollary issue concerns what information he must secure.

The NASD rule, with its reference to the broker’s belief in suitability “upon the basis of the facts, if any, disclosed by [the] customer as to his other security holdings and as to his financial situation and needs,” could be interpreted to mean that the broker must inquire into these matters but may form his judgment of suitability on the basis of whatever information he has if the customer refuses to answer any or all of his inquiries. The NASD policy statement, however, recognizes a duty of inquiry only in the case of recommendations of “speculative low-priced securities”; it is apparently a response to the *Special Study*’s recommendation of guidelines concerning “indiscriminate recommending or selling of specific securities to other than known customers.”

In explaining the policy statement to NASD members, the Board of Governors specifically denied that the rule imposes a general duty of inquiry, though noting cryptically that under the rule, “in certain circumstances more information might well be necessary.” The court in *Parsons* was willing to take literally the NASD’s disclaimer of any responsibility to inquire.

Several of the other suitability rules explicitly impose a duty to inquire but differ as to whether the broker must document his inquiries and what information is required. The NASD’s rule governing the sale of securities in a broker’s own firm does require documentation and refers to “information furnished” by the customer con-

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460. See note 19 & accompanying text *supra*.
461. See, e.g., S. JAFFE, *supra* note 110, at 250.
462. See text accompanying note 35 *supra*.
463. See text accompanying note 28 *supra*.
464. See note 37 & accompanying text *supra*.
465. See note 52 & accompanying text *supra*.
466. See notes 351-361 & accompanying text *supra*.
467. See note 39 *supra*. 
cerning his "investment objectives, financial situation, and needs." The NASD "hot issue" proposal\textsuperscript{468} was identical. Rule 15b10-3\textsuperscript{469} refers to the same information and speaks of "reasonable inquiry" but does not require documentation. Rule 15c2-5\textsuperscript{470} calls for documentation and requires flatly that the broker obtain information concerning the customer's financial situation and needs" but says nothing about "investment objectives." The NYSE apparently imposes a variable duty depending on the degree of customer reliance.\textsuperscript{471}

Under any conception of suitability, other than the particular subjective view that would uphold all formally autonomous customer choices by placing them entirely outside the reach of the broker's duty, some inquiry is necessary. Under the objective view, the broker must secure whatever information is necessary to apply the particular objective formula. Mundheim's and Cohen's risk threshold formulas, which focus on ability to bear losses,\textsuperscript{472} would call for an inquiry into the customer's financial obligations, assets, and perhaps lifestyle. Unlike Cohen's proposed rules, which pursue subjective suitability once the objective prudent person threshold has been satisfied, a purely objective rule would require no inquiry into the customer's personal investment objectives.

Portfolio theory posits that transactions cannot be assessed in vacuo. Thus any suitability construct which adopts the insights of portfolio theory must require a complete inquiry into the customer's assets and net worth. A doctrine seeking to encourage informed customer decisions must also require an inquiry designed to ascertain the customer's indifference curves. Once it is resolved whether a duty of inquiry follows from any particular suitability theory and what information a broker must obtain under that theory, all the remaining issues concern the mechanics of the inquiry, which are a function of the standard of care adopted, rather than basic doctrine.

\textit{"Per Se Unsuitability" and Contextual Unsuitability}

Several of the practices singled out by the NASD policy statement and the SEC decisions, such as churning and mutual fund switching, are per se unsuitable. A variant on the idea of per se unsuit-
ability is the presumptive suitability standard which requires that customers entering into particular transactions satisfy standards of income, net worth, or tax bracket. Such standards were proposed by the NASD for tax-sheltered investments 473 and are applied by some brokerage firms to options customers. 474 A presumptive standard rests on the judgment that the investment in question could be suitable only for those meeting it. 475 The underlying notion of all per se unsuitability rules is that no rational person would choose to enter one of these per se unsuitable transactions. Such rules need not be concerned with a particular individual’s investment preferences. Some presumptive standards may be rebuttable, but only because the variety of possible situations means that their terms may fail to draw universally valid lines around spheres of irrational behavior, not because a particular person might prove that losing money is good for him.

In one sense such per se rules restrict customer free choice, but only in the most inoffensive sense. They constitute objective suitability rules because they impose some concept of suitability other than that of the individual customer. They are a very special case of objective suitability, however, because this objective model is based on rationality rather than wisdom or prudence. To be denied the freedom to act in a way that could only entail an economic loss is considerably less intrusive than to be denied the freedom to act in a way that the state has decided merely is imprudent. Indeed, although portfolio theory is often thought of as incorporating a purely subjective notion of suitability, because its aim is to satisfy investor preferences, the very assumptions behind the indifference curves do not comprehend behavior which is actually economically irrational. Yet the NASD, at least, has vacillated in its endorsement of even this minimal modification of the definition of voluntary customer action. 476

Objective and Subjective Suitability

The concepts of objective and subjective suitability were introduced 477 as a helpful tentative dichotomy to use in tracing the chang-

473. See notes 166-81 & accompanying text supra.
474. See note 147 & accompanying text supra.
475. See, e.g., Lipton, supra note 1, at 287 (remarks of A. Fleischer, Jr.) (tax shelters or equity funding “may only make economic sense” for certain investors).
476. See note 290 supra.
477. See text accompanying notes 96-100, 116-117, 262-264 & 269-271 supra.
ing manifestations of suitability doctrine. These categories distinguish whether the customer’s (subjective) or someone else’s (objective) values are used to determine suitability. The “someone else” could be the state whose judgment takes the form of statutes, a fictional prudent person whose judgments are raised to a legal standard by the state, or a specific person, such as the broker or a guardian, whose opinion as to suitability is made binding on the customer.

A suitability doctrine need not be exclusively subjective or exclusively objective. Even the most ardent champions of investor freedom would be unlikely to quarrel with a requirement that the customer choose only securities for which he is able to pay and that the determination of that capacity be made by someone else. In fact, such requirements are prominently featured in the NASD policy statement and the mutual fund industry’s so-called voluntary suitability program. Another mixture of subjective and objective elements is represented by the rules based on portfolio theory proposed by Cohen, which would serve the customer’s own preferences subject to the limiting condition that his decision comport with an objective risk threshold. The NASD’s proposed rule on tax shelters would have imposed a similar limiting condition.

Aside from Cohen’s modified adoption of a subjective view, the authorities and even the commentators are remarkably silent on this fundamental issue of whose judgment should govern. Only a few industry spokesmen representing the investment bankers, the mutual fund industry, and the Amex have explicitly advocated a purely subjective theory. On the other hand, only the proposed MSRB and CFTC rules, Rule 15c2-5, and a few cases like Powell & McGowan seem to take a purely objective approach, and even they are not without ambiguity on this point.

In the vast middle ground, implications, intimations, and occasionally outright contradictions remain. The language of certain

478. See text accompanying note 36 supra.
479. See note 37 supra.
480. See text accompanying note 168 supra.
481. See note 31 supra.
482. See note 38 supra.
483. See note 80 supra.
484. See text accompanying notes 88 & 97 supra.
485. See text accompanying notes 273-80 supra.
486. For example the Special Study treatment of suitability in mutual fund sales was inconsistent as between subjective and objective approaches. On the one hand,
rules and statements, such as the NASD rule on brokers’ recommendations of their own securities, the SEC’s warning as to certain unsecured short-term debt securities, and the Future Structure statement suggests an objective view, but is not conclusive. The Special Study’s recommendation that the NASD develop guidelines for “categories or amounts of securities deemed clearly unsuitable in specified circumstances” could be either a general endorsement of the objective view or only an endorsement of the special application of the objective stance in the case of per se unsuitability.

As the preceding sections of this recapitulation suggest, the apparently neat dichotomy created by a classification of suitability rules as subjective or objective conceals complicated problems of how to define and protect customer free choice. Proposed options Rule 9b-2 and three SEC decisions which suggest an objective view of suitability — Philips & Co., Powell & McGowan, and Fenocchio — illustrate these problems.

The peculiar feature of proposed options Rule 9b-2 is that it would impose the general requirement expressed in Rule 15b10-3 to all options recommendations and then would single out two higher-risk subsets of this domain for special requirements of subjective customer awareness. Rule 9b-2(b)(2) would require, in limited price options recommendations, “that the customer understands the special characteristics of such option,” and Rule 9b-2(c) would require, in uncovered call and offsetting put transactions, that he be “capable of evaluating the additional risks in such transactions.” The rule’s concern with the customer’s state of mind in especially risky options trades supports the inference that the general provisions of Rule 9b-2(b)(1) embody the subjective view of suitability. Because special

it was emphasized that no position was being taken “concerning the desirability or undesirability of encouraging equity investments on the part of persons of modest means, or of any means.” Special Study, supra note 18, pt. 4, at 180. On the other hand, the study concluded that there was “no doubt that a substantial number of [contractual] plans are sold to persons for whom, because they have insufficient income or inadequate other financial resources, they are likely to be unsuitable investments.” Id. at 207; see also id. at 144, 146, 206.
requirements are imposed in high risk transactions, however, it is fair to infer that the rule's regular suitability obligations could be satisfied even though the customer cannot "understand the characteristics" of the recommended transaction or "evaluate its risks." That a broker believes an investment meets the customer's own preferences is not enough to protect a customer in certain high risk situations. The special rules thus recognize that subjective suitability rules can be more vital to the presumably sophisticated investor who engages in high risk transactions than to a less knowledgeable investor who relies more heavily on the broker's investment advice. In the specified high risk situations it does not adequately protect the customer to vest the broker with the final determination of whether a customer's preferences are satisfied by the transaction. When the potential harm of an incorrect determination is great enough, it is necessary that the customer carry out the details of the process of deciding on a suitable investment himself.

To identify Rule 9b-2's application of a subjective view of suitability only begins the analysis. The crucial factor is the nature of the free choice being protected — a concept of free choice whose protection requires that the customer be forced to choose for himself, as well as required to understand and consider certain factors in so doing. To say that such a choice is free is in one sense a fiction, but in another it is not, because ultimately the customer still decides for himself.495

The Philips & Co., Powell & McGowan and Fenocchio cases suggest other concepts of free choice that require an even more subtle analysis to be applied with respect to subjective suitability. In the resultant explication the subjective and objective theories threaten to merge. Philips & Co. makes it clear that at least in certain situations the customer cannot be allowed to decide for himself. Powell & McGowan hold that those situations may include cases in which there is full disclosure. Fenocchio indicates that "a sophisticated investor who had been engaging in securities transactions for over 50 years" and whose investment transactions had been made with his "full knowledge and approval" may not decide the suitability of his own transactions when he is elderly, lives in a rest home, and enters into transactions that appear unwise to the SEC.

These cases can be explained equally well under the objective view of suitability or under a subjective view that curtails freedom of choice by defining fully competent and informed choice so narrowly that the result is tantamount to requiring objective suitability in most instances. Any subjective theory that is not sterile and meaningless will embrace a concept of free choice which requires the broker to look to some extent beyond the formal freedom of a customer's decision; the doctrine of duress in contract law curtails formal freedom in the same respect. Thus, a subjective suitability doctrine will impose some duty on the broker to ask, "What has the customer been told about her investment choices?" "Did she understand what she was told?" and "Is she capable of evaluating the information?" Yet, because a customer could always be more knowledgeable and sophisticated, the subjective view potentially merges into an objective view which measures suitability against the ideally well-informed and intelligent customer, a standard far more exacting than the "prudent person" ideal.

E. The Cause of Action Question

The question of whether exchange and NASD rules will give rise to a federal cause of action against brokers who violate suitability rules has been the focus of significant litigation and discussion during the last decade. The availability of such an action would provide

496. It is generally recognized that no cause of action will lie under exchange or NASD rules except against those expressly bound by them. For example, in Rothstein v. Seidman & Seidman, 410 F. Supp. 244, 248-49 (S.D.N.Y. 1976), the court denied a cause of action, under a "Special Instruction" pursuant to NYSE rule 418, 2 NYSE Guide (CCH) § 2418 (1976), requiring annual "surprise audits" of members, against an auditor which allegedly failed to report to the exchange its knowledge of fraud and mismanagement in a member firm. See also Byrnes v. Faulkner, Dawkins & Sullivan, 413 F. Supp. 453, 475 (S.D.N.Y. 1976), aff'd, 550 F.2d 1303 (2d Cir. 1977). However, an exchange may be liable to various possible plaintiffs for failure to enforce its own rules. See generally Hughes v. Dempsey-Tegeler & Co., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,133 (C.D. Cal. 1973), aff'd, 534 F.2d 156 (9th Cir.), cert. denied, 419 U.S. 896 (1976).

497. In addition to the articles cited at note 515 infra, see S. JAFFE, supra note 110, §§ 10.03, 11.10; 5 A. JACOBS, supra note 6, § 10.02; E. BRODSKY, supra note 60, at 153-77; 5 LOSS (1969), supra note 18, at 2887-91; Nichols, supra note 52, at 438-45; Shipman, Implied Civil Liabilities Under the Securities Exchange Act for Violations of Stock Exchange and NASD Rules, in PLI First Annual Institute on Securities Regulation 356 (R. Mundheim, A. Fleischer, Jr. & D. Glazer eds. 1970); MacLean, Brokers' Liability for Violation of Exchange and NASD Rules, 47 DENVER L.J. 63 (1970); Hoblin, A Stock Broker's Implied Liability to its Customers for Violation of a Rule of a Registered Stock Exchange, 39 FORDHAM L. REV. 253 (1970); Allen,
additional remedies, more convenient procedures, and perhaps more plaintiff-responsive forums than the self-regulatory agencies to which the SEC usually defers. The cause of action question is important because neither the SEC nor the courts to date have read the heart of the suitability principle into such fraud sections as 10(b) and 15(c). The question remains unresolved because claims based on suitability rules are generally combined with separate claims of fraud or other illegality and because courts often adjudicate these claims and avoid the suitability cause of action question.

In 1964, the SEC General Counsel stated that the NASD suitability rule generally would not give rise to civil liability: "The concept of suitability originated with the NASD as an ethical principle. That's where it basically belongs." On the other hand, by 1973 one commentator had concluded that "it is obvious that the law..."
is moving in the direction of finding a suitability responsibility on the part of brokers for which they will be held civilly liable to their damaged customers. A survey of the case law will demonstrate that while there is some movement toward a middle position, the courts remain sharply divided and this issue remains an open and volatile one.

The Leading Cases

Two leading cases have addressed the issue of a private cause of action under some exchange and NASD rules. In Colonial Realty Corp. v. Bache & Co., suit was brought alleging that the defendant's imposition of an especially high margin requirement, even though authorized in the parties' contract, violated the NYSE Constitution and Rules, the NASD By-Laws, and the NASD's general rule requiring fair dealing. Judge Friendly noted that because the rules arise from a self-regulatory scheme that mixes legal and ethical obligations and under which the SEC has power to supersede certain rules it disapproves, the problem was a thorny one. He applied the following analysis in dismissing the suit:

[T]he court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. The rules here at issue, however, are near the opposite pole. Although they do impose a duty upon members not to engage in conduct inconsistent with fair and equitable principles of trade . . . they are something of a catch-all which, in addition to satisfying the letter of the statute, preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim. We find little reason to believe that by requiring exchanges and dealers' associations to include such provisions in their rules Congress meant to impose a new legal standard on members different from that long recognized by state law.

504. Lipton, supra note 1, at 285 (remarks of M. Lipton). The decision whether an exchange or NASD rule will support a cause of action generally is made as an interpretation of § 27, the jurisdictional provision of the Exchange Act, 15 U.S.C. § 78aa (1970). The intricacies of whether the Exchange Act or other theories sustain jurisdiction over a claim under NASD or exchange rules, already fully explored by the commentators, see sources cited note 497, supra, will not be reexamined in this Article.


506. Id. at 182 (emphasis added).
A different principle was laid down in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*507 A trustee in bankruptcy for a securities firm alleged the defendant had violated NYSE Rule 405 by allowing the firm’s sole shareholder to open a cash account and enter into transactions with converted property of the firm’s customers. On defendant’s motion for summary judgment, the court held that allegations of complete failure to investigate a customer made out a federal cause of action. The court did not, however, decide that an alleged violation of Rule 405 is actionable per se. The court noted instead that “[a]lthough mere errors of judgment by defendant might not support a federal cause of action, the facts alleged here are tantamount to fraud on the bankrupt’s customers, thus giving rise to a private civil damage action.”508 The court implied that a defendant’s knowledge of irregularities in a customer’s dealings might also be required for liability. *Buttrey* is generally cited for the principle that a rule is actionable if it is designed to protect investors509 and if the conduct in question is “tantamount to fraud.”510

**Decisions Allowing Private Actions**

The Seventh Circuit in particular, applying *Buttrey*, has unequivocally found in favor of a “suitability”511 cause of action for private

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508. *Id.* at 142-43 (emphasis added).
509. In Neill v. David A. Noyes & Co., 416 F. Supp. 78, 81 (N.D. Ill. 1976), the public-benefit rationale was used to reach the opposite result from *Colonial Realty*, a private cause of action under the general NASD rule of fair dealing.
510. See text accompanying notes 533-540 infra. In Sanders v. John Nuveen & Co., 554 F.2d 790, 797 (7th Cir. 1977), the Seventh Circuit suggested that when these standards are met, it might still be necessary to apply the *Colonial Realty* analysis before implying a cause of action. See also SEC v. First Sec. Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972).
511. The courts have generally not distinguished between NASD and exchange rules in considering the question, viewing *Colonial Realty* (in which plaintiff alleged both NYSE and NASD violations) and *Buttrey* (NYSE rule) as the important precedents as to both. It has been argued, however, that a remedy “should exist with even greater certainty and fervor . . . with reference to NASD and over-the-counter brokers, both of whom are subject to more direct SEC regulation than are the NYSE brokers.” Comment, supra note 62, at 491 n.4. On the other hand, one court recently observed that “the existence of a private right of action under Rule 405 does not lead to the conclusion that there is a corresponding right under the NASD suitability rule.” Parsons v. Hornblower & Weeks-Hemphill, Noyes, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,885, at 91,250 n.22 (M.D.N.C. 1977) (dictum); see also Architectural League v. Bartos, 404 F. Supp. 304, 314 (S.D.N.Y. 1975).

Presumably, although the question seems never to have been tested, there would be little doubt as to an implied cause of action under rule 15c2-5, and probably rule
persons. Several other courts, in deciding that various non-suitability self-regulatory rules will support civil damages suits, have expressed views that would point toward a private action under suitability and know-your-customer rules. For example, in 

\[\text{Starkman v. Seroussi,} \]

the conclusion was reached in the Southern District of New York that a civil suit will lie for violations of the duties to ascertain the real party in interest in a transaction and to supervise securities salespersons which NYSE Rule 405 imposes on member firms. Suit was brought for recovery of losses sustained when a salesman guaranteed against losses in violation of another NYSE rule. The court allowed the cause of action and offered the following comment, which would seem to apply equally to the suitability element of Rule 405:


At least Exchange Act rule 15c2-5, the “equity funding” rule, as a “fraud” rule clearly designed to protect investors and closely analogous to rule 10b-5, would likely satisfy the Piper-Cort-Borak test. Professor Loss, writing in 1969, assumed that violation of the SECO suitability rule, would “furnish just as good a ground for implication of a private action to be decided under federal law, as violation of fraud or proxy or margin rules.” 5 Loss (1969), supra note 18, at 3448; see also 6 id. at 3719-20; accord, 53 ALI PROCEEDINGS 632 (1976) (remarks of Prof. Loss); Kroll, supra note 328, at 39; Fishman, supra note 54, at 247; Rediker, supra note 47, at 36. Contra, Mundheim, supra note 60, at 468-69. On the other hand, the legislative history, see note 40 supra, might suggest that each 15b-10 rule was to stand on a similar footing, on the ethical-legal continuum, its analogous NASD rule. With the new restrictiveness of the Piper Court, and, indeed, the lumping of SECO rules with NASD rules as to a private cause of action by the Code, see text accompanying notes 614-24 infra, the question of a private action under rule 15b10-3 may well be wide open. See also Rediker, supra note 47, at 46-47 n.146.


the purpose declared in section 6(d) to "insure fair dealing and to protect investors."\(^{514}\)

In *Van Gemert v. Boeing Co.*,\(^{515}\) the Second Circuit, which has withheld judgment on the question of a suitability cause of action,\(^{516}\) did suggest that an action might be brought that was premised on the defendant's NYSE Listing Agreement and the NYSE Company Manual. Stressing the public's reliance on the exchange's reputation for stability, fair dealing, and disclosure, the court stated:

Cases involving generally broad standards of conduct and having nothing to do with disclosure require the presence of fraud to create a right of action under federal law, but this is because the only action or conduct proscribed by the rule is fraudulent conduct. Here, however, is involved a notice or notification rule.\(^{517}\)

To the extent that suitability rules are aimed at facilitating informed investor choice, this reasoning indicates that a cause of action may be derived from the rules.

Several federal courts have also expressed a willingness to hear evidence of violations of the NASD suitability rule or NYSE Rule 405 under common law negligence claims over which pendent jurisdiction has been established.\(^{518}\) In a number of other cases, courts

514. *Id.* at 524 (footnote omitted).
516. See text accompanying note 350 supra.
517. 520 F.2d at 1382 n.16. Note, however, the emphasis in Heine v. Signal Cos., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1977), on the fact than *Van Gemert* only decided that a sufficient "colorable claim" under federal law existed to support pendent jurisdiction over the issues that ultimately disposed of the case.
have applied the NYSE Rule 405 know-your-customer requirement as a standard of due care in suits against brokers for negligence in dealing in stolen or forged securities.519

Decisions Denying Private Actions

Some decisions have more or less flatly denied a right to sue under the suitability and know your customer rules.520 The most extreme position is that announced in Lange v. H. Hentz & Co.521 In Lange, plaintiff alleged violations of several NASD rules, including the suitability rule. The court first held that no jurisdiction existed over the claims because NASD rules are not part of the statutory scheme over which Congress intended to establish federal court jurisdiction. Assuming arguendo there was jurisdiction, the court held that NASD rules fail the tests outlined by the Supreme Court522 for


implying private actions: (1) the "class of security dealers," not the public investor, is the primary beneficiary of self-regulation, (2) the intent of the rules was to create ethical and not legal standards, (3) liability would deter self-regulation, and (4) liability would invade the state provinces of negligence and fiduciary duty.\textsuperscript{523}

In \textit{Plunkett v. Dominick & Dominick, Inc.},\textsuperscript{524} the plaintiff alleged violations of the NASD suitability rules and NYSE Rule 405. While noting that the SEC's promulgation of Rule 15b10-3 was evidence that the suitability requirement is an integral part of SEC regulation, the court held:

\begin{quote}
[N]either the suitability nor the supervision rules at issue here should be the basis for federal court damage actions. If § 20 does not constitute the exclusive source of employer broker-dealer liability under the federal securities laws, common law principles of agency and negligence would provide additional bases of liability under § 10(b), either via \textit{respondent superior} . . . or in any event, for breach of a duty to supervise. Even under the latter theory, broad liability would exist under the federal securities law, and it would be superfluous to imply a cause of action under the suitability and supervision rules since the duties imposed under those rules are identical to what is at least imposed at common law.\textsuperscript{525}
\end{quote}

Two other decisions have registered additional objections to a private cause of action. In \textit{Hecht v. Harris, Upham & Co.},\textsuperscript{526} the court observed that "the practical consequences of allowing private federal damage suits based on [suitability] rules . . . and involving judicial review of market judgments, would be considerable" — "a broker might honestly think that his 'ground' for believing his recommendation 'suitable' is 'reasonable,' only to find himself overruled in a law suit and found guilty of fraud notwithstanding his good faith."\textsuperscript{527} In \textit{Landy v. Federal Deposit Insurance Corp.},\textsuperscript{528} the court opined that NYSE rule 405 did not meet the \textit{Colonial Realty} regulatory-scheme test and listed several considerations indicating that a private cause of action should not be allowed:

\begin{itemize}
\item \textsuperscript{524} 414 F. Supp. 885 (D. Conn. 1976).
\item \textsuperscript{525} \textit{Id.} at 890 (footnote omitted).
\item \textsuperscript{526} 283 F. Supp. 417 (N.D. Cal. 1968), \textit{modified}, 430 F.2d 1202 (9th Cir. 1970).
\item \textsuperscript{527} \textit{Id.} at 431.
\item \textsuperscript{528} 486 F.2d 139 (3d Cir. 1973), \textit{cert. denied}, 416 U.S. 960 (1974).
\end{itemize}
[F]irst, accurate evaluation of the degree to which any particular rule represents SEC policy is often difficult, if not impossible . . . ; second, imposition of liability might chill the process of self-regulation by creating fear of damaging liability; and, finally . . . exchange rules are not promulgated by a government body after careful deliberation and weighing of the variegated competing public interests. We believe Congress intended to encourage self-regulation to invoke higher standards than could feasibly be implemented by Congress or the SEC, and we should tread carefully before interfering with that scheme.520

Also, in DeRenzis v. Levy,530 the court stated that problems would arise as to notice and opportunity to be heard in rulemaking should an exchange rule be allowed as the source of a federal cause of action.531

520. Id. at 166 n.23. See also Nelson v. Hench, 428 F. Supp. 411 (D.Minn. 1977); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777 (N.D. Cal. 1976) (denying a cause of action under the supervision and know-your-customer rules). In Zagari, for example, the court adopted the Colonial Realty tests, rejecting the Buttrey criteria because (a) the protection-of-investors criterion was viewed as too broad, as it is applicable to all exchange rules, and (b) the tantamount-to-fraud criterion was viewed as lacking in logical foundation, as requiring wasteful fact finding, and as rendering actions under the rules superfluous. It then held that Amex rule 411 failed the Colonial Realty tests for several reasons. First, the rule was not sufficiently central to the regulatory scheme; its adoption did not cause the SEC to terminate a rulemaking procedure of its own, nor was it adopted at SEC behest or pursuant to SEC rule. Second, the adoption of a parallel SECO rule (which the court simply assumed would give rise to liability), while troubling, was apparently viewed as an effort to force nonmember firms to join the NASD, where their duty there would be only an ethical one. Third, the rule was viewed as articulating a common law standard of care applicable in negligence actions, thus diminishing the need for a federal remedy. Finally, the court listed policy arguments against implied liability: a flood of litigation, the nullification of limits to Exchange Act rule 10b-5, and the chilling of self-regulation. It is unclear whether the court meant its reasoning to apply to suitability actions, though much of it of course would. Its observation that rule 411 and NYSE rule 405 “embody standards similar to” the NASD suitability rule, id. ¶ 95,777 at 90,180, and its citation of cases discussing a suitability cause of action, suggest it meant its reasoning to apply to suitability action; however, the facts of the case make clear that the complaint was for failure to supervise employees who violated margin rules. Zagari was followed in Mosser v. Bache & Co., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,183 (N.D. Cal. 1977), where the court denied a cause of action under the NASD suitability rule.


The Majority Position: "Tantamount to Fraud"

Although several of the most recent decisions have, as noted, refused to entertain suits under the suitability rules, the majority position remains that the rules are actionable, but only when their violation is "tantamount to fraud," a phrase of studied ambiguity which leaves courts a certain amount of leeway to go beyond a rigid fraud requirement. For example, in Geyer v. Paine, Webber, Jack-

532. See 6 L. Loss (1969), supra note 18, at 3715-16; note 60 supra. But see Lipton, supra note 1, at 276-77 (prepared statement of M. Lipton) (rule 405 has three mutually reinforcing purposes: protection of the market against customers acting unlawfully, of the broker against such customer, and of the customer qua customer). The argument that express suitability rules exist primarily to protect brokers from irresponsible customers, though weaker than the argument as to know-your-customer rules, has been made at least implicitly. Recall the concern expressed in the NASD policy statement that the customer have "the financial ability" to enter a transaction, see text accompanying note 36 supra, which seemed to be the exclusive thrust of the "voluntary" suitability efforts of the Association of Mutual Plan Sponsors, see note 38 supra. See also note 533 infra. But see Rediker, supra note 47, at 30 n.74 (listing ways in which suitability rules are clearly for the protection of investors).

533. See, e.g., Nelson v. Hench, 428 F. Supp. 411, 419 (D. Minn. 1977); Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1382 (N.D. Tex. 1976). Cf. Hayden v. Walston & Co., 528 F.2d 901, 902 (9th Cir. 1975) (action under NASD rule requiring registration of securities salespeople denied because although "registration inures to the benefit of the public generally by assuring professional competence, the requirement does not set a duty with respect to a particular securities transaction the breach of which tortuously interferes with the customer's rights"); Sacks v. Reynolds Sec., Inc., 434 F. Supp. 37, 39 (D.D.C. 1977) (action under NYSE rule requiring prompt transfer of accounts between brokerage firms denied because although the rule "does express some concern for the individual investor, the rule cannot be said to have been designed primarily for the purpose of protection of investors since the emphasis is on methods and procedures to be used in furtherance of orderly and expeditious account transferring").

In another decision, Halperin v. Edwards & Hanley, 430 F. Supp. 121 (S.D.N.Y. 1977), a court held that no claim for a violation of the NASD suitability rule or NYSE rule 405 may be asserted against a brokerage firm which arises out of an investment in the firm itself. Cf. note 39 supra (NASD suitability rule specifically governing such investments). The court felt the issue was governed by the holdings of the Second Circuit in Arneil v. Ramsey, 550 F.2d 774 (2d Cir. 1977), and Lank v. New York Stock Exchange, 548 F.2d 61 (2d Cir. 1977), which limited suits against stock exchanges for the non-enforcement of their own rules to public investors, and barred exchange members and partners or investors in member firms from bringing such suits. The Halperin decision is poorly reasoned. First, Arneil and Lank were clearly limited to the issue of standing to sue exchanges under section 6 of the Exchange Act, 15 U.S.C. § 78f (Supp. V 1975). Second, even if the reasoning of these decisions were applicable, the central feature of that reasoning was the importance of the protection of public investors; the plaintiff in Halperin was a public investor, and the fact that he was induced to invest in a brokerage firm should not deprive him of protection. Third, the Halperin court offered no explanation for barring suits under the NASD suitability rule; Arneil and Lank could have no bearing on this question.
son & Curtis, Inc.,534 the court noted that the Securities Act and the Exchange Act, "although designed to protect the investor, are essentially directed at fraud."535 While holding that the NYSE rule and the NASD suitability rule are actionable, "the Court [did] not mean to imply that mere negligence or errors of judgment will suffice to sustain an action under such rules. . . . Only further evidence can determine whether fraud or something tantamount to fraud is involved."536 In nearly a dozen other cases,537 courts either have limited the cause of action under suitability rules to allegations that would also constitute fraud or conduct "tantamount to fraud" or have dismissed suits merely alleging negligent violations of the suitability rules.538

535. Id. at 683 (emphasis added).
536. Id.
538. In one recent decision a court read this line of cases, inaccurately, as requiring a separate showing of a violation of an antifraud provision before a cause of action could be alleged under NASD rules, and specifically the suitability rule. Parsons v. Hornblower & Weeks-Hemphill, Noyes, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,885, at 91,249-50 (M.D.N.C. 1977). The court then announced, after setting forth the familiar language from Colonial Realty quoted supra, see text accompanying note 506 supra: "Following the guidance of Judge Friendly in Colonial Realty this Court holds that no private action exists for violations of the National Association of Securities Dealers Rules of Fair Practice." Id. at 91,250. How the court's con-
In *Rolf v. Blyth Eastman Dillon & Co.*, the district court held that suitability rules give rise to civil liability if the violations "operated as a fraud" upon the plaintiff and if the defendant acted with *scienter*, in the form of either intent or reckless disregard.

### The Proposed Federal Securities Code

The American Law Institute, at its annual meeting held May 16-19, 1978, approved the Proposed Official Draft of the ALI Federal Securities Code. Two major innovations in suitability doctrine are contained in the Code. These innovations are the creation of a new SEC rulemaking authority with respect to suitability and the establishment of a framework for the SEC and the courts to settle the private cause of action question. In addition, the Code would preserve, largely intact, all of the present underpinnings of suitability law treated in the preceding discussions of sources and enforcement mechanisms.

#### A. The Continuation of Present Law

**Sources of Suitability Rules**

Four sources of current suitability law would be preserved by the Code. First, the present statutory authority for the NASD suitability rule and the exchanges' know-your-customer rules would be...
preserved in the new law largely verbatim.\textsuperscript{545} The current statutory pattern is simplified by combining the basic authorizations in section 803(i)(1)(A), which requires both "registered securities associations"\textsuperscript{546} and "national securities exchanges"\textsuperscript{547} to have rules designed "to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade."\textsuperscript{548} Precisely the same language is now found in sections 15A(b)(6) and 6(b)(5) of the Exchange Act.\textsuperscript{549} The Code preserves two restrictions on NASD and exchange rulemaking powers which may place some limits on the scope of the suitability doctrine, although as yet these restrictions have not been invoked by any challenger. The restrictions prohibit NASD and exchange rules from "impos[ing] any burden on competition that is not necessary or appropriate in furtherance of the purposes that the organization is intended to further as a self-regulatory organization under this Code"\textsuperscript{550} and from "regulat[ing], by virtue of any authority

\textsuperscript{545} The requirements discussed in the remainder of this paragraph are imposed as prerequisites to the \textit{registration} of an association or exchange. ALI Fed. Sec. Code (Proposed Official Draft, 1978) § 803(d). To the same effect are §§ 15A(b) and 6(b) of the Exchange Act, 15 U.S.C. §§ 78o-3(b) and 78f(b) (Supp. V 1975).


\textsuperscript{547} As defined in id. § 299.6.

\textsuperscript{548} Id. § 803(i)(1)(A).

\textsuperscript{549} See text accompanying notes 21 & 56 supra.

\textsuperscript{550} ALI Fed. Sec. Code (Proposed Official Draft, 1978) § 803 (l). \textit{See also} id. § 1804(c) (effect of SEC rules on competition). The analogous provision in present law (worded identically in two sections, one governing associations, and one exchanges) requires that the rules "not impose any burden on competition not necessary or appropriate in furtherance of the purposes" of the Exchange Act. Sections 15A(b)(9) and 6(b)(8) of the Act, 15 U.S.C. §§ 78o-3(b)(9) and 78f(b)(8) (Supp. V 1975).

It might be argued that the Code, whose "necessary or appropriate" formula focuses on the particular purposes of the rulemaker as a statutory self-regulator, rather than the purposes of securities regulation generally, meaningfully reinforces the statutory expression of concern as to the possible impact of self-regulatory rules on competition. Cf. note 31 supra (potential impact of broad suitability rules on venture capital markets); O'Boyle, supra note 23, at 102 (prepared statement of T. O'Boyle) ("if suitability is ever recognized as a legal concept on a broad basis, the cost of defending (and settling) claims becomes an ever-increasing factor in the over-all cost of doing business"); Kroll, supra note 328, at 38 (rules like rule 15c2-5, if applied generally, "would be unsuitable for and would unduly interfere with the normal merchandising of securities") (emphasis in original); Rediker, supra note 47, at 16 (legalization of ethical rules threatens "potentially prohibitive effects on the cost of doing business"). But cf. Jacobs, supra note 6, at 904 n.154 (such arguments are unlikely to "be found any more acceptable in the future than they have been in the past"). But note that the language in both the Code and present law, which calls for minimizing the impact of self-regulatory rules on "competition," could be seen as directed only at broker-broker and exchange-exchange competition, rather than competition in capital markets.
conferred by this Code, matters not related to the purposes of this Code or to the administration of the organization." The authority of the SEC to override (add to, modify, or subtract from) NASD and exchange rules is also continued by the Code.

Second, the Code imposes essentially the same standards on the Municipal Securities Rulemaking Board (MSRB). The SEC is not, however, given power to override MSRB rules.

Third, the Commission's existing authority to promulgate SECO rules designed "to promote just and equitable principles of trade" would remain unchanged by the Code.

Fourth, the rulemaking authority in section 15(c)(2) of the Exchange Act, the present basis for "equity funding" rule 15c2-5, and the likely source of any future fraud-grounded development of suitability doctrine, is carried forward in section 1614 of the Code. That section empowers the SEC to "define in a manner not inconsistent with the conditions and restrictions of part XVI [which prohibits the full panoply of fraudulent and manipulative acts], and [to] prescribe means reasonably designed to prevent, any conduct made un-

551. ALI FED. SEC. CODE (Proposed Official Draft, 1978) § 803(i)(2)(D). The analogous provision in present law (again, worded identically in separate sections governing associations and exchanges) requires that the rules not "regulate by virtue of any authority conferred by [the Act] matters not related to the purposes of [the Act] or the administration of the association [or exchange]." Sections 15A(b)(6) and 6(b)(5) of the Exchange Act, 15 U.S.C. §§ 78o-3(b)(6) and 78f(b)(5) (Supp. V 1975). A comment to the Code suggests that this provision should not be read so as unduly to restrict self-regulatory organizations' rulemaking authority. See ALI FED. SEC. CODE (Tent. Draft No. 5, 1976) § 803, Comment (6).

552. ALI FED. SEC. CODE (Proposed Official Draft, 1978) § 805(e). Note that "rule change," as used in § 805(e), is a new term of art, defined in id. § 299.45(c). Section 805(e) is derived from § 19(c) of the Exchange Act, 15 U.S.C. § 78(c) (Supp. V 1975).

553. ALI FED. SEC. CODE (Proposed Official Draft, 1978) § 1103(a)(7). See also id. § 801(e)(2) (§ 803(1) does not apply with respect to a municipal security).


The reference to definition and prevention of fraudulent acts mirrors the language found in present law, but the breadth of the rulemaking grant is new insofar as it covers the entire range of the Code's substantive prohibitions of fraud or manipulation. The Code commentary indicates that this broad rulemaking grant "should encourage, when practicable, the greater use of rules rather than quasi-judicial techniques like the various manifestations of the 'shingle theory' . . . in the development of new 'fraud' doctrine."558

As to the scope of the antifraud language itself, section 15(c) (2)'s prohibition of securities transactions by brokers and dealers "in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice" is stated in simplified form in section 1602(a), the basic fraud section of the Code: "It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with . . . a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security . . . ."559 The Code thus replaces "fraudulent, deceptive, or manipulative act or practice" with "fraudulent act or . . . misrepresentation." The omission of "deceptive" is recovered in some degree by the inclusion of "misrepresentation," which is defined as "(1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in light of the circumstances under which they are made."560 An initial decision by the ALI, however, to include "deception" within the definition of fraud was abandoned in the final draft of the Code. The definition of "fraudulent act" now reads: "'Fraudulent act' includes an act, device, scheme, practice, or course of conduct that (1) is fraudulent or (2) operates or would operate as a fraud."561 An earlier draft contained a third subsection covering acts, devices, etc., "likely to deceive regardless of whether deception is intended."562

558. Id. (Tent. Draft No. 2, 1973) § 1311(a), Comment (2).
560. Id. § 297.
561. Id. § 262(a).
562. Id. (Rev. Tent. Draft Nos. 1-3, 1974) § 234D(a). While the earlier version of the "fraudulent act" definition was in effect, a comment explained that "deceptive" was deleted from the basic fraud section because it "add[ed] nothing to 'fraudulent' and 'fraud.'" Id. (Tent. Draft No. 2, 1973) § 225, Comment (1)(b). For a dis-
The intent behind the omission of "manipulative," which might serve in present law as a broader foundation for the development of suitability doctrine than the words "fraudulent" or "deceptive," is not suggested by the comments to the Code. A second subsection of the definition of "fraudulent act" states: "Inaction or silence when there is a duty to act or speak may be a fraudulent act." This subsection might be interpreted to allow the Commission freedom to promulgate rules under the fraud rubric establishing "a duty to act" so that a broker may only recommend or sell suitable securities. The language, however, seems intended to elaborate upon, rather than expand, the basic definition of "fraud." On the other hand, the use of the word "includes" to introduce the basic definition, rather than the word "means," as generally used in the definitions of the Code, was clearly intended to leave the definition of "fraudulent act" open-ended. A comment to an earlier draft declared that "[t]his definition . . . taken together with the definition of 'misrepresentation' in § 259, the provisions on manipulation in § 1308, and the rulemaking authority given the Commission by § 1311(a) . . . is meant to be as broad as the various locutions in all the source provisions." The effect that omitting the word "manipulative" has upon the possible substantive grounds for broker selling-practice liability is indicated by the collection in Code section 1609, captioned "Manipulation," of various prohibitions of the Exchange Act and rules thereunder concerning market manipulation. Although the term "manipulation" appears only in the section and subsection headings of section 1308, which "have no legal significance," a comment suggests that the section discussion of the earlier versions of these sections, see 50 ALI PROCEEDINGS 421-22, 432-33 (1973).


564. The language is apparently designed to allow the development of a non-insider's duty to disclose. See, e.g., id. (Tent. Draft No. 2, 1973) § 205(b), Comment; id. § 1303, Comment (3); id. § 1301(a), Comment (2)(e).

565. See 51 ALI PROCEEDINGS 475, 478 (1974) (remarks of Professor Loss); ALI FED. SEC. CODE (Tent. Draft No. 6, 1977) § 276, Comment (1) (an instance of the draftsmen's shifting from "means" to "includes").

566. ALI FED. SEC. CODE (Tent. Draft No. 2, 1973) § 225(a), Comment (1)(a), at 9. The comment was written at a time when the term "deceptive act" instead of "fraudulent act" was being used. The comment apparently remains in effect.


fully compensates for anything lost through the deletion of "manipulative" from the definition of "fraudulent act." In any event, whether or not the Code ultimately narrows the ground for the development of 15c2 suitability rules, it compensates for any narrowing by the separate authorization of SEC suitability rules governing all brokers.

Violation of fraud-based suitability rules like rule 15c2-5 would be a direct violation of section 1602(a)(1), exposing the broker to civil liability if he bought or sold as principal. He would also be liable if, as an agent or other fiduciary, he effected the transaction "for the account or benefit of himself or a person or estate to whom he stands in a fiduciary capacity." Whether a broker purports to act as principal or agent will not always be determinative of whether he is a fiduciary.

**Enforcement Mechanisms**

The complicated system through which suitability rules can be administratively enforced under present law is retained in the Code. The source provisions are simplified and modified in some respects, but proceedings by self-regulatory organizations, proceedings by the SEC, appeals to the SEC, and appeals to the courts are all largely preserved in their current form. Provision is made for appeals to the SEC from NASD and exchange proceedings in section 810, for

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570. *Id.* (Tent. Draft No. 2, 1973) § 1308(c), Comment (2) (written before "deceptive act" was supplanted by "fraudulent act"). In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976), the Court held that "manipulative" is "virtually a term of art" which connotes intentional or willful conduct to deceive investors by artificially influencing securities prices.

571. No attempt is made in this brief survey to specify every change the Code makes in the present law governing administrative enforcement and court review. One example of such a change in the Code's elimination of the confusion as to exchange enforcement of MSRB rules, and SEC enforcement of MSRB rules against exchange members. See *ALI Fed. Sec. Code* (Proposed Official Draft, 1978) § 806(a)(2)(A) and Note; *id*. § 1810(c); *id*. (Tent. Draft No. 5, 1976) § 806(a)(2)(A) and Comment (3); *id*. § 1507A(c) and Comment (2); *see also*, e.g., 53 *ALI Proceedings* 599-600 (1976).


573. *Id*. § 1810.

574. *Id*. § 1809(a)(4)(B).

575. *Id*. § 1818(a)(1); *see also* 53 *ALI Proceedings* 549-51, 571-72 (1976).


577. *Id*. § 803(f)(1). The requirements that association and exchange rules, respectively, provide for discipline are contained in sections 15A(b)(7) and 6(b)(6),
direct Commission proceedings against NASD and exchange members and their associates in section 1810(c),\(^ {578}\) for direct Commission proceedings against registered brokers and their associates primarily in section 1809(a)(4)(B),\(^ {579}\) and for appeals to the circuit courts from SEC orders in section 1818(a)(1).\(^ {580}\) Exchanges and associations are empowered,\(^ {581}\) and in some cases are required,\(^ {582}\) to enforce the statute, SEC rules, their own rules, and in the case of associations, MSRB rules. The SEC's direct enforcement power is more limited: it does not extend to the self-regulatory organizations' own rules.\(^ {583}\)

**B. Innovation**

Under the present federal securities laws, the body of law that controls brokers' relationships with their customers is divided between antifraud law and self-regulation. We have noted problems with both of these sources of potential liability for suitability violations. Antifraud regulation, through the shingle theory,\(^ {584}\) has suffered from the need to rely on a fiction which threatens to lose contact with the mainstream of antifraud law. The effectiveness of self-regulation has suffered from the unwillingness of the SEC to guide the development of standards and from the courts' doubts as to the appropriateness of inferring a private civil cause of action to enforce the self-regulators' rules.

The Code seeks to ameliorate these problems by two major innovations. First, it frees the law of broker regulation from the fetters of the shingle theory by directly codifying some of the best-established shingle theory violations and by giving the SEC a broad direct grant of power to promulgate rules governing all brokers in the area of suitability and in other areas without the necessity of relying on the

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\(^{579}\) See text accompanying notes 100-08 supra.

\(^{580}\) See text accompanying notes 557-71 supra.

\(^{581}\) ALI FED. SEC. CODE (Proposed Official Draft, 1978) § 1602(a)(1). Liability under § 1602(a)(1) for an antifraud suitability rule follows from id. § 1614, which makes a violation of an SEC antifraud rule “a violation of the section to which it is directed.” Section 1602(a)(1) prohibits fraud in the purchase or sale of securities.

\(^{582}\) Id. § 1703(a).

\(^{583}\) Id. § 1709(a)(1).

\(^{584}\) See 3 Loss (1961), supra note 18, at 1500-08; 6 Loss (1969), supra note 18, at 3702-08.
antifraud sections. Second, it provides a structure for a final resolution of the cause of action perplexity by giving the SEC the power to decide conclusively whether any particular self-regulatory rule shall give rise to a cause of action, and by giving the courts clearer guidelines to follow should the SEC fail to exercise this power.

**Codification of Liability for Churning and Certain Shingle Theory Violations**

Before considering the Code's grant of suitability rulemaking power it is important first to examine its direct codification of certain standards of practice for brokers. Although retaining the general prohibition against fraud and the corresponding SEC rulemaking power, the Code directly proscribes churning in section 1606 and certain specific shingle theory violations in section 913.

The prohibition against churning is directed toward discretionary accounts and accounts as to which the broker may "determine the volume and frequency of transactions by reason of the customer's willingness to follow his or his agent's suggestions." The legal-control criterion applied by the SEC and the courts in churning cases is followed by the Code. The unanimity of the decisions which apply this test is given as one reason for codification. Civil liability for churning violations is provided for in section 1717.

Section 1606 provides four nonexclusive factors to guide courts in determining when transactions "are excessive in volume or frequency." Three factors are "the size and character of the account, the needs and objectives of the customer as ascertained on reasonable inquiry, [and] the pattern of trading in the account." A fourth factor, "the amount of profits or commissions of the broker . . . in relation to the size of the account," was elevated to primary importance in the final draft of the Code. Although section 1606 does

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587. See note 292 supra.
588. ALI FED. SEC. CODE (Tent Draft No. 2, 1973) § 1306, Comment [1].
590. Id. § 1606. These factors are said to be drawn from the case law. Id. (Tent. Draft No. 2, 1973) § 1306, Comment 2. No cases are cited in the comment to illustrate any of the particular factors.
591. Id.
not provide that all these factors must be weighed by a court or that they are the exclusive considerations, these factors suggest two implications for suitability doctrine. First, the reference to "the needs and objectives of the customer as ascertained on reasonable inquiry" strongly suggests that a broker must look behind his customer's initial statement of his own preferences and inquire about his "needs and objectives," at least for purposes of determining the appropriate "volume" and "frequency" of trading. Like most of the suitability rules, however, this language is open to either an objective or a subjective interpretation. A reading of all the factors in combination suggests a definition of churning that goes beyond the special case of the no-win transaction into which no rational customer would enter. If the intent of the section is to hold brokers liable for excessive trading levels determined with reference to some objective standard, a second implication for suitability doctrine may be drawn: that section 1606's concept of suitability goes further than the relatively inoffensive intrusion on free choice involved in per se rules against irrationality.593

Section 913 codifies "the most common instances of application of the 'shingle theory.'"594 It does away with the fiction of an implied representation and makes it directly unlawful for a broker to fail to execute an order promptly,595 to fail to disclose his control relationship with an issuer,596 to effect an unauthorized transaction,597 and to charge prices not reasonably related to the market.598 Civil liability is provided for in section 1715.599

An early draft of section 913 made suitability violations unlawful as well, but this prohibition was deleted on the theory that codification of suitability doctrine is premature.600 Section 913 does not codify rule 15c2-5.

Express SEC Power to Adopt Suitability Rules Governing All Brokers

Section 915(a) of the Code provides:

593. See text accompanying notes 472-76 supra.
600. See note 653 infra.
It is unlawful for a broker . . ., in contravention of the Commission's rules,

(3) to recommend a transaction in a security unless he reasonably believes that it is not unsuitable for the customer on the basis of (A) information furnished by the customer on reasonable inquiry with respect to his investment objectives, financial situation, and needs, and (B) any other information known by the broker . . . 601

The SEC is thereby empowered, but expressly not directed, 602 to establish a regime of suitability regulation over all brokers, within the parameters of the present language of rule 15b10-3. This grant of rulemaking power is supplemented by section 915(b):

The Commission, by rule, may define in a manner not inconsistent with the conditions and restrictions of [section] . . . 915(a), and prescribe means reasonably designed to prevent, any conduct by a broker . . . that is made unlawful by [that section] or any similar conduct that constitutes unfair dealing with a customer . . . 603

Section 915(a) also empowers the SEC to issue rules respecting three practices which had come to be included under the shingle theory: failure to disclose marketmaker status or interest in a distribution; 604 failure to disclose a substantial long or short position in a security; 605 and recommending an unregistered security as to which reasonable information is unavailable. 606

The draftsmen's intent in granting the SEC power to promulgate suitability rules, and rules in these other areas, was "to carve out a degree of misconduct that is more than 'unethical,' so that it is within the proper sphere of direct regulation rather than self-regulation, but less than 'fraudulent."" 607 The Code commentary explains that the purpose is to escape the limitations of the shingle theory:

602. Section 1804(g) of the Code, id. § 1804(g), reads: "A provision of this Code that makes it unlawful to engage in specified conduct in violation of a rule or order does not require the promulgation of rules or orders, and does not apply in the absence of a rule or order."
603. Id. § 915(b).
604. Id. § 915(a)(1)(A).
605. Id. § 915(a)(1)(B). See note 109 supra.
607. Id. § 915, Note (1) (quoting id. (Tent. Draft No. 5, 1976) § 914, Comment (1)). See also id. (Tent. Draft No. 5, 1976) § 914, Comment (2) (extent to which suitability doctrine is "law as distinct from ethics . . . is left to further evolution"). Quaere whether the spirit of the following comment to the earlier version of section
There is no intention to enlarge the Commission's rulemaking authority with respect to brokers and dealers beyond the "fraud" rubric of the "shingle" theory. The design, rather, is to avoid the artificiality of that theory — however nobly it may have served its purpose in an earlier day — and to relieve both the Commission and the securities industry of the "fraud" opprobrium that is necessarily attached to every practice that is today proscribed by the "shingle" concept. 608

The express grant of suitability rulemaking power was introduced into the Code between the approval of the final tentative draft in 1977 and the approval of the proposed official draft in 1978. Earlier versions of section 915 contained only a general grant to the SEC of rulemaking power over broker practices. At first, power was granted over conduct that "involves a conflict of interest or abuse of a fiduciary relationship or otherwise takes unfair advantage of a customer," 609 and later, power was granted over conduct that "involves an abuse of a fiduciary relationship with a customer." 610 The deletion between drafts of the "conflict of interest" and "unfair advantage" language was explained on the ground that they "add[ed] nothing" to the phrase "abuse of a fiduciary relationship," which "alone is broad enough to support, for example, a 'suitability' or 'know your customer' rule." 611

The Code does not provide for civil liability for violations of the suitability rules which the Commission might adopt under section 915(a)(3). Rather, the decision on availability of a private cause of action under such rules would be left entirely to the courts, 612 guided by the standards set forth in section 1722(a), 613 discussed immediately below.

Resolving the Cause of Action Question

 Rather than definitively resolving the thoroughly debated question as to whether NASD, exchange, and SECO rules, as well as the

915 raises any question as to the Commission's power to adopt a rule proscribing in general terms any unsuitable transaction by a broker, without providing any additional standards: "It is not contemplated that this section will result in blanket rules like Inv. Co. Act Rule 17d-1 (as distinct from specified acts) to a requirement of an application for Commission approval." Id. (Tent. Draft No. 6, 1977) § 914, Comment (3).

609. Id. (Tent. Draft No. 5, 1976) § 914(a)(2).
610. Id. (Tent. Draft No. 6, 1977) § 914(a)(2).
611. Id. § 914, Comment (1)(c).
new section 915 SEC rules, should give rise to civil liability, the Code attempts in sections 1721614 and 1722(a)615 to structure a process by which the question can be answered on a rule by rule basis.

The first step in that process is to give the Commission the option to decide by SEC rule, subject to four statutory guidelines, whether any particular NASD, exchange, or SECO rule supports a private suit for damages. As to any particular rule, the Commission could decide to provide for civil liability, or to exclude civil liability. That decision would be binding on the courts, subject only to judicial review for arbitrariness under section 1818(b).616 This SEC power does not extend, however, to section 915 rules.

The four nonexclusive “criteria” which “the Commission shall consider” in adopting any such inclusionary or exclusionary rules are as follows:

(1) whether the particular self-regulatory organization rule was required by the Commission to be adopted, amended, or supplemented, (2) whether the particular rule is substantially a substitute for or parallel to a rule of the Commission (other than a section 905(c) [SECO] rule), (3) whether the particular rule is designed for the special benefit of a class of persons to which a potential plaintiff belongs against the kind of harm alleged, and (4) the risk, in the case of a self-regulatory organization rule, that the imposition of liability under section 1721 will discourage the organization from full performance of its intended role.617

The second step requires a court to decide whether a cause of action shall be inferred when a claim is based on a rule as to which the Commission has not exercised its power. This decision is to be made “in accordance with the principles of common law and equity, applied as a matter of Federal jurisprudence, and the standards of section 1722(a).”618 Section 1722(a) establishes four more criteria, but unlike those guiding the SEC under section 1721, these criteria are not merely considerations but are mandatory prerequisites to the maintenance of a private action under a section 915 suitability rule.619

614. Id. § 1721.
615. Id. § 1722(a).
616. Id. § 1818(b).
617. Id. § 1721(c). Criteria (1), (2), and (4), of course, have no applicability to SECO rules. The Code commentary describes these criteria as “an amalgam of most of the approaches” taken in the cases and publications canvassed at text accompanying notes 496-540 supra. Id. (Tent. Draft No. 2, 1973) § 1416, Comment (5).
619. Quaere why the SEC criteria should not also be mandatory.
A court is to recognize an action

only if (1) it is not inconsistent with the conditions or restrictions in any of the actions expressly created or with the scheme of the Code, (2) the provision, rule, or order is designed for the special benefit of a class of persons to which the plaintiff belongs against the kind of harm alleged, (3) the plaintiff satisfies the court that under the circumstances the type of remedy sought is not disproportionate to the violation, and (4), in cases comparable to those dealt with in [certain Code sections imposing limitations on damages], a comparable maximum is imposed.21

This statutory pattern clearly moves toward some resolution of the presently open question of a private cause of action under the suitability rules. Although it does not foreclose the SEC or the courts from considering whether a violation of the rule would be “tantamount to fraud,” its silence on this point would undermine the present view of the majority of courts that such a finding is the dispositive factor.621 Of course, the SEC can resolve the question with respect to any particular rule, except a new section 915 suitability rule, by acting under section 1721.

On the other hand, this process does not clearly suggest the outcome of the private cause of action question as to suitability rules.622 Under section 1721, the SEC may decide on the basis of any arguments and need only consider the listed criteria. As to the suitability rules, only the third and fourth factors, the class intended to be benefited623 and the potential impact on self-regulation, are relevant because the NASD rule and NYSE rule 405 were neither dictated by the Commission nor designed to substitute for or parallel a non-SECO SEC rule. These factors have already been considered by the courts and commentators and have not led them to any consensus.624 The section 1722(a) standards for courts, although mandatory, are similarly unhelpful. The limitation of damages requirement is a secondary concern, and the benefited-class standard is repeated from the SEC criteria. Whether recognition of a private cause of action is consistent with the scheme of the Code and whether such recognition has a remedial effect appropriate to the particular violation are there-

621. See text accompanying note 534-40 supra.
622. See 50 ALI PROCEEDINGS 528 (1973) (suitability is “right in the middle” of the spectrum from inclusion to exclusion).
624. See text accompanying notes 496-540; note 60 supra.
fore the pivotal questions. These criteria essentially restate the question whether the suitability rules are better left as ethical standards. In deciding the private action question as to a suitability rule, the courts are likely to find these standards add little to the admonition to observe “the principles of common law and equity.”

C. Measures of Damages for Suitability Violations

The Code provides for an assortment of damage measures which parallels the variety of routes it leaves open for civil liability under suitability principles. There has been very little discussion of the proper measure of damages for a suitability violation. The Rolp case is the only federal decision that has reached the point of awarding damages for a suitability violation. The appropriate measure, according to the trial court, was commissions and interest paid, based on an analogy to churning cases. The Second Circuit reversed and instructed the trial court to add a measure of non-market-induced portfolio loss. One commentator has assumed that rescission would be the proper award, while another has advocated that recovery should reflect the position of the plaintiff if a suitable security had been purchased. That amount would be determined by taking “the average return of a fair sample of securities that would have been suitable, and compar[ing] this to the return actually produced by the unsuitable recommendation.” A persuasive argument can be made that the damages caused by an unsuitable transaction should be measured with reference to the position of the plaintiff if he had not dealt


626. Geerlings, supra note 97, at 19-20, suggested this might be the correct remedy. Cf. note 367 supra (decision awarding cancellation of account deficit).

627. See text accompanying notes 350-52 supra.

628. Comment, supra note 5, at 541-42. Cf. Garnatz v. Stifel, Nicolaus & Co., 559 F.2d 1357, 1361 (8th Cir. 1977), cert. denied, 98 S. Ct. 1578 (1978) (risk of market decline is “rightly . . . borne by defendants” where speculative investment is fraudulently represented to be safe); Abrahamson v. Fleschner, 568 F.2d 862, 878-79 (2d Cir. 1977), cert. denied, 46 U.S.L.W. 3709, 3710 (May 15, 1978) (measure of damages in implied private action under § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1970), for fraudulent representation that portfolio was in “most conservative posture” is that proportion of net losses on unregistered securities equal to the proportion of unregistered securities which would not have been in such a portfolio).

629. Cohen, supra note 389, at 1605 n.5.
with the broker. There is no reason why he should receive the difference between a suitable investment and his actual investment if he would not have made a suitable investment even in the absence of the violation.\textsuperscript{630}

The variety of measures of damages provided by the Code that could apply to suitability violations under different theories may be summarized as follows:

<table>
<thead>
<tr>
<th>Category of Violation</th>
<th>Measure of Damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. fraud by principal</td>
<td>1. change in value of purchased or sold securities, as defined in detail\textsuperscript{631}</td>
</tr>
<tr>
<td>2. fraud by agent or other fiduciary</td>
<td>2. loss caused\textsuperscript{632}</td>
</tr>
<tr>
<td>3. churning</td>
<td>3. “commissions and profits,” plus interest paid, plus “whatever additional items of damages the court allows in its discretion on consideration of the factors enumerated in” section 1606\textsuperscript{633}</td>
</tr>
<tr>
<td>4. codified shingle theory violations</td>
<td>4. loss caused\textsuperscript{634}</td>
</tr>
<tr>
<td>5. violations of SEC section 915 suitability rule</td>
<td>5. not specified — probably loss caused\textsuperscript{635}</td>
</tr>
<tr>
<td>6. violations of NASD, exchange, or SECO rules which the SEC holds actionable</td>
<td>6. loss caused\textsuperscript{636}</td>
</tr>
<tr>
<td>7. violations of NASD, exchange, or SECO rules which a court holds actionable</td>
<td>7. loss caused, subject to certain limitations\textsuperscript{637}</td>
</tr>
</tbody>
</table>

\textsuperscript{630} Cf. ALI Fed. Sec. Code (Proposed Official Draft, 1978) § 1716(a)(2)(B) (court may award plaintiff, in its discretion, “the difference between the borrower’s trading losses and any trading losses that he would have suffered in the absence of” a violation of a Federal Reserve Board credit rule under § 918); id. (Tent. Draft No. 2, 1973) § 1414, Comment (7) (discussing need to satisfy requirement of causation before such damages may be awarded); id. (Tent. Draft No. 2, 1973) § 215A, Comment (3)(a) (same).

\textsuperscript{631} See id. (Proposed Official Draft, 1978) § 1708(a). This measure of damages is also subject to variation “on a showing that a different . . . measure of damages would be plainly more appropriate on consideration of such factors as the plaintiff’s loss, the defendant’s profit, and the deterrent effect of the particular type of liability.” Id. § 1723(e).

\textsuperscript{632} See id. § 1709(a).

\textsuperscript{633} See id. § 1717. The § 1606 factors appear at text accompanying note 590 supra.

\textsuperscript{634} See id. § 1715. Previous drafts provided for recovery of the greater of loss caused or “profit, commission, or fee.” See id. (Tent. Draft No. 6, 1977) § 1413A.

\textsuperscript{635} The closest provision appears to be id. (Proposed Official Draft, 1978) § 1715.

\textsuperscript{636} See id. § 1721(a).

\textsuperscript{637} See id. §§ 1721(a), 1722(a)(4).
On all theories of recovery, incidental or consequential damages are also available.\textsuperscript{638}

D. Defenses Against Liability for Suitability Violations

Some of the Code provisions considered above also provide specific defenses. A broker sued for a violation of a rule promulgated pursuant to section 1614(a) may defend on the grounds that "the plaintiff bought or sold with knowledge of the relevant facts . . . as they should have been disclosed,"\textsuperscript{639} but only if he was not acting as a fiduciary.\textsuperscript{640} A broker who commits one of the codified shingle theory violations is liable only if he acts "without reasonable justification or excuse."\textsuperscript{641} The sections on liability for churning and violations of self-regulatory rules offer the broker neither escape.

The courts' tentative applications of defenses of proximate cause, estoppel, and \textit{in pari delicto} would be variously affected by the Code. As seen above, only some of the suitability damage measures are concerned with losses "caused" by the violation; such losses would be subject to manipulation by the courts through their construction of that "question-begging but useful term, 'legal cause,' which § [220] defines in the reasonable expectancy language of \textit{Restatement of Torts Second}."\textsuperscript{642} "The treatment of estoppel and ratification is left to the general law."\textsuperscript{643} The defenses of unclean hands and \textit{in pari delicto} "are valid only to the extent (which may be complete) that it is so determined on consideration of (1) the deterrent effect of the particular type of liability, (2) the financial and legal sophistication of the parties, and (3) their relative responsibility for the loss incurred."\textsuperscript{644}

The Code Criticized

Any criticism of an effort as massive as the Federal Securities Code is likely to be regarded as both presumptuous and futile. How-

\begin{itemize}
  \item \textsuperscript{638} See id. § 1723(a).
  \item \textsuperscript{639} Id. § 1703(e)(1).
  \item \textsuperscript{640} See id. § 1709.
  \item \textsuperscript{641} Id. § 1715.
  \item \textsuperscript{642} Id. (Tent. Draft No. 2, 1973) § 215A, Comment (5)(b).
  \item \textsuperscript{643} Id. § 1420(d), Comment (4).
  \item \textsuperscript{644} Id. (Proposed Official Draft, 1978) § 1727(d). The commentary also recalls "an elementary bit of Latin translation sometimes overlooked — that in \textit{pari delicto} means equal fault." Id. (Tent. Draft No. 2, 1973) § 1419(d), Comment (2).
\end{itemize}
ever, as the present commentary will be predominantly favorable, it perhaps tends more to the first vice than the second.

In its central initiative in the area of suitability, the Code properly gives the SEC an express authorization to enact suitability rules, but the Code should also provide that the rules so adopted will give rise to civil liability. Three premises underpin the conclusion that the Code is to be praised for its grant to the SEC of suitability rulemaking power. First, surer and better defined suitability protection for customers and less uncertainty for brokers about their suitability responsibilities are desirable ends. Second, the plethora of suitability law suits and of specialized suitability rules, proposals, and statements, reflects a serious problem. The self-regulators are succeeding neither in discouraging suitability abuses nor in defining the suitability doctrine. Third, if the future brings a continued bull market, the abuses will become even more severe. The time to act is now.

For several reasons, the general fraud provisions are inadequate to provide a solution. As argued above, suitability obligations imposed under the shingle theory unduly strain its rationale. It is in any event desirable to avoid fictions, as the Code could by outlawing directly certain shingle theory violations. Drawing suitability doctrine into the statutory definition of fraud threatens to distort the growth and integration of the doctrine and, should the Supreme Court ultimately find the suitability-fraud connection too tenuous, such action could actually halt further doctrinal development. Also, despite intermittent paeans to the superiority of adjudication over rulemaking, and however well adjudication may have served in

647. See text accompanying notes 114-18 supra.  
650. See, e.g., Cohen, Book Review, 35 U. Chi. L. Rev. 399, 406 (1968) (in proposed boiler room rule, SEC “found it impossible to define a species of fraud in a manner which would specify the full range of improper conduct without encompassing
other areas, it has not been true of suitability that "Commission decisions and judicial affirmation thereof [have] suggest[ed even] partial guidelines." Indeed, the Commission has actively avoided elucidating the relationship between fraud and suitability doctrine.

On the other hand, direct codification of a broker suitability obligation also seems undesirable. The direct codification of a broad suitability rule, or adoption by the SEC of an inclusionary rule making the general suitability rules subject to civil liability, would do nothing to resolve the many ambiguities of the doctrine. Pressure on the courts to do so would redouble. The evidence that is available suggests that, even when they do reach the merits, the courts are unable to arrive at consistent positions on the basic themes of the doctrine by interpreting rules like the NASD suitability rule and NYSE rule 405. In addition, the courts have failed to address such issues as the proper conception of investor choice to be embodied in the rules, the place of portfolio theory in the application of the rules, and the appropriate standard of care to apply to brokers.

The present administrative and appellate mechanisms surrounding the NASD and SECO rules do not seem to promise a solution. Over a decade ago, Mundheim appealed to the NASD to resolve the central questions of suitability doctrine. Notwithstanding the fact that something of a consensus has emerged in the courts which limits other activities not intended to be reached"; Cohen & Rabin, supra note 75, at 714-19, 725-27.

651. Comment, supra note 60, at 740.
652. See text accompanying notes 295-312, 330-33 supra.
653. See ALI FED. SEC. CODE (Tent. Draft No. 2, 1973) § 1423(a), Comment (2); 50 ALI PROCEEDINGS 524-25 (1973) (remarks of Professor Loss) ("[W]e are probably going to make some law on suitability. We are not going to rely anyway on the association and the exchanges on suitability.").

At least initially, the Reporter envisioned a suitability provision aimed chiefly at fraud in oral sales practices. 49 ALI PROCEEDINGS 417-18 (1972) (colloquy between Prof. R. Knauss and Prof. Loss). See also id. at 376-77 (remarks of Prof. Loss) (initial consideration of suitability test for limited offerings).

For a time, section 913, the shingle-theory codification, contained a provision on suitability. This provision was deleted in the belief that the doctrine is "still to amorphous for codification." 53 ALI PROCEEDINGS 538 (1976) (remarks of Prof. Loss).

Instead, the present intent seems to be to "leave the whole doctrine of suitability to further administrative development by rule." Id. at 542 (remarks of Prof. Loss). "We went through various drafts and decided that we would neither foreclose the development nor encourage the development but just maintain a neutral position." Id. at 542-43 (remarks of Prof. Loss).

654. See Mundheim, supra note 60, at 451, 466-87.
private actions to violations "tantamount to fraud," a situation which some had argued would free the NASD to elaborate the rule without the fear of legal liability, the NASD has failed to so limit private actions. It persists in identifying the rule with its special per se applications. The apparently infrequent NASD enforcement has led to only a handful of appeals to the SEC. Thus, Commission adjudication has contributed no more to the construction of the NASD rule than it has to that of the fraud-suitability relationship. The SECO rule has not even led to a single reported case. Finally, the SEC's power to force a clearer rule on the exchanges and the NASD, though cited by the Code commentary as an available recourse, will almost certainly go unexercised because of its potential to upset the entire self-regulatory equilibrium. It seems likely that the stalemate will persist.

If such a stalemate in fact continues—the NASD refusing to attack the basic problems of the suitability doctrine, the courts without the skills to do so, the SEC unable or unwilling to do so—then the Code's new model of liability offers the most promise. Section 915 would empower the Commission to shape the suitability doctrine through rulemaking.

The draftsmen were also wise to confer specific power on the SEC to issue suitability rules, rather than a general broker-practice rulemaking power limited by the "fiduciary relationship" standard. One very practical reason is that, if the Code refers directly to suitability by name, it is far more likely that the Commission will be motivated, and perhaps even pressed, to proceed in that area. In addition, the absence of any clear indication in the law as to what interactions between broker and customer are enough to establish a fiduciary relationship would lend further uncertainty to a rulemaking power based thereon. "The fiduciary theory will probably be of little value in the many suitability cases where the reason for the broker-dealer's dereliction was partly attributable to minimal prior contacts with the customer." There is some authority that a broker is neces-

656. ALI FED. SEC. CODE (Tent. Draft No. 6, 1977) § 914, Comment (1)(c).
658. Leavell, supra note 60, at 1595-99.
659. Rediker, supra note 47, at 40 n.116. See also Mundheim, supra note 60, at 470-71, 473-75. But see Hed-Hofmann, supra note 20, at 200 ("If the broker-dealer
On the other hand, the *Special Study* was unwilling to conclude that a general suitability doctrine as to recommendations could be derived from fiduciary obligations, and in 1969 the Commission expressly held that "it is not necessary to show a fiduciary relationship with their customers to hold [brokers] accountable for the recommendations" they make. Thus, it was wise of the ALI not to court unnecessary controversy over the scope of the Commission's power when the power of Congress to enact a provision conferring specific power on the SEC to adopt suitability rules could not realistically be contested.

Even assuming that the "fiduciary relationship" language would cover any situation where reliance or even a recommendation was present, the definition and significance of investor free choice govern the rationality of restricting the doctrine to the context of recommendations or of reliance. Because the analysis of the wisdom of such restrictions in the context of a particular concept of investor free choice is likely to turn upon empirical assessments, those restrictions should not be frozen into legislation.

Limits upon the Commission's power to respond to breakthroughs in portfolio theory on an ad hoc basis are also undesirable. If, for example, it became incontestably clear that a certain form of portfolio diversification yielded dramatic advantages, the Commission now would probably have the authority, through the supplementary "unfair dealing" rulemaking power of section 915(b), to require brokers to advise their customers against transactions that fail to exploit such diversification, even in order clerk situations.

It might, however, have been preferable to list certain standards as a guide for the Commission, in the manner that standards are provided to the Commission for its adoption of rules on civil liability. Among the broad values that might be specified are (a) the preservation of investor free choice, (b) the avoidance of securities regulation masquerading as suitability regulation, (c) the application of

advises the customer — even though he is acting as a dealer — he becomes a fiduciary.

660. See, e.g., Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 45 (2d Cir. 1978); text accompanying note 160 *supra* (SEC commentary accompanying rule 11Acl-1).


663. See text accompanying notes 426-46 *supra*.

664. As to the pro's and con's of providing the SEC with standards to channel its discretion, see 49 ALI PROCEEDINGS 382-85 (1972).
portfolio theory in developing operational suitability rules, and (d) the adoption of a standard of care which does not remain static.

Providing the SEC by statute with specific rulemaking power in the area of suitability offers several additional advantages. First, by allowing the Commission to promulgate a general rule applicable to all brokers, the confusion caused by the differences between the NASD suitability rule and rule 15b10-3 is eliminated. Second, such power leaves the Commission with the vital flexibility to choose whether to defer to the NASD in initiating cases under the rule (subject to Commission review) or to bring actions directly. This power would provide a strong incentive to the NASD to clarify the doctrine and, so long as the NASD responded to that incentive, would allow the Commission to benefit from the special knowledge and experience of the self-regulators. Such a course would also give the SEC the ability it now lacks to generate cases directly that will further refine the doctrine. Thus, the proposal would not abandon a beneficial mix of rulemaking and adjudication but rather would strengthen both of these vital ingredients of lawmaking. Third, the rulemaking power may be broad enough to permit the SEC to clarify the confusion as to measure of damages. SEC rules could grant an award measured as accurately as possible in terms of the departure from the portfolio the customer would have had if the broker had acted lawfully, or could, at least, allow greater flexibility in arriving at damages. Finally, the SEC could use its rulemaking power to determine whether any defenses in addition to the general statutory defenses of estoppel and in pari delicto should be permitted.

The only shortcoming of the Code approach, which may well be merely an oversight caused by haste, is the failure to provide for civil liability for violations of section 915 suitability rules. The intent behind section 915 seems to have been to empower the Commission to add to the list of shingle theory violations directly codified in section 913, which unambiguously provides for civil liability. It is certainly anomalous that the SEC is empowered under section 1721(a)(1) to designate any self-regulatory rule as giving rise to civil liability, but is not so empowered with respect to its own section 915 suitability rules. Especially in light of the uncertain guidance afforded the courts by the section 1722(a) criteria it is unfortunate that the Code fails to provide for private suits to enforce section 915 suitability rules.