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A STOCK BROKER'S IMPLIED LIABILITY TO ITS CUSTOMER FOR VIOLATION OF A RULE OF A REGISTERED STOCK EXCHANGE

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I. Introduction

THE last decade, which was ushered in by the Special Study of the Securities Markets,[1] has seen a significant increase in the number of law suits alleging broker violations of the Securities Act of 1933[2] and the Securities Exchange Act of 1934,[3] under theories of express and implied liability. The concept of implied liability has been gradually developing, expanding from implied liability for a violation of a federal statute,[4] to implied liability for violation of a rule adopted by a national securities exchange. This concept could well have a profound effect on Exchange members.

This article will consider one aspect of implied liability for violation of a New York Stock Exchange[5] rule; specifically, that of the customer and his broker. There are other relationships which will not be reviewed, such as those between two listed companies, between a broker and a listed company and between a listed company and a customer of the

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1. Special Study of Securities Markets of the Securities & Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as Special Study].

2. Securities Act of 1933, 15 U.S.C. 77a to 77bb (1964), as amended 15 U.S.C. (Supp. V, 1970).

3. Securities Exchange Act of 1934, 15 U.S.C. 78a to 78hh-1 (1964), as amended 15 U.S.C. (Supp. V, 1970) [hereinafter cited as Securities Exchange Act].

4. There are a series of cases affirming implied liability for a violation of a rule adopted under the Securities Exchange Act. See J.I. Case Co. v. Borak, 377 U.S. 426 (1964); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965); Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 303 F.2d 527 (10th Cir. 1962) (by implication); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

5. The term Exchange which is used throughout this article refers to the New York Stock Exchange (NYSE); however, the principles involved would apply equally to any Exchange registered under section 6 of the Securities Exchange Act, note 6 infra. This article is not directed toward the question of implied liability for a violation of a rule of the National Association of Securities Dealers (NASD). However, to a great extent the principles involved are the same, and many of the cases on this subject are concerned with claims for a violation of both NYSE and NASD rules.

broker. Nor will this article treat the express and implied liabilities created by the federal statutes.

The article is organized into four sections, the first briefly considering the statutory basis for the theory of implied liability; the second, the major cases decided in the area of implied liability of a broker to his customer for violating an Exchange rule; the third, a critique; and the fourth, a section suggesting the considerations which the New York Stock Exchange and the Exchange community should give to the development of the law in this area.

II. Statutory Basis

There are two pertinent sections of the Securities Exchange Act, namely, section 6(b):

> No registration shall be granted or remain in force unless the rules of the exchange include provisions for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade,[6]

and section 27:

> The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder . . . .[7]

The question presented is whether or not section 6 creates an implied liability for a rule adopted by an Exchange registered under this section. If the Exchange has an implied liability, does a broker who is a member of the Exchange have a similar liability? Assuming that this implied liability exists, is the Exchange rule to be interpreted as a "rule and regulation" contemplated by section 27? If the answer is affirmative, then the federal courts would have exclusive jurisdiction in actions for a violation of an Exchange rule, to the exclusion of the state courts and arbitration forums.

The objection to imposing liability under section 27 is the argument that this section does not specifically state that Exchange rules adopted under section 6 would come within the provisions of section 27—as for example in section 29,[8] where Congress intended that Exchange rules be included and it was specifically so stated. The counter argument is that section 27 gives the federal courts power "to enforce any liability or

6. Securities Exchange Act § 6(b), 15 U.S.C. § 78f(b) (1964).
7. Securities Exchange Act § 27, 15 U.S.C. § 78aa (1964).
8. Securities Exchange Act § 29, 15 U.S.C. § 78cc (1964).

duty" under the Securities Exchange Act. Consequently, if section 6 imposes a liability under the Securities Exchange Act, then section 27 gives the federal courts exclusive jurisdiction.

III. Case Law

The first case to consider implied liability for a violation of New York Stock Exchange rules was *Baird v. Franklin*,[9] an action which was an outgrowth of the "Whitney scandal" of 1937. Richard Whitney was a senior partner of Richard Whitney and Co., a member firm of the New York Stock Exchange, and had at one time been president of the Exchange.[10] In 1937 his firm was entrusted with the responsibility for investment of the assets of the Gratuity Fund.[11] He also was broker for a Mary Stevens Baird and Treasurer of the New York Yacht Club, the two plaintiffs in the action. Whitney illegally converted the securities of the plaintiffs and of the Gratuity Fund by hypothecating them for his own benefit. The New York Stock Exchange discovered Whitney's defalcations on November 24, 1937.[12] The plaintiffs and the Gratuity Fund sustained losses due to these conversions (although the Gratuity Fund was made whole by Richard Whitney's brother George). The plaintiffs brought this action against the New York Stock Exchange under the theory that the Exchange had a duty under section 6(b) to take disciplinary action against Whitney, which it had failed to do. Upholding the decision of the United States District Court[13] in dismissing the action, the majority of the Court of Appeals for the Second Circuit held that the Exchange's failure to discipline Whitney was not a proximate cause of their losses as the Exchange did not become aware of Whitney's actions until after the losses had been sustained, although the court in dictum found that "the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937 . . . ."[14]

9. 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944).

10. NYSE Const. art. III, § 3, 2 CCH NYSE Guide ¶ 1251 (1970) provides for the election of a full-time, salaried president of the NYSE, who is not a regular or allied member of the Exchange. This provision is an outgrowth of the Whitney matter of 1938. See 2 L. Loss, Securities Regulation 1181-82 (2d ed. 1961).

11. The Gratuity Fund is a sum of money set aside for the payment of a death benefit (currently $20,000) to the widow of any regular member (floor partner) who dies prior to retirement. NYSE Const. art. XVI, § 3, 2 CCH NYSE Guide ¶ 1753 (1970).

12. November 24th was a critical date in the decision, as the court determined that the plaintiffs had already been damaged prior to the discovery by the Exchange; consequently the failure of the Exchange to act was not a proximate cause of the plaintiff's loss. 141 F.2d at 239.

13. Civ. Doc. No. 7-354 (S.D.N.Y., Nov. 30, 1942).

14. 141 F.2d at 239.

It is interesting to note that it was the opinion of Judge Clark, who dissented in part, which is quoted in support of the theory of implied liability. As Judge Clark stated: "There can be no doubt that § 6(b) places a duty upon the Stock Exchange to enforce the rules and regulations prescribed by that section . . . . Our considered opinion is that the Act itself grants the right of action; hence it is unnecessary to consider the narrower contract problem."[15]

This was a rather tenuous beginning for such an expansive theory of law in that the minority opinion of the court, even if representing the majority thinking, constituted dictum in view of the factual determination. Nevertheless, the current theories of implied liability spring from the *Baird* case. There was still one important question to be answered by the judiciary; although Whitney individually was *not* named as a defendant in the *Baird* action,[16] did the cause of action under section 6(b) extend to the Exchange member? Could Whitney or his firm, Whitney & Co., have been held liable under section 6(b)?

Before they were presented with this problem, the courts had another opportunity to evaluate the New York Stock Exchange's position in the regulatory scheme of the Securities Exchange Act in the case of *Silver v. New York Stock Exchange*.[17] The plaintiff in *Silver* was a Texas broker who was registered with the National Association of Securities Dealers, but was not a member of the New York Stock Exchange. According to the custom of the trade in 1958 Silver, through his company, Municipal Securities Co., obtained direct private telephone wire connections to securities firms who were members of the New York Stock Exchange. This afforded Silver "live" quotations and gave him direct access to the trading desks of the member firms. In accordance with Exchange rules then in effect, the member firms filed for approval of these connections. However, in this instance, approval was denied without the Exchange offering an explanation to the firms or to Silver, although Silver requested both an explanation and a hearing. Silver thereupon brought an action asserting that the Exchange's action was in violation of section 1 of the Sherman Act.[18] The United States District Court[19] granted plaintiff's

15. Id. at 244 (Clark, J., dissenting in part).

16. The opinion of the court does not indicate the reason. It has been argued that he was omitted because any action against him would not prove fruitful due to his insolvency. From a litigant's standpoint, this argument does not seem meritorious, as actually it would appear that bringing all the defendants together in the same action avoids the possibility that the defendants named will point to the unnamed defendant as the true wrongdoer.

17. 373 U.S. 341 (1963) (Stewart and Harlan, JJ., dissenting).

18. Sherman Antitrust Act § 1, 15 U.S.C. § 1 (1964). Silver contended that the refusal of the Exchange to permit its members to deal with non-members constituted discriminatory trade practices in violation of the Sherman Act.

19. 196 F. Supp. 209 (S.D.N.Y. 1961).

motion for summary judgment, but the Court of Appeals for the Second Circuit[20] reversed, holding that the Exchange was not subject to the antitrust restrictions of the Sherman Act even if it had acted arbitrarily. The court of appeals relied on the *Baird* case, fully accepting the concept that section 6(b) imposes a duty on the Exchange.[21] However, the United States Supreme Court took the opposite view that there was no per se exemption available to the New York Stock Exchange under the Securities Exchange Act. "Our decision today recognizes that the action here taken by the Exchange would clearly be in violation of the Sherman Act unless justified by reference to the purposes of the Securities Exchange Act, and holds that that statute affords no justification for anticompetitive collective action taken without according fair procedures."[22]

The *Silver* case posed a dilemma for the New York Stock Exchange. On the one hand it was faced with the threat of antitrust action concerning many of its rules. Its defense, on the other hand, was the Securities Exchange Act; its argument simply was that the Exchange is regulated under the Securities Exchange Act by the SEC, which thus confers antitrust immunity, and that it had to comply with the requirements of section 6 since its failure to do so would expose it to liability. The Court readily affirmed that the New York Stock Exchange is regulated and has a section 6 obligation. The Court affirmed this duty but it nevertheless denied that there existed an automatic per se exemption from the antitrust laws, and stated further that this exemption would clearly not exist if the Exchange acted arbitrarily or capriciously outside the scope of the statute.

> Yet it is only frank to acknowledge that the absence of power in the Commission to review particular exchange exercises of self-regulation does create problems for the Exchange. The entire public policy of self-regulation, beginning with the idea that the Exchange may set up barriers to membership, contemplates that the Exchange will engage in restraints of trade which might well be unreasonable absent sanction by the Securities Exchange Act. Without the oversight of the Commission to elaborate from time to time on the propriety of various acts of self-regulation, the Exchange is left without guidance and without warning as to what regulative action would be viewed as excessive by an antitrust court possessing power to proceed . . . . But, under the aegis of the rule of reason, traditional antitrust concepts are flexible enough to permit the Exchange sufficient breathing space within which to carry out the mandate of the Securities Exchange Act.[23]

20. 302 F.2d 714 (2d Cir. 1962), rev'd, 373 U.S. 341 (1963).

21. Id. at 719-20.

22. 373 U.S. at 364. Although the Court held that there was no per se antitrust exemption available to the New York Stock Exchange under the Securities Exchange Act, it did not rule out an exemption under certain circumstances. Id. at 360-61.

23. Id. at 360. This proved to be a case which should not have been pursued. It placed before the Court the very significant question of the Exchange's "antitrust exemption" with a poor set of facts. A firm was effectively put out of business by the action of a non-governmental agency and denied not only a hearing but even an explanation. It would

Although the thrust of the *Silver* case was the non-availability of an antitrust exemption to the New York Stock Exchange, a side effect was the apparent affirmation of the doctrine that the Exchange has a duty imposed on it by the Securities Exchange Act and by inference could be liable for failure to perform this duty. The question that was still unanswered was whether this duty under section 6(b) would be extended to an Exchange member so that a customer would have an implied right of action against his broker for a violation of an Exchange rule. The first case to consider this question was *Colonial Realty Corp. v. Bache & Co.*[24]

The *Colonial* case grew out of the market "crash" of 1962. Colonial Realty was a closely held corporation controlled by a Philadelphia attorney, Milton Selig, and was a very large active trading vehicle. In May of 1962 its portfolio had a value of approximately \$26,000,000—\$30,000,000 against a debit balance of approximately \$18,000,000. Beginning on May 29, 1962 and ending on June 27, 1962, Bache liquidated the Colonial account over the objections of Selig. Bache asserted that it had the right to do so based upon the provisions of a signed margin agreement. Selig countered that the liquidation was in violation of an understanding between the parties that no liquidation would be required or call made over and above New York Stock Exchange requirements. He contended, therefore, that Bache's breach of this understanding was contrary to rule 401[25] of the New York Stock Exchange, the so-called "just and equitable principles of trade" rule. Bache contended no such agreement existed and relied upon the aforesaid written agreement permitting a call by Bache above the Exchange minimum.[26]

appear from the record that the Exchange had what it considered valid reasons, but was concerned with the possibility of slander and libel if it disclosed the information. Perhaps this was an example of the old adage of "difficult cases make bad law." It is also interesting to note that after the case the Exchange abolished the requirement that they approve connections. Instead of requiring approval, it reserved the right to discontinue any wire connection. NYSE rule 359, 2 CCH NYSE Guide ¶ 2359 (1970). Rule 359 has recently been amended by MF Circular No. 305 (July 17, 1970) which has not yet been published.

24. 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966).

25. Rule 401 provides: "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." NYSE rule 401, 2 CCH NYSE Guide ¶ 2401 (1970). Compare the similarity of this rule to section 6(b) of the Securities Exchange Act which is contained in the accompanying text. The plaintiff in the Colonial case contended that rule 401 was adopted to comply with section 6(b). 358 F.2d at 180.

26. The margin agreement itself was challenged by Selig, who asserted that it did not apply to the account in question but rather to another account. The district court held that the agreement was binding, the effect of which was to require arbitration of this dispute in accordance with one of the provisions of the agreement. Absent a federal question under section 27 of the Securities Exchange Act, arbitration could be compelled.

It was the plaintiff's contention that Bache had a duty under section 6(b) of the Securities Exchange Act to handle its account in such a way as would be consistent with "just and equitable principles of trade" under rule 401, since that rule was adopted by the New York Stock Exchange in accordance with section 6(b). The plaintiff argued, moreover, that in view of section 27, its claim should be heard by a federal court rather than an arbitration forum. The United States District Court[27] disagreed: "Sections 6(b) and 15A of the Act, however, do not explicitly impose duties upon brokers, but rather require securities exchanges and national securities associations registered under the Act, respectively, to promulgate rules requiring their members to abide by 'fair and equitable principles of trade.' "[28] The court further stated: "[T]his court is convinced that Congress did not intend, indirectly, to create a cause of action under the Exchange Act on behalf of a customer against his broker on account of transactions 'not consistent with fair and equitable principles of trade.' "[29] The court dismissed the complaint involving rule 401 and stayed the proceeding pending arbitration.

See Wilko v. Swan, 346 U.S. 427 (1953); Reader v. Hirsch & Co., 197 F. Supp. 111 (S.D.N.Y. 1961). It appears that the purpose behind the assertion of a rule 401 violation and the argument that a violation of this rule creates a cause of action under the Securities Exchange Act was to avoid arbitration. When the case was decided by an arbitration panel, Bache prevailed.

It appears that Colonial's account was above the Exchange's minimum maintainance requirements. Accepting Colonial's figures as correct ($26 million stock value and $18 million debit), as a general rule, no call would be required under Exchange rules until the market value dropped to $24 million. See NYSE rules 430-33, 2 CCH NYSE Guide ¶¶ 2430-33 (1970). Generally, "House" rules are at 30% or higher. At 30%, the Colonial account was on the border line at $26 million ($2 million above house call). However, this account, according to the record, was heavy in puts and calls (which have different requirements), so that it is difficult to exactly determine the position from the record. Under the agreement, Bache had the right to require additional margin. A trading account such as Colonial is highly leveraged, and in a falling market large leveraged accounts are carefully scrutinized. A call for additional margin in a leveraged account is tantamount to forcing a liquidation, as the client's liquid assets are in the account. This would appear to be the crux of Selig's complaint. In addition, in a falling market the put side is exposed and it is difficult to hedge, thereby creating open-end liability for the put. (A sale of a put at a given price gives the buyer of the put the right to require the seller to purchase at a given price within a specified time period).

27. Colonial Realty Corp. v. Bache & Co., [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,351 (S.D.N.Y. 1964).

28. [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500. The court also decided that NASD rules were also non-actionable. Id. at 94,500-01. Hence, the reference to section 15A which requires the registration of a national securities association, i.e., the NASD. Securities Exchange Act § 15A, 15 U.S.C. § 78o-3 (1964).

29. [1961-1964 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,351, at 94,500.

The ruling of the district court in the *Colonial* case was criticized in a law review article by one commentator,[30] who wrote in part:

Where the SEC has the power of life and death over the rules of an exchange and where, presumably in deference to the policy of encouraging exchange self-regulation, the SEC forbears from adopting its own rules because exchange rules have already preempted the field, it seems only reasonable to conclude that these exchange rules afford private investors the same rights they would possess had the SEC promulgated rules identical to those adopted by the exchange.[31]

This commentator also asserted that certain Exchange rules should be actionable per se, as they effectively took the place of or were adopted in lieu of a federal statute. However, his theory became much more expansive: "Simply stated, exchange rules which are promulgated for the direct protection of the investing public should give rise to private actions against an exchange and other private parties . . . ."[32] This is in effect an argument for a theory of third party beneficiary; that is, if the public is intended to benefit from the rule, they should have an implied right of action if a rule designed for their benefit is violated.

What better case could there have been for the court to adopt the "public benefit" theory? Clearly rule 401 could only have been adopted for the benefit of the public and for no other purposes. The court of appeals had an opportunity to consider this theory and the entire concept of implied liability. Four considerations were discussed by the court in *Colonial.*

First, did the *Baird* case impose liability per se on the broker? The court answered in the negative:

Although we agree that a federal claim against the member firm existed in *Baird* since the misconduct charge was a violation of the statute itself . . . this does not establish that implication of a private right of action against an exchange for culpable failure to enforce its rules necessarily calls for recognizing a similar right against an individual broker who is claimed to have violated them.[33]

Having dealt with *Baird,* the court next considered section 27 of the Securities Exchange Act. Because Congress omitted to specifically mention Exchange rules, did that mean that it did not intend that these rules be actionable in a federal court? The court felt that this was not necessarily the case:

30. Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules, 66 Colum. L. Rev. 12 (1966) [hereinafter cited as Lowenfels, Implied Liabilities]. Lowenfels refers to the NYSE preempting the SEC, which appears to be incorrect, since the SEC cannot be preempted by a self-regulatory agency. Id. at 18.

31. Id. at 18.

32. Id. at 24-25.

33. 358 F.2d at 181.

That Congress did not intend violations of all rules adopted under § 6(b) to give rise to civil claims under federal law is somewhat indicated by the explicit reliance in the section on the disciplinary function of the exchanges to provide protection for the investing public . . . . Basis for an even broader negation can arguably be found in the absence of any reference to exchange rules in the grant of federal jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder," Securities Exchange Act § 27, in contrast to the explicit reference to exchange rules in § 29(a)—although acceptance of this argument would not foreclose a contention that there might still be a federal claim of which district courts would have concurrent jurisdiction under 28 U.S.C. §§ 1331 or 1337.[34]

On the question of federal jurisdiction, the court continued:

On the other hand, we cannot ignore 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*. Not content with insisting upon Commission approval of exchange rules as a prerequisite to registration under §§ 6 and 15A, Congress authorized the agency to request modification of particular rules or to promulgate superseding regulations on its own, § 19. A particular stock exchange rule could thus play an integral part in SEC regulation notwithstanding the Commission's decision to take a back-seat role in its promulgation and enforcement, and we would not wish to say that such a rule could not provide the basis for implying a private right of action.[35]

In the *Colonial* case the court determined that the breakpoint for determining federal jurisdiction is whether or not the rule is a substitute for a federal statute. The court next considered what guidelines were to be followed. The court stated the test in the following terms:

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined *on the simplistic all-or-nothing basis urged by the two parties*; rather, the 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.[36]

The court, although aware of the public benefit theory, declined to apply it in *Colonial*.[37] In effect, the court rejected the public benefit theory for an SEC substitution concept.

34. Id. at 181-82 (citations omitted).

35. Id. at 182 (emphasis added and footnote omitted).

36. Id. (emphasis added). Note that the court of appeals also equates Exchange and NASD rules when considering implied liability.

37. Lowenfels, Implied Liabilities, supra note 30, was completed prior to the Colonial decision. However, that writer had an opportunity to comment in a subsequent article, Lowenfels, Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules, 51 Cornell L.Q. 633 (1966) [hereinafter cited as Lowenfels, Private Enforcement]. Lowenfels analyzed the Colonial decision, stating in part: "The

The court found against Colonial under rule 401. In so holding, it was pointed out that were it to decide otherwise, an aggrieved investor would saddle the federal courts with "garden-variety customer-broker suits."[38] As stated above, if a violation of an Exchange rule is a per se violation of the Securities Exchange Act, the federal courts under section 27 would have exclusive jurisdiction, thereby eliminating arbitration.[39] The court

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court appears to have left this problem to be resolved in the future on a case-by-case basis depending upon burden of proof, with the burden being the lightest where the rule at issue imposes a specific duty unknown to the common law." Id. at 650. Later in this article Lowenfels stated: "When the standard set out by the Court of Appeals in Colonial Realty is applied to the specific scheme of NASD regulation, the most fruitful approach appears to be to sustain private actions based upon certain NASD rules and not to sustain such actions based upon other NASD rules. In other words, the NASD rules which are promulgated for the direct protection of the investing public should engender private actions, while the NASD rules which are promulgated merely as 'housekeeping' devices . . . should not engender such actions." Id. (emphasis omitted). This was a restatement of the theory that Lowenfels had proposed in his first article.

The court of appeals was aware of Lowenfels, Implied Liabilities, and in fact cited to it in concluding that a cause of action should exist where the SEC terminated a rule making procedure because the Exchange had adopted a rule of its own. 358 F.2d at 182 n.4. As stated in the body of this article, rule 401 is exactly the kind of rule—one which was adopted solely for the public's benefit—which the court could have found to be the basis for a cause of action for implied liability.

An interpretation contrary to Lowenfels was reached by another commentator. Shipman, Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements, 17 W. Res. L. Rev. 925 (1966). This commentator concluded that Exchange rules would only be actionable if they were in substitution for an SEC rule and he suggested an interesting test for determining when an Exchange rule was, in effect, a substitute for an SEC rule. Shipman suggested that an Exchange rule would be a substitute for an SEC rule where there existed, "(1) a Commission rule expressely exempting persons from its requirements on the basis of self-regulatory requirements found adequate by the Commission, or (2) a Commission rule limited to non members or unlisted companies and imposing requirements similar to those imposed by the self-regulators." Id. at 1007 (footnote omitted). This appears to be the most precise and workable test yet proposed to cope with what the court called a "thorny problem." As is true with most tests, it is not without problems which will be reviewed in the Critique to this article.

It is interesting to note that Lowenfels and Shipman also disagree as to the relationship of the court of appeals and district court decisions in Colonial. Compare Lowenfels' statement that "Judge Friendly's opinion, however, virtually reversed Judge Croake's holding," Lowenfels, Private Enforcement 649, with Shipman's statement that "[t]he Second Circuit affirmed the district court's holdings and, to a considerable extent, agreed with its reasoning." Shipman, supra at 997 (footnote omitted). See also Allen, Liability Under the Securities Exchange Act for Violations of Stock Exchange Rules, 25 Bus. Law. 1493 (1970).

38. 358 F.2d at 183.

39. See Wilko v. Swan, 346 U.S. 427 (1953) (decided under the Securities Act of 1933; however, the wording as to exclusive jurisdiction is similar in both the Securities Act of

decided that Congress never intended to view Exchange rules in the same light as rules under the Securities Exchange Act.

The next case that developed under the theory of implied liability was *Mercury Investment Co. v. A.G. Edwards & Sons*,[40] which involved the NASD's so-called suitability rule.[41] The plaintiff, a customer of A.G. Edwards, brought this action urging that since the suitability rule was unknown at common law, then under the *Colonial* doctrine it was actionable.[42] The court stated that the plaintiff failed "to recognize that initially *Colonial* requires the Court to determine if the N.A.S.D. rule is consistent with the federal regulatory scheme."[43] The court then cited *Hecht v. Harris, Upham & Co.*,[44] pointing out the danger in attempting to determine what was or was not suitable. The *Mercury* court held that "a violation of this N.A.S.D. rule *per se* does not give rise to federal civil liability under the Securities Act."[45]

The most recent case to be decided was *Buttrey v. Merrill Lynch*,

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1933 and the Securities Exchange Act). See also Reader v. Hirsch & Co., 197 F. Supp. 111 (S.D.N.Y. 1961).

40. 295 F. Supp. 1160 (S.D. Tex. 1969).

41. NASD Rules of Fair Practice art. III, § 2, NASD Manual ¶ 2152 (1970) provides: "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." See also SEC Securities Exchange Act Release No. 34-8135 (effective Oct. 2, 1967), [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,459 (1967).

42. It is interesting to note that the court in its decision pointed out that the only case cited was Colonial, and it was cited by both parties. 295 F. Supp. at 1162.

43. Id. at 1162-63 (footnote omitted).

44. 283 F. Supp. 417 (N.D. Cal. 1968), modified, 430 F.2d 1202 (9th Cir. 1970). The court of appeals referred to the suitability argument but did not decide the question, as it affirmed the district court's estoppel holding. The language in the Hecht case is interesting from the standpoint of how Colonial was interpreted, i.e., whether any concept of public benefit was being encouraged by the courts. The court in Hecht cited the Colonial court of appeals decision for the proposition that "although there may be implied civil liability on the part of a broker under the Securities Exchange Act for violations of certain kinds of exchange or dealer association rules, (e.g., rules which merely amount to a substitute for regulation by the S.E.C. itself), no implied civil liability may be predicated on rules which give power to discipline members for certain kinds of misconduct, including merely unethical behavior, which Congress could well not have intended to give rise to a legal claim, e.g., conduct which, although unethical under the association or exchange rules, does not amount to a fraud within the meaning of the fraud provisions of the Act itself." 283 F. Supp. at 431 (citation omitted). The Hecht decision clearly did not propose a public benefit theory; in fact, it viewed an unethical act as nonactionable unless it was also a fraud under the statute.

45. 295 F. Supp. at 1163.

Pierce, Fenner & Smith, Inc.[46] The plaintiff in this action was the trustee in bankruptcy for Dobich Securities Corporation, a customer of Merrill Lynch. His claim set forth six causes of action, the first alleging a violation of rule 405,[47] the second, third, fourth and fifth causes alleging violations of various state and federal securties laws, and the sixth alleging a violation of Regulation "T".[48] The plaintiff claimed that Michael Dobich, an Indiana broker-dealer, maintained an account at the Indianapolis office of Merrill Lynch in his individual capacity and through a sole proprietorship known as Dobich Securities. Due to his financial instability, he incorporated as Dobich Securities Corporation on October 23, 1963. In December of 1963 Dobich Securities opened a cash account at Merrill Lynch. It was acting as a broker-dealer on behalf of its clients in the

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46. 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969). There have been other cases involving implied liability, but not between the broker and his customer. See O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) (court denied that a cause of action existed against a listed company for the violation of an Exchange rule); Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963) (court upheld a section 6 liability against the American Stock Exchange in an action by a trustee in bankruptcy of a company listed on that Exchange). See also Butterman v. Walston & Co., 387 F.2d 822 (7th Cir. 1967), cert. denied, 391 U.S. 913, rehearing denied, 392 U.S. 947 (1968); Kroese v. NYSE, 227 F. Supp. 519 (S.D.N.Y. 1964).

47. NYSE rule 405, 2 CCH NYSE Guide ¶ 2405 (1970). It appears that only the body of this rule was alleged to have been violated and not the "supplementary material." The rule read, in part, at the time of the Buttrey case:

"Rule 405. Every member organization is required through a general partner or an officer who is a holder of voting stock to

(1) 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.

Supervision of Accounts

(2) Supervise diligently all accounts handled by registered representatives of the organization.

Approval of Accounts

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization."

Subsequent amendments to rule 405 would not have affected the Buttrey decision.

48. 12 C.F.R. § 220 (1970).

purchase and sale of securities.[49] The trustee claimed that Merrill Lynch knew that Dobich was insolvent, that he had passed non-sufficient-funds checks and that they had made no check on Dobich's credit or filing with the SEC.[50] It was further alleged that Merrill Lynch knew that Dobich had fraudulently converted its customers' funds since checks from customers payable to Dobich were endorsed to Merrill Lynch.[51] Certain of these checks were earmarked to purchase securities but were "diverted" by Michael Dobich and were tendered to and accepted by the defendant.[52] The allegation continued that Dobich effectively used the trading account as a trading vehicle and lost a considerable amount of money.

The plaintiff, in his first cause of action, asserted that Merrill Lynch's behavior constituted a violation of rule 405 and a per se violation of section 6 of the Securities Exchange Act. Plaintiff moved in the United States District Court for summary judgment on the first five causes of action. Judgment was denied as to the first three causes of action and granted as to the fifth, with the fourth being voluntarily dismissed. The denial of summary judgment for the first cause of action and its connection with rule 405 is pertinent to this discussion. In upholding the first cause of action, the district court held:

> The rules adopted by the Exchange would appear to serve two functions: protection of Exchange members and protection of the investing public. The former serves a "housekeeping" function for the Exchange, while the latter affects directly the interest of the public. Exchange rules which serve a mere "housekeeping" function are not, in the opinion of the Court, actionable; *Exchange rules which affect the public interest, however, are actionable.* In the opinion of the Court, a violation of Rule

49. It is a very common practice for the over-the-counter (OTC) dealer to maintain a dealer account with a member firm for the purpose of purchasing or selling securities for its clients. This affords the OTC dealer access to the facilities of the Exchange and trading markets of various cities. The member firm "knows" only the OTC dealer, not the dealer's customer. In other words, he generally accepts orders only from the dealer, not the dealer's customer.

50. This allegation seems illogical. If a broker such as Dobich is registered with the SEC as a broker-dealer, is it not the responsibility of the SEC or NASD, as the case may be, to insure compliance with its own rules? Should not anyone dealing with that broker assume that the SEC or NASD did their job? Why should Merrill Lynch have "checked up" on the SEC? Did it have a duty to do so? This author doubts that Merrill Lynch had such a duty and if such a duty did exist, very few members would permit accounts with small OTC firms, which would effectively put these firms out of business and pose serious antitrust problems.

51. This is a nonsequitor. Obviously Merrill Lynch knew Dobich was purchasing and selling for his own customers. The fact that Dobich endorsed customer checks rather than issuing its own checks is irrelevant. The fact that Dobich was acting for his own customers does not necessarily mean that he was a converter.

52. Complaint of Plaintiff at 5, para. 12, Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Civ. Doc. No. IP-66-210 (S.D. Ind. June 28, 1967).

405 is not actionable *per se*, since that rule appears to be one which, in part, is for the protection of Exchange members and to that extent may be characterized as a "housekeeping" rule. However, Rule 405 also, undoubtedly, has as one of its functions, the protection of the investing public and, to that extent, is actionable. Depending on the proof of the violation, therefore, Rule 405 could give rise to a civil action for damages under Section 6 of the Securities Exchange Act of 1934. Here the pleadings, depositions and affidavits on file indicate an almost callous disregard of Rule 405 and the purposes thereof which are directed toward protection of the public.[53]

The district court in *Buttrey* obviously adopted the public benefit theory and misinterpreted or ignored the *Colonial* decision which held that if the rule is a substitute for a federal statute, it is actionable. Consider the guidelines in *Colonial* regarding the absence of a common law remedy. Did this common law remedy exist in *Buttrey?* Facts sufficient to give rise to a common law remedy were, in fact, pleaded in the second and third causes of action, both of which were based upon *the same facts;* in particular a violation of rule 10b-5 was alleged in these causes of action. Rule 405 clearly did not provide a remedy unknown at common law. The "callous disregard" referred to by the court[54] was clearly actionable in the absence of rule 405.[55]

What is the effect of rule 405? Does it replace or substitute for a federal statute? Rule 405 is hardly a replacement or substitute for a federal statute since it was adopted in 1909 and, like many other rules, predates the conception and enactment of the Securities Exchange Act and the SEC. How did the court conclude that rule 405 "undoubtedly" had a public protection function? The statement seems unsupported. Is it designed to protect the public? This is doubtful, since the rule appears to be designed to protect the broker from his own foolishness by preventing him from dealing with a client who is apt to "renege" on him or otherwise cause him to sustain a loss, and thereby impair his capital.[56]

Before reviewing the concept of rule 405 further, consider the opinion of the court of appeals upholding the decision of the district court in *Buttrey*: "The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct protection of investors' . . . Here one of the functions of

53. Civ. Doc. No. IP-66-210, at 3-4 (emphasis added). The idea that Exchange rules which affect the public interest are actionable is also found in Lowenfels. Lowenfels, Implied Liabilities 24-25.

54. 410 F.2d at 143.

55. See note 59 infra.

56. Special Study, pt. 1, at 239 n.15. During the Special Study's public hearings, G. Keith Funston, then president of the Exchange, expressed the opinion that this rule was primarily designed to protect firms against financially irresponsible customers. Id. See also NYSE, Supervision and Management of Registered Representatives and Customer Accounts (1962). The examples given of rule 405 violations all involve exposure of firm capital.

Rule 405 is to protect the public, so that permitting a private action for its violation is entirely consistent with the purposes of the statute."[57]

The court seemed strongly persuaded by the allegation that the defendants had actual knowledge of the conversion of customer funds by Dobich.[58] If such were the case, the plaintiff had sufficient remedies at common law,[59] so that rule 405 certainly did not provide a remedy unknown at common law. The court also stated: "Although 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 . . . ."[60] What is the relationship between a fraud concept and that of a rule violation? No one disputes that a charge of fraud is actionable at common law or under rule 10b-5; that was not the question before the court. With respect to that count, fraud was irrelevant; either the violation of the rule was actionable or it was not. The question of fraud should not have entered into the court's consideration.[61]

Again it is interesting to note that there is nothing in the record to demonstrate how the court of appeals also reached the conclusion that rule 405 was adopted to protect the customer rather than to insure the solvency of the broker, which would afford the customer only indirect protection.[62] The court apparently made no effort to determine the New York Stock Exchange's official position with respect to the rule. The rule

57. 410 F.2d at 142 (citation omitted). The court was quoting from Lowenfels, Implied Liabilities 29. The Seventh Circuit reaffirmed its holding in Buttrey in the case of Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969), cert. denied, 397 U.S. 963 (1970) by holding that the NASD Rules of Fair Practice were actionable, and that the district court was in error when it dismissed this cause of action. Id. at 1242. The court pointed out that the plaintiff was not damaged, as the same theory was included in another cause of action. Again the Colonial standard was ignored, that is, an available remedy existed by the rule.

58. 410 F.2d at 144.

59. See, e.g., Wood v. Fisk, 215 N.Y. 233, 109 N.E. 177 (1915) (conversion); Haight v. Haight & Freese Co., 112 App. Div. 475, 98 N.Y.S. 471 (1st Dep't 1906), aff'd mem., 190 N.Y. 540, 83 N.E. 1126 (1907) (accounting); McMorris v. Simpson, 21 Wend. (N.Y.) 610 (Sup. Ct. Jud. 1839) (nonfeasance or misfeasance of broker as agent).

60. 410 F.2d at 143 (emphasis added and citation omitted).

61. Cf. Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis, Civ. Doc. No. 69 C 1995 (N.D. Ill. April 7, 1970). There is an interesting comment made by the court as to the Securities Exchange Act: "Among other things, Section 6(C) expressly requires that rules adopted by a stock exchange be 'not inconsistent with . . . the applicable laws of the state in which it is located.'" Id. at 12. See also Irving Weis & Co. v. Offenberger, 31 Misc. 2d 628, 220 N.Y.S.2d 1001 (N.Y.C. Mun. Ct. 1961) which cited with approval Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715 (Sup. Ct. 1953), aff'd mem., 284 App. Div. 870, 134 N.Y.S.2d 590 (1st Dep't 1954) for the doctrine that noncompliance with margin maintenence requirements does not give a customer a right of action.

62. See note 56 supra.

was obviously intended to be a guide for the businessman, not a statute. Will the courts now, one by one, make their own judgments as to the purposes behind a rule in a highly sophisticated technical industry, without looking for expert guidance within the securities industry?

Did the *Buttrey* court ignore *Colonial*? Not only did the *Buttrey* court not ignore *Colonial*, it "summed up" the *Colonial* principle by quoting what one writer called "the standard"[63] and by completely ignoring the earlier paragraphs wherein the *Colonial* court enunciated the theory of federal substitution—a theory not even mentioned in *Buttrey*.[64] It appears to this writer that the court in *Buttrey* erroneously reached the conclusion that *Colonial* was bordering on a public benefit theory, which is clearly not the case. *Buttrey* did not challenge the *Colonial* decision; instead, for reasons unknown, it sidestepped *Colonial* and adopted its own theory, acting as if the *Colonial* decision did not exist. The *Buttrey* decision is questionable both as to the rule of law and the assumptions made concerning the purpose of the Exchange rule involved, since the court gave no indication as to how it reached its conclusion.

As a result of the decisions in *Colonial* and *Buttrey*, there are two conflicting rules at the court of appeals level. The first rule is based on the Second Circuit's holding in *Colonial* that an Exchange rule is actionable only if it stands in the place of a federal statute or rule. This is referred to as the substitution theory. The second rule derives from the Seventh Circuit's holding in *Buttrey* that an Exchange rule is actionable if it is designed for the protection of the public. This is the public benefit theory.

IV. Critique

A. *Possible Adverse Effects of Implied Liability*

The imposition of implied liability on brokers for violating an Exchange rule could have several adverse effects on the securities industry under either the substitution theory of *Colonial* or the public benefit theory of *Buttrey*. These adverse effects will be discussed below.

1. Arbitration

Contrary to the opinion of one writer,[65] a plaintiff probably could not seek arbitration if implied liability were imposed. If an Exchange rule is equated with an SEC rule and comes within the provisions of section

63. Lowenfels, Private Enforcement 650.

64. Note that in the Buttrey case the court quoted only the second paragraph of what this author believes to be the crux of the Colonial decision. 410 F.2d at 142. See 358 F.2d at 182 for the first paragraph of the quote.

65. Lowenfels, Implied Liabilities 29.

27 of the Securities Exchange Act granting the federal court exclusive jurisdiction, a broker would be entitled, as a defendant, to protection under section 27 and could stay the arbitration. Would a broker do so? In many instances this would definitely be to the broker's benefit. In a relatively small claim a plaintiff would be required to engage his own counsel, which he need not do in arbitration. Consequently, final judgment would be delayed for several years, probably at great expense to the plaintiff. A large broker is well equipped to handle small litigation with an in-house staff, and could delay a speedy resolution of the claim at a minimal cost to itself. However, the Department of Member Firms of the New York Stock Exchange, as a matter of procedure, reviews all arbitrations for possible rule violations; therefore, a broker may suffer a fine or suspension even if he prevails. The broker, under certain circumstances, might prefer the courts and attempt to avoid such scrutiny by the Exchange.

Generally, brokers prefer arbitration when they are right and courts when they are wrong. It is difficult to confuse an arbitrator of long experience in the securities business, while the technical aspects of securities transactions often prove incomprehensible to persons outside the industry. In defense of court action, as opposed to arbitration, one writer pointed to the constitution of an arbitration panel as being composed of a group of "professionals" rather than the average juryman.[66] This may be a positive aspect of arbitration, as the case to be decided may be very technical and require great expertise.

While the purpose of this article is not to defend arbitration, that procedure seems to be the whipping boy whenever certain aspects of the securities laws are discussed. There are obviously pros and cons to arbitration, as there are to jury and non-jury trials, or state and federal jurisdiction. However, the laws of many states respect the consent decree and indeed encourage and enforce arbitration agreements.[67]

2. Interpretation of Exchange Rules

The New York Stock Exchange rules were written more as general guidelines than as rules in the federal sense.[68] They were designed to be interpreted by experts in the securities industry. Often these rules are vague and are not readily interpreted by a layman. For example, in the

66. Id. at 29-30.

67. E.g., New York provides a procedure for enforcing an arbitration agreement and, of course, the federal court upheld the procedure in the Colonial case. For a detailed review of arbitration and its procedures, see M. Domke, The Law and Practice of Commercial Arbitration (1968).

68. See NYSE Const. art. 3, §§ 1 & 5, 2 CCH NYSE Guide ¶¶ 1101 & 1105 (1970).

Colonial case, a professional in the securities business would have been better able to determine whether Bache's action in liquidating the Colonial account was in accordance with "just and equitable principles of trade." A professional would have determined how such liquidations were entered, how the larger orders were handled on the floor in the light of market activity, how they were executed, etc. Who is better equipped to judge these matters than a professional? On a question of margining alone, it is doubtful that there are many members of the bench who have sufficient knowledge of the complicated procedures involved, such as the margin implications of a put and call.[69]

3. Fiduciary Duty of the Broker

The court in *Buttrey* did not state that rule 405 was actionable per se, as many of its sections were of the housekeeping variety. This could imply that the rule itself was actionable and not the supplementary material.[70] Consider what a broker's legal relationship is to his client. It is often stated that a broker is a "fiduciary." Partly due to the puffing form of advertising used by the industry in describing the securities salesman,[71] and partly due to a certain laxness in the use of the term, a securities salesman is considered a "fiduciary." In some cases the broker clearly is a true fiduciary, as when he is entrusted with a full power of attorney over a customer's account and is paid a "fee" for managing the account, as opposed to a commission on a purchase or sale. In some cases he recommends a security, in which instance he has certain obligations at common law and under the Securities Exchange Act.[72] At other times he follows the customer's instructions on an "unsolicited" basis. In each instance the greater percentage of customers' orders are entered on the floor of the Exchange with the brokerage firm acting as an *agent* for the

69. As a simple example, this author has many times dealt with members of the bar in various states who assert that their clients have a cause of action for a violation of the Securities Exchange Act due to a failure to maintain proper maintenance margins in the client's account; yet Regulation "T" does not have any maintenance requirements. See note 48 supra.

70. See note 47 supra for the text of rule 405.

71. The broker is the firm that is registered with the SEC under the Securities Exchange Act. Its sales employees are termed by the Exchange registered representatives. Registered representatives are very often incorrectly called brokers. As to sales puffing, see Mundheim, Professional Responsibilities of Broker-Dealers: The Suitability Doctrine, 1965 Duke L.J. 445. Mundheim quotes from an advertisement in the Wall Street Journal comparing a securities salesman to the family doctor. The industry has created a problem with statements and advertisements of this nature.

72. See E. Weiss, Registration and Regulation of Brokers and Dealers (1965). Consider the shingle theory; that is, by the broker hanging out his shingle, he makes certain representations.

client. Essentially this is an agent-principal relationship with no more fiduciary responsibility than is imposed at common law or under the Securities Exchange Act.[73]

With the above statements as to agency in mind, again consider rule 405, the "Know Your Customer" rule. A new customer enters the branch office of a member firm and opens an account with an order to purchase $50,000 of a listed security. The salesman enters the order without checking the customer's credit. The customer's check "bounces" and the position is sold out at a $5,000 loss. Did the salesman violate rule 405? Yes; however, does that mean the customer can claim rule 405 for his protection in an action by the broker to recover damages? What if the customer sets up an affirmative defense under rule 405 and seeks to remove the case to the federal courts? Under the public benefit theory, does he have a valid defense?[74]

Consider the not uncommon case where a customer who normally purchases long term growth stocks in moderate amounts tells his salesman to buy 10,000 shares of Get Rich Quick Uranium, an OTC security. Although the saleman does not recommend the stock, he does not on the other hand vigorously dissuade the customer from making the purchase. The customer later asserts that under rule 405 the salesman "shouldn't have let him do it," and seeks a rescission. Should the customer's claim prevail? Clearly the salesman should have tried to dissuade him; but if unable to do so, should he have refused the order or does the customer have a God-given and constitutional right to exercise poor judgment? Should all firms refuse this order and perhaps be faced with antitrust charges?[75]

What if the salesman persuades the customer to buy a particular security on a sound fundamental basis but permits the customer to overextend

73. Perhaps a clean hands doctrine could come into play. See Kuehnert v. Texstar Corp., 286 F. Supp. 340 (S.D. Tex. 1968), aff'd, 412 F.2d 700 (5th Cir. 1969).

74. In SEC v. North Am. Research and Dev. Corp., 280 F. Supp. 106 (S.D.N.Y. 1968), modified, 424 F.2d 63 (2d Cir. 1970), based upon an article in a newspaper, customers sought to rescind purchases despite the fact that in many instances their salesman attempted to dissuade the customer from making the purchases. The broker asserted that he had an exemption under section 4(1) of the Securities Act of 1933 but the court found the exemption inapplicable. 280 F. Supp. at 123.

75. For several years the Exchange has published reports on disciplinary actions. This author has maintained a file on these reports as they were issued. It is interesting to note that in each instance where disciplinary action was taken under rules 405 and 408, the concept, express or implied, was not that the customer had been wronged but rather that the firm was exposed to a monetary loss due to its injudicious action. As these reports are not numbered and as all disciplinary actions are not reported, it is impossible to state with certainty that such a case does not exist but it certainly appears to be representative of how the rule is, in fact, interpreted.

himself? Has the salesman violated rule 405? The salesman has probably violated rule 405 for using poor judgment, but should poor judgment by an agent be actionable? Under rule 408,[76] the written authorization of a customer is required before a salesman may exercise discretion over a customer's account. Despite the efforts of brokerage firms to police this rule, customers do give and salesmen do accept oral discretion, which is clearly legal as an oral agency under common law.[77] The saleman has definitely violated rule 408. However, should the customer be allowed to rescind the oral authorization? This hardly seems equitable.

Rule 345[78] prohibits a salesman from sharing in the profits or losses of a customer account. An oral agreement is reached and the customer later seeks to rescind all losses in transactions due to the violation of the rule, which was obviously devised to protect the public. Rule 345 has been violated. However, should the customer prevail? As previously stated, when this author says that a rule is for public protection, it is for the protection of the public as a unit and not intended as actionable in a particular case. As in the profit and loss sharing situation, is not rule 345 designed to discourage this practice and to maintain a high standard in the industry? Is not the intent thus to benefit the public as a whole rather than the individual customer, who very often profits from and participates in the rule violation?

4. Internal Rules and Procedures

Another possible side effect of implying liability under the public benefit theory will arise in instances where firms are required by the NASD to establish internal procedures.[79] Very often firms have established practices to control their business beyond the rule requirements either to bring them far over the "legal" side of the white line or to establish rules to conform to their own internal policy. For example, some firms prohibit any form of trading authorization, even though the Exchange and other self-regulatory agencies permit them. Some firms prohibit recommending any security not on the firms "buy" list of recommended stock or any low priced OTC securities. Will a customer be able to sustain an action under a theory of implied liability for a violation of internal policy rules on the ground that because they were adopted pursuant to Exchange or NASD rules, which in turn were adopted under

76. NYSE rule 408, CCH NYSE Guide ¶ 2408 (1970).

77. Thomkin Corp. v. Miller, 156 Fla. 388, 24 So. 2d 48 (1945); Harris v. Barnes, 100 Ga. App. 412, 111 S.E.2d 147 (1959); Sharpe Sign Co. v. Parrish, 33 Wash. 2d 883, 207 P.2d 758 (1949).

78. NYSE rule 345, 2 CCH NYSE Guide ¶ 2345 (1970).

79. NYSE rule 342, 2 CCH NYSE Guide ¶ 2342 (1970) and NASD Rules of Fair Practice.

the public protection concept, they are actionable under the Securities Exchange Act?

With respect to the broker's fiduciary duty and the internal rules of the brokerage firms, what will be the obvious response if the public benefit concept prevails? Neither the Exchange nor the firms will adopt rules which will subsequently injure them. This would destroy the concept of self-regulation and require the SEC to assume responsibility for adopting procedures for day to day control of the securities business, a responsibility it does not want and which Congress did not intend it to assume.[80] Perhaps a move in this direction has already begun, as the Exchange has been prolific in the issuance of what are termed "MF Circulars."[81] These are not rules per se (although they are sometimes used to announce a rule change), nor are they adopted formally, but the firms nevertheless are required to conform to the circulars as though they were rules.

This author believes that the industry will be very hesitant to adopt any rule which may result in legal liability. The only time that a rule will be adopted will be at the strong urging of the SEC, in which event the rule would have been actionable under the *Colonial* ruling. This would emasculate the concept of self-regulation and greatly affect the position of the Exchange in the industry. This author recognizes that the adverse effects that would result from the adoption of a public benefit theory would also occur under a federal substitution doctrine. However, in the case of federal substitution, these effects are a logical extension of Congressional intent in that if the SEC adopted the rule (which it most certainly will do if the public is denied a right which it would otherwise have), the adverse effects would follow. The end result will be that the consequences would probably be the same, whether or not the federal substitution rule were adopted; that is, the effects will either result from the federal substitution concept or the SEC will adopt a similar rule "forcing" the same effects. Under the public benefit theory, this is not the case. In addition, the number of situations which fall into the public benefit category appears to be far greater than in the case of federal

80. A standard counter argument is that the Exchange will be encouraged to adopt a rule to avoid the SEC adopting its own rule. If, however, the Exchange rule has the same force and effect as an SEC rule, the opposite seems to be true; that is, the Exchange will take no action hoping that the SEC will not act.

81. The current booklet of MF Circulars dates back to 1965. The first circular in the booklet is numbered 201; to December 31, 1968, a total of 41 more circulars were issued. From January 1, 1969 to August 1, 1970, a total of 55 were issued, of which 26 were issued in 1970. This author has no way of determining whether these MF Circulars were issued with the Buttrey decision in mind. They are neither indexed nor referred to in the Exchange rules, which creates a difficult problem for counsel of member firms.

substitution. For example, rules 401, 405 and 408 are clearly not federal substitution rules, but they could all be considered public benefit rules; claims of an Exchange rule violation most often fall under one of these three rules.

B. *The Substitution Theory and the Theory that Exchange Rules are Per Se Not Actionable*

At the present time there are three possible theories that the courts may follow:

(1) Exchange rules are per se *not* actionable.

(2) The *Colonial* substitution rule.

(3) The *Buttrey* public benefit rule.

It is difficult to frame an argument which would support the first of the three alternatives in opposition to the *Colonial* rule. If the SEC refrains from adopting a rule because the Exchange or the NASD adopts its own rule, thereby placing the control in the self-regulatory rather than the federal scheme, should the "third party beneficiaries" of that rule be denied a cause of action because the SEC failed to act? If so, then the SEC would have little choice but to adopt its own rules in those areas where it feels the public requires protection, despite the fact that the industry has established its own controls. This would result in needless duplication. In the *Colonial* case, Bache strongly urged the court in its brief that the Exchange rules are per se not actionable.[82] The Bache brief to the Second Circuit Court of Appeals stated:

> Sections 6(b) and 15A(b)(7) of the Exchange Act thus confirm a standard of business ethics which is to be applied by the exchanges and by the NASD in regulating the conduct of their members. That standard has no application to controversy in a court of law between stockbrokers and their customers, for if it did, any customer could invoke exclusive federal jurisdiction and seek to preclude the traditional remedy of arbitration by adding to its complaint the talismanic accusation that the broker acted in a manner 'inconsistent with just and equitable principles of trade.'[83]

The *Colonial* court rejected this "simplistic all-or-nothing basis" and looked to congressional intent, which of course is controlling. It may reasonably be argued that Congress intended that the SEC adopt rules for the protection of a customer and that if the SEC is restrained from adopting a rule due to the enactment of a comparable rule by the industry, then it would refrain only if the public received the same protection as an SEC rule would afford. This could only be achieved if the Exchange rule

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82. Brief and Supplementary Appendix for Appellee at 10-11, Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966).

83. Id.

were itself actionable. The *Colonial* rule is logical, not oppressive, and seems to fit within the scheme of self-regulation.[84]

C. *The Substitution Rule and the Public Benefit Rule*

The question now posed is the conflict between the *Colonial* and *Buttrey* rules. As stated above, the court of appeals in *Colonial* conclusively rejected the public benefit theory. Counsel for defendant-petitioner Merrill Lynch specifically raised the point before the Supreme Court in the *Buttrey* case, that rule 401 clearly could have no purpose other than protecting the public; yet the Second Circuit rejected the public protection theory.[85]

One writer's argument for the public benefit theory is as follows:

> Rather than the present case law's mechanical distinction between actions brought against an exchange and actions brought against private parties, a more fruitful approach might be to determine whether the reasons behind a particular exchange rule justify its use as a basis for imposing liability either upon the exchange or a private party. Simply stated, exchange rules which are promulgated for the direct protection of the investing public should give rise to private actions against an exchange and other private parties, while rules promulgated merely as 'housekeeping' devices to guide membership should not. Both logic and policy support such a distinction. *Under the first set of rules the investing public is, in a very real sense, a third party beneficiary of the duties imposed upon those required to adhere to these rules, and as such should be entitled to redress when harmed by their violation.*[86]

Consider the last sentence of the above argument—is this a liability which Congress intended to impose upon a broker? Isn't this third party beneficiary theory comparable to a common law negligence concept, whereby the injured party asserts that a safety rule was adopted for his protection and, if he is injured due to the failure to observe this rule, the breach of the rule is evidence of negligence?[87] Can this concept be extended to a potential section 6 liability in the belief that it was intended to equate an Exchange rule to an SEC rule? This author finds

84. The concept of self-regulation of the securities industry is very strong. In Silver v. NYSE, 373 U.S. 341 (1963), the Supreme Court stated: "The pattern of governmental entry, however, was by no means one of total displacement of the exchanges' traditional process of self-regulation. The intention was rather, as Mr. Justice Douglas said, while Chairman of the S.E.C., one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" Id. at 352.

85. See Petitioners Brief for Certiorari at 32-33, Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 396 U.S. 838 (1969) (denying certiorari).

86. Lowenfels, Implied Liabilities 24-25 (emphasis added).

87. See Phillips v. Montgomery Ward & Co., 125 F.2d 248 (5th Cir. 1942); Dunham v Des Moines Ry., 240 Iowa 421, 35 N.W.2d 578 (1949).

it difficult to accept the concept that Congress even remotely intended such an interpretation. The SEC's hands are not tied and if protection is required, the SEC will provide it by rule. The rule so adopted would be designed with the awareness that it is creating a potential cause of action, as opposed to Exchange rules which were never so designed and are often vague and subject to varying interpretations. How necessary is this protection? In view of the few cases involving the rules and the numerous broker actions, it hardly seems to afford a truly aggrieved client any additional remedy. Could not the plaintiff in *Buttrey* have prevailed on the facts under rule 10b-5; in fact, does not 10b-5 afford a customer remedies probably never conceived when 10b-5 was adopted and going far beyond common law?[88] The public benefit concept would, as the Second Circuit said in *Colonial*, saddle the federal courts with garden-variety claims—many of which would allege a rule violation merely to state a prima facie case under federal jurisdiction.

What purpose do Exchange rules serve if they are adopted for the public's benefit but are not adopted in lieu of a federal rule? How can the public benefit if in fact the public cannot enforce them in a court of law? These rules are intended to benefit the public only in the sense that if they are enforced by the Exchange, the public as a whole will benefit by virtue of higher ethical standards. It does not appear that these rules were ever adopted to protect the individual member of the public in an ad hoc case, but rather to protect the public in the generic sense. It is interesting to consider that if an individual member of the public could bring an action for a rule violation, it would have a power under the Securities Exchange Act denied the SEC, since the SEC does not appear to have the power to sanction an Exchange member for a violation of an Exchange rule.[89] This unusual result seems to reinforce the position that Congress never intended such a result.[90]

In summation, it is this author's opinion that liability should not be implied against a member firm for a violation of an Exchange rule, unless that rule was adopted in lieu of a federal statute. The public benefit theory is not a logical extension of the Securities Exchange Act and does not appear to be a valid basis for asserting that Congress intended such unwarranted extensions. From a day to day business standpoint, the public benefit theory would have the negative effect of discouraging progressive rule making by the New York Stock Exchange and its members. The public would not be damaged by a failure to apply this standard,

88. Rule 10b-5 doctrines are constantly expanding to the point that they appear to be "controlling the industry." See A. Bromberg, Securities Law ch. 2.4 (1969).

89. See Silver v. NYSE, 373 U.S. 341, 360 (1963).

90. See Special Study pt. 4, at 704.

as there is ample provision in the law for the SEC to adopt a rule for its protection if it feels that it is in the public interest to do so. In addition, Exchange rules which have been adopted for the benefit of the public were adopted in the language of businessmen and were intended to elevate the standards of the securities industry, not to provide an individual cause of action for their violation.

D. *When Is An Exchange Rule A Substitute for An SEC Rule?*

The remaining consideration for the courts, assuming they reject the public benefit theory and adopt the substitution theory, will be to determine in individual cases whether or not the SEC did, in fact, refrain from adopting a rule to afford the self-regulatory agencies an opportunity to do so. With respect to future rule making, the SEC could issue a public release setting forth its position, and possibly clarify the status of rules presently in effect. In some cases the problem will be quite simple as the record will be clear. One excellent example would be the current proxy rules which were adopted by the New York Stock Exchange after the SEC proposed rules and subsequently withdrew its proposal due to the Exchange action.[91] In this situation the courts should have little difficulty in affirming that such a rule is actionable per se.

The court of appeals in *Colonial* proposed a test that if the rule was not actionable at common law, it would be evidence of intent. However, this test, to use the court's own words, is "simplistic." If a rule was adopted prior to the Securities Exchange Act, such a test would prove meaningless as clearly there is no substitution for a Securities Exchange Act rule. However, if the rule was adopted after the Securities Exchange Act, it would be evidence of intent, though certainly not conclusive evidence; in fact, how much weight should be attached to the rule would have to be determined in each case. Of course, the opposite would appear to be true; that is, if a remedy already exists, then it is unlikely that the SEC would adopt a rule and, therefore, the Exchange rule could hardly be considered as a substitute.

Consider the test proposed by one writer referred to earlier in this article, namely, implied liability would arise if there existed "a Commission rule expressly exempting persons from its requirements on the basis of self-regulatory requirements found adequate by the Commission . . . ."[92] This test certainly seems fair and equitable on the surface, depending on the sequence: that is, if the SEC adopts a rule in the area not covered by an Exchange rule and provides an exemption to the Exchange if the Exchange agrees to adopt a substantially similar rule, then that Exchange

91. Lowenfels, Implied Liabilities 17.

92. Shipman, supra note 37, at 1007.

rule should certainly be actionable, provided that the individual asserting his claim can demonstrate that he was damaged by the failure to observe the rule. Consider the reverse situation where the Exchange already has a rule in existence and the SEC intends to impose a similar rule on firms that are not members of the Exchange. Does it necessarily follow that the Exchange rule then creates an implied liability? It may well be that this is not the intent. Consider the 1964 amendments to the Securities Exchange Act which required that a registered broker-dealer which is not a member of the NASD be directly regulated by the SEC in those areas covered by the NASD.[93] The choice was effectively left with the broker either to join the NASD or have the SEC perform the NASD functions. In this case it is not clear that the SEC rules, although imposing a liability on the SEC firms, were intended to grant an implied liability for violation of NASD rules. The only way these brokers could be regulated was for the SEC to adopt rules in "ethical" areas with all the implied liabilities. It does not appear that there was any intent to equate NASD rules with SEC rules.[94] The above test should prevail or fail based upon the express intent of the SEC.

This same writer also proposed a second test, namely, there would be implied liability if there existed "a Commission rule limited to non-members or unlisted companies and imposing requirements similar to those imposed by the self-regulators."[95] The same criteria proposed as to the first test would reasonably apply to this second test. These two criteria are better guidelines when applied negatively; that is, if the Exchange has a rule governing its members, which the SEC did not adopt with respect to firms which are not members of the Exchange, it would be good evidence that the Exchange rule does not substitute for an SEC rule.

V. Suggestions

The development of the legal theories in the area of implied liability will suggest responsive actions on the part of self-regulatory agencies, in particular the New York Stock Exchange, if the interests of its members are going to be protected. This is a matter of concern to the membership of this Exchange, particularly the so-called "wire house."[96] The New York Stock Exchange not only represents the wire house, but also specialist floor traders and its own listed companies. Although it would appear that the public interest demands that the Exchange emphasis be

93. Securities Exchange Act § 15(b)10, 15 U.S.C. § 78o(b)(10) (1964). See Shipman, supra note 37, at 1007 n.416.

94. Shipman reaches a contrary conclusion. Shipman, supra note 37, at 985.

95. Id. at 1007.

96. The term "wire house" refers to multi-branch office firms such as Merrill Lynch, Pierce, Fenner & Smith, Inc.

directed towards those members having the most contact with the public, the opposite is apparently true as evidenced by the fact that the wire houses represent a minority on the Board of Governors. Until this is reversed, it is doubtful that the Exchange will be able to act effectively in protecting its wire house members' interests. At the present time it would seem that the "voice" of the broker is that of the Association of Stock Exchange Firms and not that of the New York Stock Exchange. Despite this apparent ignoring of the wire house problems, the New York Stock Exchange will have to seriously review the effect of the doctrine of implied liability. The following suggestions are made:

A. Exchange Rules

1. These rules should be divided into logical categories. As the court pointed out in *Buttrey*, rule 405 contains many "housekeeping" requirements which are not properly part of the "Know Your Customer" rule. One suspects, going a step further, that actually some of the New York Stock Exchange rules seem to have been used solely as a convenient depository for new ideas.
2. The purpose and history of a rule should be set forth in much the same way as a federal statute is defined.
3. The rules should be annotated reflecting civil decisions such as *Buttrey* and the Exchange's own determinations, including disciplinary proceedings which are precedent setting.
4. The Exchange should prepare guidelines for its Department of Member Firms and for arbitrators. In the case of the former, the guide rules should be in the form of a "table of maximum punishments;" for the latter, they should be designed to assist in determining monetary liability to the public for a rule violation.
5. The Exchange should carefully consider the legal impact of any rules proposed in the future. An example would be a rule permitting the Exchange to deny counsel to a member or employee of a member at a disciplinary proceeding.[97] Another example would be the Exchange requiring under rule 405 that a copy of a corporate charter be obtained for all corporate margin accounts.
6. A general counsel's office should be established at the New York Stock Exchange, one of its responsibilities being to give official rule interpretations. Another responsibility would be to see to it that the Exchange participates in civil proceedings where appropriate, as outlined below.

B. Exchange Participation

The Exchange has apparently been reluctant to inject itself into member firms' suits. The SEC has not found the same hesitation when the

97. NYSE Const. art XIII, § 23, 2 CCH NYSE Guide ¶ 1673 (1970).

"public interest"[98] is involved. There is also a "member interest" position that may be important in assisting the court to arrive at a particular decision. In addition, it may be incumbent upon the Exchange to come to the defense of its members.

C. *Arbitration*

The arbitration procedure needs improvement not so much in the quality of the staff of arbitrators but in its ability to handle matters expeditiously.[99] Many of the senior arbitrators are close to retirement and will soon have to be replaced.

1. Both the Board of Arbitrators and the Exchange staff should be significantly increased, so that a hearing is made possible within four months after filing. The Board should be designed so that qualified personnel are available in all fields and assigned to a particular case based on their expertise. These areas of expertise should include, but not be limited to, underwriting, floor, cashiering, margins, capital, trading, etc. Qualified personnel in various areas may readily be found in the various divisions of the Association of Stock Exchange Firms (ASEF).

2. One member of the panel should be a member of the bar and actively engaged in brokerage law, preferably a member of the Compliance and Legal Division of the ASEF.[100] He would advise on rule interpretations in addition to being a member of the panel.

3. To reduce the number of arbitrations, member firms should be requested to settle disputes between each other before a panel of three allied members who are chosen from the various ASEF divisions from a previously prepared list. Member firms should also be required to show that an honest effort was made to resolve the dispute before choosing arbitration.

4. The arbitration rules need to be overhauled. A member should not be precluded from seeking relief from the courts when this relief cannot be provided for in arbitration. The New York Stock Exchange should take the leadership in attempting to provide provisional remedies as in many instances arbitration is not effective unless injunctive or similar relief is available.[101]

This author specifically suggests that a committee be appointed to revise Exchange rules in accordance with the suggestions in this article.

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98. The SEC has appeared as amicus curiae in several matters, as for example in Silver v. NYSE, 373 U.S. 341 (1963).

99. An arbitration takes about one year or more from the date of submission.

100. The compliance directors and inside counsel for the member firms are members of this division.

101. See M. Domke, supra note 67, at 267-68.