The Suitability Rule: Should a Private Right of Action Exist?

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NOTE

THE SUITABILITY RULE: SHOULD A PRIVATE RIGHT OF ACTION EXIST?

The Nature of the Suitability Obligation

In order to promote “just and equitable principles of trade” in the securities industry, the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), and several national securities exchanges have formulated rules to ensure that broker recommendations in securities conform to the needs and investment objectives of each individual customer. The NASD Rules of Fair Practice, for example, impose upon NASD members the obligation to recommend only those securities “suitable” for their customers’ accounts. Likewise, the “know-your-customer” rule of the New York Stock Exchange (NYSE) is also thought to create implied suitability duties for exchange members. Furthermore, SEC Rule 15b10-3 provides that nonmember brokers must have reasonable grounds to believe that their recommendations are “not unsuitable” to the investor’s needs.

Since the suitability rules which supplement the antifraud

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3 NASD Rules of Fair Practice, art. III, § 2, reprinted in [1976] NASD SEC. DEALERS MANUAL (CCH) ¶ 2152 19; see text accompanying note 38 infra.


5 17 C.F.R. § 240.15b10-3 (1980); see text accompanying note 44 infra.
provisions of the Securities Exchange Act of 1934,\(^6\) originally were intended to promote ethical broker conduct,\(^7\) the question has arisen whether suitability violations, like the antifraud prohibitions, give rise to implied civil liability.\(^8\) It remains unclear, however, whether a suitability violation is a legal wrong redressable in a private civil action or merely an ethical breach actionable only in an administrative proceeding.\(^9\) A majority of courts addressing the

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\(^8\) See, e.g., Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 41 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Landy v. FDIC, 486 F.2d 139, 144 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); Avern Trust v. Clarke, 415 F.2d 1238, 1239 (7th Cir. 1969); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 423 (N.D. Cal. 1968). Under the “implied rights” doctrine, a private litigant may be permitted to maintain a civil suit in federal court even though the statute from which his substantive rights derive does not expressly grant a private right of action. See J.I. Case Co. v. Borak, 377 U.S. 426, 431-33 (1964); Bell v. Hood, 327 U.S. 678, 683-84 (1946). In general, the courts have allowed an implied private right of action where the legislative history of the statute in question indicates that Congress intended to grant private relief but failed to commit that intent to statutory form. See, e.g., Lau v. Nichols, 414 U.S. 563 (1974); Allen v. State Bd. of Elections, 393 U.S. 544, 554-57 (1969); Bossier Parish School Bd. v. Lemon, 370 F.2d 847, 851-52 (5th Cir.), cert. denied, 388 U.S. 911 (1967); Starkman v. Seroussi, 377 F. Supp. 518, 523-24 (S.D.N.Y. 1974). Accordingly, several sections of the Securities Exchange Act have been deemed to give rise to an implied private right of action. See, e.g., Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (15 U.S.C. § 78j(b) (1976) and 17 C.F.R. § 240.10b-5 (1980)); J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (15 U.S.C. § 78n(a) (1976)). But see Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (no private right of action under 15 U.S.C. § 78q(a) (1976)). Typically, civil suits by investors based on unsuitable investment recommendations involve a deprivation of the customer's portfolio or depletion of his principal as a result of speculative trading or "churning" violations by the defendant-broker. For example, in Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 423 (N.D. Cal. 1968), the plaintiff, an elderly woman with a conservative investment outlook, wanted to ensure that her $533,000 account would yield a guaranteed monthly income for life. Id. at 424-26. She consulted a broker, therefore, who warranted that he would manage the account in accordance with her investment objectives so that she would have a steady source of dividend income with no depletion of her invested principal. Id. at 426. During the next 7 years, however, the net income from the plaintiff's portfolio diminished to approximately $1000 per year. Id. Upon investigation, it was revealed that the defendant had engaged in excessive trading, expending $232,000 of principal in interest payments and broker commissions, id. at 425, and had speculated in several high risk securities and commodities. Id. at 427. The investor thereafter filed suit against the broker and the brokerage firm, alleging that the broker had made "unsuitable" recommendations in the purchase and sale of his client's securities in violation of the NYSE and NASD rules. Id. at 426-27.

existence of the implied right of action under the suitability rules have held that unsuitable broker recommendations are actionable only when the alleged conduct is "tantamount to fraud." Since suitability claims are often joined with separate allegations of fraud under rule 10b-5, however, the suitability ground rarely has been dispositive. Moreover, under the "tantamount to fraud" standard, the issue of whether the suitability rules give rise to an implied right of action has been rendered academic, because fraudulent conduct in the purchase or sale of securities is generally redressable under the Act's antifraud provisions. Thus, the courts have not defined adequately a broker's misconduct in making unsuitable investment recommendations as a basis for implying a private remedy. In addition, recent Supreme Court pronouncements addressing the general issue of implication have construed narrowly the instances in which any implied right of action will be permissible.

In view of these considerations, it is clear that the suitability rules have been the source of great unsettlement in the area of implied broker liability. Initially, therefore, this note will examine the causes of such unsettlement by setting forth the scheme of cooperative regulation of broker conduct established pursuant to sections 6 and 15A of the Securities Exchange Act. This will be followed by an explanation of the sources and the extent of a broker's suitability duties. The leading cases which have addressed directly the existence of a private right of action for suitability violations will then be discussed. Finally, the viability of enforcing a suitability claim under more traditional antifraud remedies will be analyzed. The Note will conclude that both the nature of the suitability rules and recent judicial precedent militate against recognition of an im-


plied federal right of action.

**THE SCHEME OF COOPERATIVE SELF-REGULATION**

Prior to the enactment of the Securities Exchange Act of 1934, the national stock exchanges functioned as unincorporated associations to provide meeting places for the transaction of business among members of the exchange. As a voluntary association, the exchange was not governed by statute. Instead, the exchange adopted a constitution and bylaws which set forth its own standards of acceptable member behavior as well as procedures for disciplinary action. Upon admission to the exchange, a member expressly consents to be bound by these rules and by the decisions of the governing body charged with their enforcement. Traditionally, however, the exchange rules did not serve as a basis for civil liability, but rather set forth “ethical” standards with which the members of the exchange agreed to comply.

Recognizing that direct federal regulation of member conduct was impracticable, Congress perpetuated this policy of exchange self-administration in the Exchange Act. Pursuant to sections 6

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16 See Jennings, supra note 15, at 663 n.2.
18 See Jennings, supra note 15, at 663 n.2.
21 15 U.S.C. § 78f (1976). Under section 6 of the Exchange Act, the exchanges must promulgate and enforce disciplinary rules and procedures as a precondition to registration with the SEC. Section 6(a)(3) provides in pertinent part:
(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions . . . of this title, by filing with the Com-
THE SUITABILITY RULE

and 1922 of the '34 Act, national securities exchanges are charged with the primary responsibility for disciplining any member for conduct or proceedings "inconsistent with just and equitable principles of trade."23 The Commission, on the other hand, is authorized to suspend an exchange or its members or officers for violations of the Act or an SEC Rule,24 and to "abrogate, add to, and delete from . . . the rules of [the] self-regulatory organization as [it] deems necessary or appropriate."25 In practice, however, the SEC's suspension power has rarely been exercised,26 and the Commission generally plays only a supervisory role in the regulation of member conduct.27 As former chairman William O. Douglas stated, "[t]he government would keep the shotgun . . . behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never have to be used."28

Although the Exchange Act provided the SEC with supervisory powers over the exchanges, it soon became apparent that regulation of the over-the-counter dealers remained inadequate.29 Therefore, Senator Maloney proposed an amendment to the Exchange Act which was approved by Congress in 1938.30 Enacted as section 15A,31 the "Maloney Act" provided for the organization and registration of associations of over-the-counter dealers in a

mission an application for registration in such form as the Commission, by rule, may prescribe containing the rules of the exchange and such other information . . . as the Commission . . . may prescribe as necessary or appropriate . . . .

15 U.S.C. § 78f(a) (1976). In addition, § 6(b) of the Act states that an exchange shall not be registered unless "[t]he rules of the exchange provide that . . . its members . . . shall be appropriately disciplined for violations of this chapter . . . by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member or any other fitting sanction." Id. § 78f(b)(6) (1976).

26 2 L. Loss, SECURITIES REGULATION 1171 (2d ed. 1961).
28 W. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed. 1940).
30 See S. REP. No. 1455, 75th Cong., 2d Sess. 3 (1938).
manner similar to that followed by the exchanges under section 6. The association which came into being as a result of the Maloney Act is the National Association of Securities Dealers. As a prerequisite to registration with the SEC, the NASD is required to formulate rules governing selling abuses in order "to prevent fraudulent and manipulative acts and practices, [and] . . . to protect investors and the public interest." The association also must include in its rules provisions for disciplining members for violations of the Exchange Act or the NASD rules themselves. As with the exchanges, the SEC acts in a supervisory capacity with respect to NASD activities, reserving the power to relieve the organization of its duties under the Exchange Act if "consistent with the public interest [and] the protection of investors."

Pursuant to this scheme of cooperative self-regulation, national exchanges and brokerage associations have promulgated rules requiring member broker-dealers to make only investment

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32 Section 15A provides in pertinent part:

(a) An association of brokers and dealers may be registered as a national securities association . . . by filing with the Commission an application for registration in such form as the Commission, by rule, may prescribe containing the rules of the association and such other information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78o-3(a) (1976). In addition, subdivision (b) of section 15A provides:

(b) An association of brokers and dealers shall not be registered as a national securities association unless the Commission determines that—


36 15 U.S.C. § 78a(g)(2) (1976); see 2 L. Loss, supra note 27, at 1364.
recommendations suited to their customers' accounts. Three principal sources of the broker's suitability obligations exist. The balance of this Note will examine the sources of these suitability obligations and their utility as bases for private civil suits by investors.

The Sources of the Suitability Obligations

The NASD's Rules of Fair Practice, adopted in 1939, impose an express suitability obligation on member broker-dealers. Article III, section 2, of the Rules provides that a member's recommendation to purchase, sell, or exchange any security must be based upon "reasonable grounds for believing that the recommendation is suitable for [the] customer on 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." The language of the NASD rule does not define precisely the nature and extent of a broker's suitability obligations. In a 1964 policy statement, however, the Association indicated that its suitability rule was aimed at "ethical" abuses in member-customer dealings. Significantly, the NASD Board of Governors has also stated that "no affirmative obligation to ascertain a customer's resources and needs [is] imposed upon a salesman nor [is] the extremely difficult test of suitability imposed upon [every transaction in] the securities business." Thus, while the NASD's suitability rule institutes some minimal ethical constraints and general duties of fair dealing upon its members, it seems clear that the broker's suitability duty is to be applied flexibly so as not to inhibit standard, legitimate sales practices.

The SEC, on the other hand, has imposed a more extensive suitability obligation on registered brokers who are not members of a national securities association. In rule 15b10-3, promulgated

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37 See notes 3-5 and accompanying text infra.
42 The Securities Act Amendments of 1964, Pub. L. No. 88-467, § 1, 78 Stat. 565 (1964), gave the SEC rulemaking power with respect to brokers who are not members of a regis-
pursuant to the 1964 amendments to the Act, the Commission directed:

Every nonmember broker . . . 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 . . . .

By creating an affirmative duty of "reasonable inquiry," the SEC rule apparently places more stringent suitability responsibilities on the nonmember broker-dealer. In the release accompanying rule 15b10-3, the Commission stated that a broker's inquiry generally would extend to "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 SEC stressed, however, that the broker is

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<th>Section</th>
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<td>15 U.S.C. § 78o(a)(1) (1976)</td>
<td>Provides: It shall be unlawful for any broker or dealer . . . who does not make use of any facility of a national securities exchange . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security . . . unless such broker or dealer is registered in accordance with subsection (b) of this section.</td>
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<td>15 U.S.C. § 78o(b)(1) (1976)</td>
<td>Subsection (b)(1) of section 15 provides in pertinent part: A broker or dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such broker or dealer and any persons associated with such broker or dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.</td>
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<td>15 U.S.C. § 78o(b)(9) (1976 &amp; Supp. III 1979)</td>
<td>Section 15(b)(9) of the Exchange Act provides: &quot;No broker or dealer . . . shall effect any transaction in, or induce the purchase or sale of, any security . . . in contravention of such rules and regulations as the Commission may prescribe designed to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest.&quot;</td>
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<td>17 C.F.R. § 240.15b10-3 (1980)</td>
<td>Lipton, The Customer Suitability Doctrine, Practicing Law Institute, Fourth Annual Institute on Securities Regulation 278 &amp; n.16 (1973); Rosch, supra note 40, at 1079. The SEC has stated that the broker's obligation under Rule 15b10-3 to make recommendations that are &quot;not unsuitable&quot; is generally equivalent to the NASD's directive to make only &quot;suitable&quot; recommendations. See SEC Exch. Act Release No. 7984, at 6 (1966). But see Lange v. H. Hentz &amp; Co., 418 F. Supp. 1376, 1382 (N.D. Tex. 1976); Lipton, supra, at 277-78.</td>
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not under a duty of independent verification; he can rely on the accuracy of the information furnished by the investor and need not refrain from making a recommendation if, after reasonable inquiry, the customer refuses to provide the information.47

While the rules of the New York Stock Exchange (NYSE) have no explicit suitability requirement, most courts and commentators agree that the NYSE's "know-your-customer" rule also imposes an implied suitability obligation upon exchange members.48 Rule 405 of the NYSE provides that every member organization and its employees are required to "use due diligence to learn the essential facts relative to every customer, every order, every cash and margin account accepted or carried by such organization."49 The NYSE Guide to Supervision and Management of Registered Representatives and Customer Accounts indicates that prior to making an investment recommendation, the broker must "determine pertinent facts concerning his client's situation," including his major assets, resources, and liabilities, his investment experi-


48 See, e.g., Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 41 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Landy v. FDIC, 406 F.2d 139, 144 (3d Cir. 1973); Avern Trust v. Clarke, 415 F.2d 1238, 1239 (7th Cir. 1969); Butrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 137 (7th Cir.), cert. denied, 398 U.S. 838 (1969); Nichols, The Broker's Duty to His Customers Under Evolving Federal Fiduciary and Suitability Standards, 26 BUFFALO L. REV. 435, 436 (1977); Lipton, supra note 45, at 275-76. On the other hand, there is considerable authority to the effect that the "know-your-customer" rules are designed primarily to protect member firms against financially irresponsible customers. See, e.g., Lange v. H. Henitz & Co., 418 F. Supp. 1376, 1382-83 (N.D. Tex. 1976); SPECIAL STUDY, supra note 1, at 316; 5A. JACOBS, THE IMPACT OF RULE 10b-5, § 211.01[b], 9-42 n.2 (1979); 2 L. Loss, supra note 26, at 3715-16; Rediker, supra note 7, at 66 n.208; Note, The "Know-Your-Customer" Rule of the NYSE: Liability of Broker-Dealers Under the UCC and Federal Securities Laws, 1973 DUKE L.J. 489.

49 NYSE GUIDE (CCH) ¶ 2,405 (1980). A rule similar to NYSE Rule 405 has been enacted by the American Stock Exchange. See Rule 411, 2 AM. STOCK EX. GUIDE (CCH) ¶ 9,431 (1980). The know-your-customer rules are generally read in conjunction with the exchanges' "fair dealing" rules as creating suitability obligations. Roach, supra note 39, at 1082-83; see 2 NYSE GUIDE (CCH) ¶ 2,401 (1980); 2 AM. STOCK EX. GUIDE (CCH) ¶ 9,236 (1980). NYSE Rule 401, for example, states: "Every member, member firm and member corporation shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs." 2 NYSE GUIDE (CCH) ¶ 2,401 (1980).
ence, and the other securities in his portfolio. Thus, like the SEC suitability provision, the NYSE “know-your-customer” rule places on the broker an affirmative duty of inquiry in formulating suitability judgments, at least as to those customers who actively seek investment advice.

JUDICIAL EVOLUTION OF THE SUITABILITY ACTION

The first case to address the issue of a private right of action for member violations of stock exchange rules was Colonial Realty Corp. v. Bache & Co. In Colonial Realty, the plaintiff alleged

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51 NYSE, SUPERVISION AND MANAGEMENT OF REGISTERED REPRESENTATIVES AND CUSTOMER ACCOUNTS 4-5 (1973 ed.). In addition to the existing suitability rules of the SEC, stock exchanges, and national broker associations, the Federal Securities Code which has been proposed by the American Law Institute also contains a suitability provision. Section 1721 of the proposed code provides:

(a) Determination of Rules to Which Section Applies—A member of or participant in a self-regulatory organization who violates a rule of the organization . . . is liable to his customer for any loss caused by the violation if—

(1) the rule violated has been determined by Commission rule to be within section 1721; or

(2) a court, except with respect to those rules determined by Commission rule not to be within section 1721, decides that a private right of action under this Code should be recognized in accordance with the principles of [federal] common law and equity . . . .

(b) Commission's Rulemaking Authority—The rules of the Commission may designate either specific self-regulatory organization . . . rules or categories of such rules that are not within section 1721.

ALI FED. SEC. CODE § 1721(a)-(b), at 768-79 (1980). Thus, section 1721 of the proposed code is an “amalgam of most of the violation approaches” utilized by the courts to assess liability. Id. § 1721, Comment 5 at 772-73. Under the Institute’s proposal, the Commission would be authorized to determine categories of self-regulatory organization rules which, in turn, would be a basis for civil liability. In addition, courts would be permitted to designate certain rules as actionable, applying federal common law to this issue. The section also enumerates several criteria to be used in determining whether a rule may be actionable. See id. § 1721(c), at 769.

52 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966). The issue of whether a private right of action may be implied against an exchange or broker association itself for failure to discipline members was a precursor to the question of broker liability for violation of stock exchange or broker association rules. In Baird v. Franklin, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), the Second Circuit acknowledged that an exchange's culpable failure to enforce rules adopted pursuant to section 6(b) of the Exchange Act, 15 U.S.C. § 78f (1976), see note 21 supra, may give investors a federal cause of action against the exchange. 141 F.2d at 244 (Clark, J., dissenting in part). The court denied recovery on the ground that the plaintiff had not established a causal connection between his injury and the failure of the exchange to enforce its rules. Id. at 239. Baird left unanswered, however, the question whether liability may be asserted for violation of exchange rules by an ex-
that the defendant’s margin requirements violated the NASD’s by-
laws and general fair dealing rule, and the NYSE Constitution and
Rules. Judge Friendly determined that if an NASD rule was, in effect, a substitution for
direct SEC regulation, implication of a private right of action could
be proper. The court dismissed the suit, however, holding that
the rules at issue “preserve[d] 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.” Thus, Judge Friendly concluded, there was “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.”

In contrast to the “substitution test” of Colonial Realty, a
simpler analysis of the implication question was advanced by the
Seventh Circuit in Buttrey v. Merrill Lynch, Pierce, Fenner &
Smith, Inc. In Buttrey, a broker who had been suspended from
trading for “erratic trading practices” was permitted by the defen-
dant brokerage firm to open and manage an account in favor of a
bankrupt corporation and to speculate in large stock transactions
on the customer’s behalf. A trustee in bankruptcy brought an ac-
tion alleging that the defendant had completely failed to investi-
gate the bankrupt’s financial responsibility in violation of NYSE
Rule 405. The Seventh Circuit stated that “[t]he touchstone for

change member.

63 358 F.2d at 180.
64 Id. at 182.
65 Id. The court stated that “the concept of supervised self-regulation is broad enough
to encompass a rule which provides what amounts to a substitute for regulation by the SEC
itself.” Id.
66 Id. at 182.
67 Id. Judge Friendly reasoned that a federal right of action under stock exchange rules
would inundate the federal courts with “garden-variety customer-broker suits.” Id. at 183.
69 410 F.2d at 141.
70 Id. The plaintiff alleged that Merrill Lynch had authorized the opening of the cus-
tomer’s cash account without requiring any bank references or financial statements and
later converted the cash account to a margin account without investigating the bankrupt’s
financial responsibility. Id.
determining whether or not a violation of a particular rule is actionable should properly depend on its design ‘for the direct protection of investors.’ " Finding that Rule 405 was “designed to protect investors,” the court determined that an implied right of action for violation of the rule was consistent with the purposes of the Exchange Act. 62 The Buttrey court declined, however, to hold that suitability violations were actionable per se. 63 Instead the court ruled that where the alleged misconduct was “tantamount to fraud,” 64 a private federal cause of action was stated, since “such a breach of fair practice undermined the protection of investors and surely ‘plays an integral part in SEC regulation.’ ” 65

Following the rationale of Colonial Realty, district courts in the Second, Fifth, Eighth and Ninth Circuits have disallowed a private right of action for violations of NYSE and NASD suitability rules. 66 Typically, those courts have determined that while the federal securities laws are essentially directed at fraud, 67 violations

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61 Id. at 142. See also Lowenfels, Implied Liability Based Upon Stock Exchange Rules, 66 COLUM. L. REV. 12, 18-19 (1966).
62 410 F.2d at 142.
63 Id. at 143.
64 Id.
65 Id. at 142 (quoting Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir.), cert. denied, 385 U.S. 17 (1966)). Although the Buttrey court held that the presence or absence of fraud was determinative of whether an implied right of action was stated, it acknowledged the rationale of the Second Circuit in Colonial Realty by noting that the protection of investors was an integral part of SEC regulation of exchanges and their members. 410 F.2d at 142. Furthermore, the court relied on Colonial Realty and its progeny when it conceded that “mere errors of judgment by a defendant might not support a federal cause of action.” Id. at 143 (citing Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 430, 431 (N.D. Cal. 1968) (dictum), modified, 430 F.2d 1202 (9th Cir. 1970)). The Buttrey court, however, did not adopt the reasoning of the Colonial Realty line of cases. Finding that the rules were aimed at unethical rather than fraudulent conduct, the Buttrey court concluded that they could not give rise to a legal claim. 410 F.2d at 143; see Hecht v. Harris, Upham & Co., 283 F. Supp. at 431. For a comprehensive discussion of the Colonial Realty and Buttrey decisions, see Hoblin, A Stock Broker's Implied Liability to Its Customers for Violation of Stock Exchange Rules, 99 FORDHAM L. REV. 253 (1970); Lashbrooke, Implying a Cause of Action for Damages: Rule Violations By Registered Exchanges and Associations, 48 U. CIN. L. REV. 949 (1979); Rediker, supra note 7.
by a broker of his suitability obligations sound in common-law negligence. Therefore, the courts have concluded that a federal remedy for suitability violations is inconsistent with the regulatory scheme developed under the securities laws, and that such claims are better suited to state court adjudication. It has been reasoned that hindsight review of a broker's suitability judgments could have a considerable adverse impact on the broker-customer relationship; that self-regulatory organizations might refrain from promulgating and enforcing suitability rules for fear of creating a basis for federal court damage actions; and that rules created by exchanges and industry associations, rather than by a governmental agency, are not the product of "careful deliberation and weighing of variegated competing public interests."

A majority of courts, on the other hand, have adopted the "tantamount to fraud" standard enunciated in Buttrey. While recognizing that suitability violations are actionable, these courts have held that the implied right of action under the suitability rules extends only to fraudulent misdeeds. Those actions pre-
mised upon mere negligence or error of judgment will not support a federal damages action and, therefore, are subject to dismissal.76

Thus, it appears that the two courts which initially considered the suitability issue did not agree upon a viable basis for implication. While the Colonial test is in partial conformity with subsequent Supreme Court pronouncements,76 the Buttrey approach is not consistent with recognized standards for implication.77 Additionally, Buttrey is problematic in that the fraud requirement enunciated by the court has clouded the implication question. Subse-


77 See Cort v. Ash, 422 U.S. 66, 78 (1975); notes 80-92 and accompanying text infra. Cort v. Ash, 422 U.S. 66, 78 (1975); see Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777 (N.D. Cal. 1976). In Zagari, the court specifically rejected the protection theory espoused in Buttrey, since, if a desire to protect the public was the basis for implying a private right of action, any provision of the Exchange Act could give rise to a private remedy. [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777, at 90,808-09. Relying upon Judge Friendly's analysis in Colonial, the Zagari court also refused to accept the reasoning that a purpose to benefit the public is sufficient to meet the Colonial "substitution test." Id. at 90,811; see text accompanying notes 51-54 supra; accord, Parsons v. Hornblower & Weeks-Hemphill, Noyes, 447 F. Supp. 482, 494 (M.D.N.C. 1977), aff'd, 571 F.2d 203 (4th Cir. 1978) (per curiam). The court then criticized the "tantamount to fraud" requirement on the ground that it forces implication to depend on the conduct of the defendant rather than upon the nature of the rule violated. [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777, at 90,809. The court further noted that the Buttrey approach forecloses decisions on motions to dismiss for failure to state a claim upon which relief may be granted, Fed. R. Civ. P. 12(b)(6), until the case has been heard on the merits because, prior to that point, the fraud cannot be determined. Id. at 90,809.
sequent to Buttrey, courts have focused their inquiry upon determining the degree of fraud required to sustain a violation rather than upon delineating a justifiable basis for implication. Consequently, the fraud issue has become inextricably intertwined with the implication question. It is submitted that the court must first establish that a private right of action exists. The fraudulent nature of the broker's conduct is irrelevant in this regard.

Colonial Realty and Buttrey, however, were superseded in 1975 by the Supreme Court's decision in Cort v. Ash, which expressly set forth the factors for determining the existence of an implied private right of action. In Cort, the Supreme Court held that, in general, an implied cause of action may be made out if (1) the plaintiff is a member of the class for whose "especial" benefit the statute was enacted, (2) the legislative intent grants such a right, (3) implication of a private civil remedy would be consistent with the legislative scheme, and (4) the cause of action is not one which has traditionally been relegated to state law. The first case to apply the Cort guidelines to private damages actions for breach of the NASD and similar rules was Lange v. H. Hentz & Co. In Lange, a securities dealer employed by the defendant was alleged to have manipulated the market in certain stock in order to protect his own holdings. When the corporation ultimately failed, the plaintiffs, who had been fraudulently induced by the dealer not to sell their stock, commenced a civil damages action under the NASD suitability rule in an attempt to recoup their losses. In denying a private right of action for the suitability claim, the Lange court concluded that none of the four Cort criteria could be satisfied. Declaring that the historical roots of the NASD rules lie

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79 See Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777 (N.D. Cal. 1976). The Zagari court resolved that if a private right of action exists for violation of an exchange rule, then it should exist for all violations of the rule regardless of whether the specific conduct involved appears to be fraudulent. Id. at 90,809.
80 422 U.S. 66 (1975).
81 Id. at 78.
83 Id. at 1378.
84 Id. at 1377.
85 Id. at 1382-83. In the period since the Supreme Court's reaffirmance of the Cort criteria in Touche Ross & Co. v. Redington, 442 U.S. 560, 575-76 (1979), several courts have recognized that section 6 of the Exchange Act is not likely to support an implied private right of action for suitability violations. See, e.g., Raakl, Elkins, Stroud, Suplee & Co., No. 79-3187 (E.D. Pa. June 12, 1980); Klitzman v. Bache Halsey Stuart Shields, Inc., [1980
in the concept of cooperative self-regulation, the court held that the NASD and similar rules protect the investing public only incidentally. The purpose of the rules, the court stated, was the professionalization of the securities industry and, therefore, the group "specially benefitted from the adoption of NASD rules is the class of securities dealers." Second, the district judge concluded that the rules were intended by the legislature as "ethical" standards for broker conduct to be enforced by the association or exchange itself; there was no intent to create a civil remedy. The court also postulated that "vigilante enforcement" of NASD rules would disrupt the "delicate concept of self-regulation" and thus conflict with the general legislative scheme. Finally, the court observed that the cause of action was one which traditionally had been subsumed under state-law fiduciary duty and negligence concepts and, therefore, was more appropriately left to state court adjudication.

Following the lead of the Lange court, several subsequent cases have acknowledged the importance of evaluating the Cort factors before implying a private suitability action. Consequently, these cases have rejected the earlier analysis of the Buttrey court as inadequate. In spite of the approach adopted in Lange, how-

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86 418 F. Supp. at 1382; see notes 15-20 and accompanying text supra.

87 418 F. Supp. at 1382.

88 Id. (emphasis in original).

89 Id.

90 Id. at 1382-83. The court reasoned that implied civil liability could lead the NASD "to lower its high standards of ethical guidance . . . thereby reduc[ing] their efficacy." Id. at 1382.

91 Id. at 1383. The district court asserted that an implied federal cause of action for suitability violations could erode state-defined fiduciary duties and negligence concepts. Id. On the other hand, the Lange court noted, there was "little likelihood that federal policy would be thwarted" by allowing the interplay between NASD self-regulation and state negligence and fiduciary duties to continue. Id.

ever, the majority of post-Cort suitability cases have ignored the guidelines set forth in the Cort opinion. The preoccupation with fraud, initiated by the Buttrey decision, apparently has been largely responsible for this inadvertent disregard of the mandated implication inquiries. Consequently, even subsequent to the Cort decision, a potential basis for implication remains unidentified. Nevertheless, in Touche Ross & Co. v. Redington, the Supreme Court affirmed the importance of evaluating the Cort factors, instructing courts to pay particular attention to the legislative intent. In light of this pronouncement, the possibility of discovering a basis for implication under section 6 of the Exchange Act appears unlikely as several post-Touche Ross courts have


See notes 76-79 and accompanying text supra.

See Cort v. Ash, 422 U.S. at 78; see notes 80-81 and accompanying text supra.

See notes 76-79 and accompanying text supra.


Id. at 575-76 (1979); accord, Transamerica Mtge. Advisors, Inc. v. Lewis, 444 U.S. 11, 23 (1979). In Touche Ross, the Court addressed the question of whether a private right of action may be implied under section 17(a) of the Exchange Act. Although recognizing the existence of the four factors outlined in Cort, Justice Rehnquist emphasized that "[t]he central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action." 442 U.S. at 575. The Court declared that "[t]he source of plaintiffs' rights must be found, if at all, in the substantive provisions of the 1934 Act which they seek to enforce." Id. at 577. Accordingly, the Court stated that if the legislative history is silent, the inquiry whether Congress intended to create a private right of action is "answered in the negative" and proceeds no further. Id. at 576. Mere allusions to the "remedial purposes" of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.'" Id. at 578 (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978)). Thus, the Touche Ross decision appears to undermine the Buttrey protection theory. The Court clearly recognized that it is not the judiciary's place to improve upon a federal statutory scheme. If a private action is, indeed, warranted, "Congress must provide it." Id. at 579.

Section 6 of the Exchange Act, 15 U.S.C. § 78(f) (1976), the "substantive basis" of the suitability claim, delineates the requirements which must be satisfied by an exchange seeking registration as a "national securities exchange." See Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777 at 90,806; note 21 and accompanying text supra. The language of section 6 does not specifically declare any conduct to be unlawful, nor does it expressly provide a private right of action for violation of a rule promulgated in accordance with the section. The purpose of the section is merely to set
recognized.\textsuperscript{100}

THE PRIVATE RIGHT OF ACTION REJECTED

Private civil relief for violations of a broker's suitability obligations would supplement the already existing enforcement and disciplinary powers of the SEC,\textsuperscript{101} the exchange arbitration procedure,\textsuperscript{102} and the more traditional private antifraud remedies under the Exchange Act.\textsuperscript{103} It is submitted, however, that civil liability for suitability violations was not contemplated by either Congress or the self-regulatory organizations, and is not supported by the general regulatory scheme of the Act.

forth procedural registration requirements while simultaneously insuring that the exchanges will be supplied with a workable means of self-regulation. See Jennings, supra note 15, at 670.

Much of the legislative history surrounding section 6 reflects a preoccupation with the concept of self-regulation. See S. Rep. No. 1517, 75th Cong., 2d Sess. 4 (1938); Comment, Implication of Civil Liability Under the New York Stock Exchange Rules and Listing Agreement, 22 Va.L. Rev. 130, 130 n.2 (1976). Examination of both the language of section 6 and its legislative history, however, does not reveal any congressional intent to create a private right of action for violation of an exchange rule. See Jablon v. Dean Witter & Co., 614 F.2d 677, 680 (9th Cir. 1980).


\textsuperscript{101} See 15 U.S.C. §§ 78o(4), 78s(h) (1976 & Supp. III 1979). Section 78s(h) authorizes the SEC to revoke the registration of the self-regulatory organization, id. § 78s(h)(1), to suspend any member of the self-regulatory organization from participation therein, id. § 78s(h)(2), to suspend any person from being associated with a member of the national securities exchange, id. § 78s(h)(3), and to remove from office or censure any officer or director of the self-regulatory organization, id. § 78s(h)(4). See also 15 U.S.C. § 78u(a)(1976) which, inter alia, authorizes the SEC to "make such investigations as it deems necessary to determine whether any person has violated ... the rules or regulations [of the Securities Exchange Act], the rules of a national securities exchange or registered securities association of which such person is a member ... ."


\textsuperscript{103} See 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1980).
The statutory basis for implied civil liability for breach of the suitability rules is found in sections 6 and 15A of the Exchange Act. These sections prohibit broker conduct inconsistent with “just and equitable principles of trade.” The legislative history of the Exchange Act does not address expressly the issue of whether exchange and broker association rules promulgated pursuant to sections 6 and 15A were intended to be civilly actionable by private litigants. It is unlikely, however, that Congress would have created a federal cause of action on behalf of an apparently limitless class of plaintiffs based on such a general, ill-defined standard of liability. Furthermore, many courts as well as SEC interpretive materials have suggested that the suitability and “know-your-customer” rules of the self-regulatory organizations are to be regarded as “ethical” guidelines, and that the SEC’s suitability rule was

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105 See Baird v. Franklin, 141 F.2d 238, 244 (2d Cir.), cert. denied, 323 U.S. 737 (1944). The argument that Congress could not have intended to create a cause of action in favor of an unlimited class of plaintiffs seems particularly cogent in light of recent Supreme Court decisions which have narrowed plaintiffs’ standing to sue under rule 10b-5, see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), and have raised the standard of culpability in a private action under the rule, see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See notes 125-128 and accompanying text infra. One author, however, has taken the contrary position:

Still, ‘conduct inconsistent with just and equitable principles of trade’ is the exact language adopted by Congress, and though the standard of liability be broad, it is the direct creature of legislative fiat. Further, if under Section 15A(b)(4) of the 1934 Act a broker can be barred from the National Association of Securities Dealers [NASD] for ‘conduct inconsistent with just and equitable principles of trade,’ it would not seem any more drastic to grant a private right of action to an aggrieved investor for a violation of rules embodying this same standard.


106 See SPECIAL STUDY, supra note 1, at 309 (purpose of NASD rules is to supply brokers with “general ethical standard”). Furthermore, in SEC Exch. Act Release No. 9420, Feb. 11, 1972, reprinted in [Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 25,529, the Commission recognized and, for the most part, sanctioned “the standards of conduct and general interpretive principles which have been prescribed by the NASD for its members.” Id.; see Roach, supra note 39, at 1078-79 n.41. The policy statement issued by the NASD clarifying its suitability rule, in turn, speaks generally of “ethical standards” resulting in “disciplinary action.” NASD, Special Report to NASD Members (Oct. 9, 1964), reprinted in 1976 NASD MANUAL (CCH) ¶ 2,152, at 2,051. Several courts in denying a private right of action have agreed also that exchange and broker association rules merely set forth ethical standards and therefore do not sustain a legal remedy in federal court. See, e.g., Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1378 (N.D. Tex. 1976); Jenny v. Shearson, Hammill & Co., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,021, at 97,582 (S.D.N.Y. 1975); Avery v. Moffatt, 187 Misc. 576, 592, 55 N.Y.S.2d 215, 228 (Sup. Ct. N.Y. County 1945). See generally Rediker, supra note 7, at 15-26.
meant to impose only comparable ethical constraints on nonmember broker-dealers.\textsuperscript{107} Indeed, it is arguable that the suitability principle, as embodied in the SEC, NYSE, and NASD rules, may simply be a statement of public policy, merely intended by the Commission and rulemaking boards to articulate and institutionalize the Exchange Act's general philosophy of fair dealing.\textsuperscript{108}

Moreover, it is submitted that a private right of action for suitability violations is barred by section 27 of the Exchange Act.\textsuperscript{109} Specifically, it appears that the drafters of the '34 Act failed to provide for federal subject matter jurisdiction over violations of stock exchange and broker association rules. Section 27 of the Exchange Act vests the federal courts with exclusive jurisdiction of "all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder."\textsuperscript{110} The Seventh Circuit\textsuperscript{111} and several lower federal courts have reasoned that since disciplinary rules must be adopted by the self-regulatory organizations as a precondition to registration with the SEC, "these rules were created by direct command of statute."\textsuperscript{112} Thus, the courts have concluded that the failure of a broker to make suitable investment recommendations is a

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\item \textsuperscript{107} See SEC Exch. Act Release No. 9420 Feb. 11, 1972, reprinted in [Transfer Binder], Fed. Sec. L. Rep. (CCH) \$ 25,592, at 18,578; Roach, supra note 39, at 1078-79 n.41. See generally Phillips & Shipman, An Analysis of the Securities Acts Amendments of 1964, 1964 Duke L.J. 706, 822-28. Thus, a merely ethical duty comparable to that imposed on NASD members, see note 107 and accompanying text supra, would also apply to nonmember broker-dealers subject to regulation under rule 15b10-3. In fact, one court has suggested that the adoption of a suitability rule by the SEC was an attempt to encourage nonmember firms to join a national broker association, where their suitability obligation would be only an ethical one. See Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 95,777 at 90,811 (N.D. Cal. 1976).
\item \textsuperscript{108} See Hoblin, A Stock Broker's Implied Liability to Its Customer for Violation of a Rule of a Registered Stock Exchange, 39 Fordham L. Rev. 253, 279 (1970) ("some of the New York Stock Exchange rules seem to have been used solely as a convenient depository for new ideas").
\item \textsuperscript{110} 15 U.S.C. \$ 78aa (1976).
\end{itemize}
violation of a "duty created by [the Exchange Act]." It is suggested, however, that the only duty created by sections 6 and 15A is the duty of the self-regulatory organization to register with the Commission prior to effecting any transactions in securities. The promulgation and enforcement of suitability rules, on the other hand, are preliminary and independent obligations, violation of which can lead only to administrative sanctions. It is submitted, therefore, that a broker's suitability responsibilities are not equivalent to the duties which can give rise to federal subject matter jurisdiction under the Exchange Act.

The courts and commentators also agree that section 27's grant of federal jurisdiction over violations of "rules and regulations" does not create subject matter jurisdiction over breaches of suitability rules. In Colonial Realty, the Second Circuit found that "rules and regulations" in section 27 include only those rules promulgated by the SEC itself. This conclusion is bolstered by the fact that other sections of the '34 Act specifically refer to rules of stock exchanges, while the language of section 27 omits any

117 358 F.2d at 181-82. In United States v. Bloom, 450 F. Supp. 323 (E.D. Pa. 1978), the court clearly rejected the contention that the NASD was merely an extension of the SEC:

The Court must conclude that the NASD is not part of government . . . . To hold otherwise would be to eliminate a bulwark of our economic regulatory scheme, for there would be no need for a NASD if it were in effect a lower level of the SEC. Although private, it plays an important role in the scheme of securities regulation. It allows the securities industry to keep its own house clean and holds back the seemingly overwhelming tide of government supervision.

118 See, e.g., 15 U.S.C. § 78cc(a) (1976). Section 29 of the Exchange Act provides in pertinent part: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any
such reference. Furthermore, a 1975 amendment to the Exchange Act indicates that although the SEC may “amend” the rules of a self-regulatory organization, such an amendment “shall not be considered to be a rule of the Commission.” It appears, therefore, that the jurisdictional section of the Exchange Act precludes implication of a private right of action for violations of exchange and broker association suitability rules by failing to provide a basis for federal subject matter jurisdiction.

In addition, developments in implied-rights cases under rule 10b-5 indicate that merely negligent misconduct, encompassed

rule of an exchange required thereby shall be void.” Id. (emphasis added).


121 For the same reason that exchange and broker association rules do not qualify as “duties” created by federal law or as rules or regulations thereunder, see notes 110-116 and accompanying text supra, it is submitted that the federal district courts do not have subject matter jurisdiction of suitability claims under 28 U.S.C. § 1331 (1976). Section 1331 vests the district courts with original jurisdiction of civil actions “arising under the Constitution, laws, or treaties of the United States.” 28 U.S.C. § 1331(a) (1976), as amended by Pub. L. No. 96-486, 94 Stat. 2369. Although sections 6 and 19 of the Exchange Act provide that promulgation of disciplinary rules and procedures by self-regulatory bodies is a prerequisite to registration with the SEC, the rulemaking function of the exchanges and associations is an undertaking distinct from their duties to register under federal law. See notes 19-37 and accompanying text supra. In addition, the fact that exchange rules predated the enactment of the federal securities laws, see notes 15-19 and accompanying text supra, lends credence to the proposition that the rules of the self-regulatory organizations are not “federal laws.” Indeed, if direct regulation of broker conduct were desired, the SEC could adopt such rules as Commission rules. See ALI Fed. Sec. Code § 1721 (1980); note 51 supra.

122 Section 10(b), 15 U.S.C. § 78j(b) (1976), of the Securities Exchange Act provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976). Rule 10b-5, promulgated by the SEC pursuant to section 10(b), states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the
THE SUITABILITY RULE

in the suitability concepts of due diligence and reasonableness,\textsuperscript{123} may not properly serve as a basis for private relief. In \textit{Ernst \& Ernst v. Hochfelder},\textsuperscript{124} the Supreme Court held that a private right of action under rule 10b-5 did not lie in the absence of scienter, an intent to deceive, manipulate, or defraud.\textsuperscript{125} It seems, therefore, that implication of a suitability cause of action sounding in negligence would resurrect a basis of liability expressly rejected by the \textit{Hochfelder} Court.\textsuperscript{126} Furthermore, a negligence cause of action

circumstances under which they were made, not misleading or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5 (1980).
\textsuperscript{123} See notes 68-69 and accompanying text supra.
\textsuperscript{124} 425 U.S. 185 (1976). In \textit{Hochfelder}, the plaintiffs had been induced by the president of an investment firm to invest in nonexistent "escrow accounts." \textit{Id.} at 189. In bringing suit under rule 10b-5, the plaintiffs alleged that the defendant accounting firm had aided the president by negligently failing to conduct proper audits. \textit{Id.} at 190.
\textsuperscript{125} \textit{Id.} at 193. Prior to the \textit{Hochfelder} decision, the circuit courts of appeals were in conflict as to whether negligence was sufficient to support a 10b-5 claim. \textit{Compare} White v. Abrams, 495 F.2d 724, 734-35 (9th Cir. 1974) \textit{with} Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir.), \textit{c}ert. \textit{d}enied, 414 U.S. 910 (1973), \textit{reh}.-\textit{d}enied, 430 U.S. 976 (1977). In rendering its decision, the \textit{Hochfelder} Court considered the statutory history of rule 10b-5 as well as the legislative history of section 10(b). 425 U.S. at 196-206. Relying on a Senate report which stated that "[t]he defendant may escape liability by showing that the statement was made in good faith," \textit{id.} at 206 (quoting S. REP. No. 792, 73d Cong., 2d Sess. 12-13 (1934) (emphasis supplied by the Court)), the \textit{Hochfelder} Court concluded that the term "manipulate" as used in the statute "connotes intentional or willful conduct, designed to deceive or defraud investors." 425 U.S. at 199. The Court expressly declined to rule, however, on whether reckless conduct in some instances may be sufficient to sustain civil liability under 10b-5. \textit{Id.} at 194 n.12.
\textsuperscript{126} \textit{See} \textit{Zagari v. Dean Witter \& Co., [1976-1977 Transfer Binder]} FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,812 (N.D. Cal. 1976). In \textit{Zagari}, the court disallowed a private right of action under Rule 411 of the American Stock Exchange (AMEX), which states in pertinent part: "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 R.411, \textit{reprinted in} [1978] 2 Am. Stock Ex. GUDE (CCH) ¶ 9,431, at 2,647. The district judge reasoned that an implied right of action under the AMEX know-your-customer rule would permit many types of negligent conduct no longer actionable under rule 10b-5 to become cognizable in federal court. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,812. Furthermore, the court stated, "there [is] no need to imply a private right of action for violations of [rule 411] since such [fraudulent conduct] [is] actionable under rule 10b-5 itself." \textit{Id.} Additionally, the \textit{Zagari} court suggested that an implied right of action under the exchange rule would circumvent the "purchase or sale" requirement of rule 10b-5, \textit{id.; see} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); that "garden variety" customer-broker complaints would, through implied liability, gain standing in federal courts, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,812; and that implied liability would deprive state courts of the opportunity to adjudicate customer-broker cases, undermine the availability of exchange arbitration as a remedy,
based on suitability rules would permit plaintiffs to circumvent the strict procedural limitations which accompany other negligence-based remedies in the Exchange Act.\(^{127}\) Therefore, in order to maintain the integrity of the rule 10b-5 action and consistency within the overall legislative scheme, claims based on unsuitable broker recommendations should not be cognizable in the absence of more culpable conduct.

In view of the fact that courts addressing the issue have seemingly imposed a fraud standard for broker liability,\(^{128}\) it is submitted that fraudulent suitability violations, committed with scienter, are redressable in federal court under rule 10b-5. Since an established remedy for fraud exists, therefore, a separate cause of action under stock exchange or broker association rules is superfluous.\(^{129}\)

It seems that a plaintiff claiming a willful or reckless disregard of the suitability rules could successfully satisfy the elements of the 10b-5 action in order to establish broker liability. A plaintiff suing under rule 10b-5 claiming unsuitable investment recommendations would have to allege that the defendant either willfully or with reckless disregard for the truth, misrepresented or omitted to state a material fact in connection with the purchase or sale of a


A fact is deemed material if a reasonable person would attach importance to it in arriving at his investment decision. Since the broker normally stands in a relation of expertise vis-a-vis the average investor, it is likely that a customer will attach importance to his broker's investment recommendations, thereby satisfying the materiality element. The 10b-5 plaintiff must also establish that he justifiably relied on his broker's misrepresentations or omissions. In essence, the investor must prove that the defendant's advice was a "substantial factor" in determining the course of conduct which resulted in his loss or, in the case of an omission, that he "would have been influenced to act differently" if all material information had been revealed to him. Since the gravamen of a suitability claim is that the customer has incurred injury as a result of transactions effected in reliance on his broker's investment recommendations, it is submitted that the reliance requirement will almost inevitably be met. Next, it must be established that the defendant's misstatements or omissions were made.

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133 See Geyer v. Paine, Webber, Jackson & Curtis, Inc., 389 F. Supp. 678 (D. Wyo. 1975). In Geyer, the plaintiff investors were induced to purchase almost $95,000 worth of securities based on their broker's representation that such was the minimum amount they could procure. Id. at 680. In reality, the securities were available in face amounts of $25,000. Id. The court noted that the "plaintiffs reposed particular trust and confidence" in the broker's recommendations. Id.
134 See Myzel v. Fields, 386 F.2d 718, 735-37 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968). The reliance element of the 10b-5 cause of action is addressed to the issue of causation in the sense that "the defendant's wrong must have been the cause of the plaintiff's harm." Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976), cert. denied, 430 U.S. 1035 (1978).
135 Weitzman v. Stein, 436 F. Supp. 895, 904 (S.D.N.Y. 1977). A customer's reliance on his broker's suitability judgments may vary, of course, depending upon whether the account is discretionary or nondiscretionary. When an investor opens a discretionary account, he relinquishes complete control of the account to his broker. Naturally, in this instance, the investor has placed complete reliance on the broker's expertise and ability to make suitable and appropriate investment decisions. See Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 432 (N.D. Cal. 1968), modified, 430 F.2d 1202 (4th Cir. 1970). Where a nondiscretionary account is involved, however, the investor retains ultimate control over the decisions affecting his portfolio. See Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1069-70 (2d Cir. 1977), cert. denied, 434 U.S. 1035 (1978).
“in connection with the purchase or sale” of a security. Accord-
ing to the language of the suitability rules, a broker’s suitability obligations attach only to recommendations to purchase, sell, or exchange any security. The situation appears unforeseeable, therefore, in which a suitability action would not arise “in connection with” a purchase or sale. Finally, the plaintiff in a 10b-5 action must prove that damage has resulted from the defendant’s fraudulent behavior. In suitability cases, while the measure of damages presents a complex issue, the fact of damage itself is usually not in dispute. Thus, in the event that broker misconduct rises to the level of scienter or reckless disregard, it is submitted that the plaintiff-investor could successfully meet the elements of the 10b-5 cause of action.

CONCLUSION

In view of the recent Supreme Court pronouncements addressing the private right of action issue, it has become apparent that the suitability claim will be deemed appropriate only where the judiciary has discerned a clear legislative intent to create an implied private right. The legislative history surrounding the promulgation of the suitability rules, however, does not reveal an intent to create civil liability but, rather, discloses a scheme designed to es-

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138 See notes 2-8 and accompanying text supra.
139 The mere fact that a suitability rule violation may give rise to a rule 10b-5 cause of action, does not mean that a plaintiff would be likely to recover on the merits. Since rule 10b-5 is clearly a fraud-oriented provision, any degree of broker negligence, whether it be “gross, grave or inexcusable-cannot serve as substitute for scienter.” McLean v. Alexander, 599 F.2d 1190, 1198 (3d Cir. 1979). It is a rare instance where the broker conduct alleged in a suitability claim does, in fact, rise to the level of actual fraud.
ablish ethical standards of broker conduct. Moreover, the absence of legislative intent is not the sole factor militating against implication of the suitability action. This Note has asserted that the But- trey "Protection Theory," upon which some courts have relied as a basis for implication, does not conform with the standard enunciated in Cort v. Ash, and, thus, is inadequate. Additionally, the Hochfelder Court's refusal to premise rule 10b-5 liability upon merely negligent conduct stands as some indication that a greater standard of culpability would likewise be required in a suitability claim. Furthermore, since fraudulent conduct in the purchase or sale of a security is cognizable independently under rule 10b-5, fraudulent suitability violations, committed with scienter, are redressable under existing antifraud remedies. The need for implying a right of action under NASD, NYSE, or SEC Rules, therefore, has been obviated. Finally, the propriety of federal subject matter jurisdiction under section 27 of the Exchange Act has been questioned and rejected. Thus, "[t]he federal securities laws [were not intended as] a panacea for all losses suffered on the stock market upon [the] recommendation of brokers." It has been submitted, however, that while negligence is insufficient to support a claim for implied federal liability, an ethical breach of suitability duties may be relevant evidence in a common-law negligence, breach of fiduciary duty, or breach of contract action. In light of these considerations, therefore, it appears that if the Supreme Court were to view the suitability issue today, the trend toward limitation of implied remedies would be continued.

Kathy Connelly