

Comments

PRIVATE ACTIONS UNDER THE SUITABILITY AND SUPERVISION DUTIES OF EXCHANGE AND DEALER ASSOCIATION RULES: THE FRAUD REQUIREMENT

A number of courts have implied private causes of action against securities broker-dealers for their breach of the supervision and suitability duties imposed by the self-regulatory rules of the New York Stock Exchange and the National Association of Securities Dealers. The prevailing view denies recovery in the absence of conduct "tantamount to fraud." In examining the development of the fraud requirement, the author distinguishes Rule 10b-5 actions and contends that such a strict curtailment of actions brought under self-regulatory rules is not compelled by clear judicial precedent or by legislative purpose.

In providing for the registration of stock exchanges with the Securities and Exchange Commission (SEC), Congress enacted section 6 of the Securities Exchange Act of 1934 (Exchange Act).¹ Section 6 prohibits registration of an exchange unless its internal rules provide for the expulsion, suspension, or discipline of members for conduct inconsistent with just and equitable principles of trade.² At the same time, Congress granted exchanges the power to enact these self-regulatory rules.³ Amendments to the Exchange Act were later enacted to impose similar requirements of registration and self-regulation on voluntary associations of over-the-counter broker-dealers who are not members of a stock exchange.⁴

Eventually, investors sought to use the federal district courts to assert damages claims against their securities broker-dealers for alleged violations of certain of these exchange and dealer associa-

1. Ch. 404, 48 Stat. 881 (codified at 15 U.S.C. § 78f (1976)).

2. 15 U.S.C. § 78f (1976).

3. Ch. 404, § 6, 48 Stat. 885 (codified at 15 U.S.C. § 78f (1976)).

4. As added, ch. 677, § 1, 52 Stat. 1070 (1938).

tion rules. Such claims have most frequently involved violations of the "suitability" and "supervision" rules of the New York Stock Exchange (NYSE)⁵ and the National Association of Securities Dealers (NASD).⁶ The theory of civil liability for breach of these rules is based on section 27 of the Exchange Act, which grants the federal district courts exclusive jurisdiction to hear "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 Proponents of implied federal causes of action have maintained that some of these rules impose duties upon broker-dealers within the meaning of section 27.⁸

*Colonial Realty Corp. v. Bache & Co.*⁹ was the first case to suggest that violations of exchange and dealer association rules might give rise to a private action for damages.¹⁰ In *Colonial*, Judge Friendly stated that in considering whether to imply federal civil liability, a "court must look to the nature of the particu-

5. Rule 405 of the New York Stock Exchange states:

Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) 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.

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

(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 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

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[1979] NYSE GUIDE (CCH) ¶ 2405, at 3697, 3701. Rule 405 is often referred to as the "Know Your Customer" rule. *Wolfson v. Baker*, 444 F. Supp. 1124, 1132 (M.D. Fla. 1978).

6. Article III, § 2 of the NASD Rules of Fair Practice 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.

[1971] NASD MANUAL (CCH) ¶ 2152. The foregoing rule sets forth the NASD "suitability" provision. For the NASD "supervision" duty, see note 35 *infra*.

7. 15 U.S.C. § 78aa (1976). Even if an exchange or association rule is not considered to be a rule "thereunder," a violation of such a rule may nevertheless be actionable as a "duty created by this chapter." See Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 18-19 (1966).

8. See, e.g., *Wolfson v. Baker*, 444 F. Supp. 1124, 1133 (M.D. Fla. 1978).

9. 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

10. The *Colonial* court ultimately concluded that no private cause of action was stated for violation of an NASD rule requiring observance of "high standards of commercial honor and just and equitable principles of trade." *Id.* at 183.

lar rule and its place in the regulatory scheme."¹¹ According to the *Colonial* court, rules imposing broad duties, such as the one under consideration in *Colonial*,¹² are too vague to be enforced by implying a private cause of action. The court further stated that the party urging implication of federal liability carries a greater burden of persuasion when no statute or SEC regulation has been violated.¹³ "The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."¹⁴

Following the lead of the *Colonial* decision, a number of courts have concluded that in appropriate circumstances, violations of exchange and association rules designed for investor protection may give rise to a private right of action.¹⁵ Other courts have flatly refused to find the breach of any of the self-regulatory rules actionable.¹⁶ In light of such divergent views, the district court in *Rolf v. Blyth Eastman Dillon & Co., Inc.* recently stated that whether an investor may prevail in a private cause of action for violation of these rules is an "open question."¹⁷

Despite the series of decisions that accepts the proposition that such liability may exist, no reported cases exist in which a broker-dealer has actually been held liable solely for the violation of NYSE or NASD rules.¹⁸ Nevertheless, the district court in *Rolf v. Blyth Eastman Dillon & Co., Inc.* concluded that the "prevailing" view is that these rules may form the basis of liability in damages but only if the plaintiff alleges and demonstrates that the broker's violation of the rule was fraudulent, or at least "tantamount to fraud."¹⁹

Thus, to avoid dismissal of his claim under the "prevailing"

11. *Id.* at 182.

12. *See* note 10 *supra*.

13. 358 F.2d at 182.

14. *Id.*

15. *E.g.*, *Ocrant v. Dean Witter & Co.*, 502 F.2d 854, 858 (10th Cir. 1974); *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970); *Wolfson v. Baker*, 444 F. Supp. 1124, 1134 (M.D. Fla. 1978).

16. *Parsons v. Hornblower & Weeks-Hemphill, Noyes*, 447 F. Supp. 482, 494 (M.D.N.C. 1977), *aff'd per curiam*, 571 F.2d 203 (1978); *Plunkett v. Dominick & Dominick, Inc.*, 414 F. Supp. 885, 890 (D. Conn. 1976).

17. 424 F. Supp. 1021, 1040 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978). The court of appeals commented that of the two issues reserved by the court, the question of broker liability under NYSE or NASD rules was the "thornier." 570 F.2d at 48 n.19.

18. *Wolfson v. Baker*, 444 F. Supp. 1124, 1133 (M.D. Fla. 1978).

19. 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978).

view, a plaintiff must allege not only breach of the proper type of rule as indicated by *Colonial* but also facts that tend to show that his broker's violation of such rule was in some way fraudulent. One court has observed that by requiring fraudulent conduct, the courts have "fashioned the contours of liability for rules violations."²⁰ Rather, the fraud requirement may amount to a repudiation of these rules as an independent basis for liability.²¹ To the extent a broker's violation is fraudulent, a cause of action may be stated under SEC Rule 10b-5,²² and the self-regulatory rules become superfluous.²³

This Comment contends that civil liability for rules violations should not hinge on whether the violating conduct is fraudulent. In fact, several of the decisions recognizing an implied cause of action have not expressly required a showing of fraud, insisting only that the breached rule be designed for the protection of the investing public.²⁴ Although the fraud requirement would undoubtedly ease the federal court workload,²⁵ such a limitation unnecessarily frustrates the acknowledged congressional purposes served by holding brokers civilly liable for their violations.²⁶ The fraud requirement may indeed amount to an indirect repudiation of this implied theory of liability. Inasmuch as there are other ways to restrict the volume of litigation brought under the self-regulatory rules, the fraud/non-fraud distinction appears to be arbitrary.

RECOGNITION OF IMPLIED ACTIONS—THE ABSENCE OF A DEFINITE FRAUD REQUIREMENT

*Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*²⁷ has been used as underlying authority for the proposition that con-

20. *Id.* at 1040.

21. See *Architectural League v. Bartos*, 404 F. Supp. 304, 314 (S.D.N.Y. 1975).

22. 17 C.F.R. § 240.10b-5 (1978).

23. See E. BRODSKY, GUIDE TO SECURITIES LITIGATION 169 (1974).

24. *SEC v. First Sec. Co.*, 463 F.2d 981, 988 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *Starkman v. Seroussi*, 377 F. Supp. 518, 523-24 (S.D.N.Y. 1974).

25. In the *Colonial* decision, Judge Friendly cautioned that failure to limit the scope of implied liability from rules violations would flood the federal courts with "garden variety" customer-broker lawsuits. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 183 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

26. Congress enacted the Securities Exchange Act of 1934 "to protect the public and investors against malpractices in the securities and financial markets." H.R. REP. NO. 1418, 88th Cong., 2d Sess. 4, reprinted in [1964] 2 U.S. CODE CONG. & AD. NEWS 3013, 3016. Stock exchange and dealer association rules were authorized to promote the Act's protective goal through self-regulation. S. REP. NO. 1455, 75th Cong., 3d Sess. 3-4 (1938); H.R. REP. NO. 2307, 75th Cong., 3d Sess. 4-5 (1938).

27. 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

duct tantamount to fraud must be pleaded to state a cause of action for the breach of self-regulatory rules.²⁸ However, *Buttrey* did not expressly require conduct tantamount to fraud. The court first stated that whether the violation of a particular rule is actionable should depend upon whether its purpose is "the direct protection of investors."²⁹ After implying a cause of action for the defendant's failure to supervise accounts under NYSE Rule 405,³⁰ the court cautiously avoided holding that a violation of Rule 405 is "*per se* actionable."³¹ Instead of precisely defining the limits of liability, the court concluded that "[a]lthough mere errors of judgment by defendant might not support a federal cause of action, the facts alleged here are tantamount to fraud . . . thus giving rise to a private civil damage action."³²

At most, this statement permits an action for a violation tantamount to fraud and rules out strict liability. The decision neither compels the "tantamount to fraud" standard nor prohibits a cause of action for a negligent violation. Subsequent decisions³³ that interpret *Buttrey* as foreclosing the possibility of liability for negligence equate "mere errors of judgment" with negligence and read "might not" as *shall not*. An error of judgment may be wholly without legal fault and thus not negligent. The *Buttrey* court's mention of "mere errors of judgment" is therefore not necessarily a reference to negligent errors.

Had the *Buttrey* court wished to limit the implication of a cause of action to acts tantamount to fraud, it could have so indicated. Inasmuch as the court alluded to rules violations constituting mere errors of judgment as the outer limit of liability, it is possible to infer that a cause of action may be permitted when the violating conduct involves any degree of fault. Of course, *Buttrey* does not expressly authorize liability for negligent violations. A fair interpretation of the ambiguous language in that case is that the question of such liability is left open. Therefore, to the extent

28. *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 168 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977); *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978); S. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* 196 (1977).

29. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d at 142.

30. Rule 405 is set out in note 5 *supra*.

31. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d at 142.

32. *Id.* at 143.

33. *E.g.*, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978).

Buttrey is relied upon as precluding the implication of a cause of action for less than fraudulent violations of Rule 405, its holding is overstated.

Several decisions subsequent to *Buttrey* suggest that a federal cause of action may be implied for the violation of stock exchange or dealer association rules in the absence of fraudulent conduct. These cases stop short of expressly holding that fraud is an essential element of a cause of action. They do, however, require that the rule under which liability is asserted be designed for the protection of investors and the public.

In *SEC v. First Securities Co.*³⁴ the same panel of the Court of Appeals for the Seventh Circuit that decided *Buttrey* considered a claim for violation of the NASD "supervision" rule.³⁵ First Securities Company, a member broker-dealer of the NASD, employed its president as an investment counselor. The president fraudulently converted funds invested by the firm's customers to his own use.³⁶ He directed customers to mail checks payable to himself in envelopes labeled "confidential" and sought to conceal his scheme by imposition of a rule prohibiting employees of First Securities from opening his mail.³⁷ The court held that by allowing enforcement of the president's rule, First Securities Company violated the supervision provisions of NASD Rule 27 and that such violation provided the basis for First Securities' liability to the customers defrauded by its president.³⁸

The court's opinion did not include fraudulent conduct as a prerequisite for liability based on a firm's failure to comply with the supervision rule. The court concluded that First Securities' conduct was "sufficient without more to constitute a violation" of the rule, adding only that such violations give rise to private damages "where the rule violated serves to protect the public."³⁹

The result in *First Securities* presents an ambiguity similar to that in *Buttrey*. Neither case expressly conditions liability upon finding a fraudulent violation. Yet each court concluded that

34. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

35. Article III, § 27 of the NASD Rules of Fair Practice provides in part:

(a) Each member shall establish, maintain, and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder with the rules of this Association.

(b) Final responsibility for proper supervision shall rest with the member

[1971] NASD MANUAL (CCH) ¶ 2177.

36. *SEC v. First Sec. Co.*, 463 F.2d at 983-84.

37. *Id.* at 985.

38. *Id.* at 988.

39. *Id.*

some level of fraud was present. In *Buttrey*, the facts alleged were explicitly found to be "tantamount to fraud."⁴⁰ In a separate section of the *First Securities* opinion dealing with an alternative basis for the firm's liability, the court held that First Securities Company aided and abetted the president's fraud by "willfully" allowing his enforcement of the rule regarding the mail.⁴¹ Apparently the court found that the firm's failure to supervise was willful, thereby constituting an independent act of actionable fraud for aiding and abetting the president's fraud.⁴² However, the court did not characterize First Securities' failure to supervise as willful *until* the opinion turned to a discussion of aiding and abetting liability. The preceding section of the opinion treating liability under the supervision rule failed to refer to the firm's willfulness. If the court felt that willfulness was essential to a cause of action based on the supervision rule, why was the finding of the firm's willfulness not mentioned until the subsequent section of the opinion devoted to aiding and abetting?

Similarly, the decision in *Starkman v. Seroussi*⁴³ did not mention fraud as an essential element of a plaintiff's implied cause of action. In *Starkman*, an investor alleged breach of NYSE Rules 405⁴⁴ and 345.16.⁴⁵ Defendants, the brokerage firm and its employee, Seroussi, asserted that the brokerage agreement signed by plaintiff compelled the latter to submit his claim to arbitration.⁴⁶ The court ruled that because the rules violations alleged gave rise to a cause of action under section 27 of the Exchange Act of 1934,⁴⁷ the agreement to arbitrate was void as against the plaintiff's right to maintain his action in federal court.⁴⁸ In concluding that the plaintiff had sufficiently carried his burden to establish jurisdiction by stating a cause of action, the court looked

40. *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 143 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

41. *SEC v. First Sec. Co.*, 463 F.2d at 988.

42. To establish aiding and abetting liability under the securities laws, the plaintiff must prove that an independent wrong existed and either that the alleged aider and abettor had knowledge of the wrong or that he acted with reckless disregard. *Lowenschuss v. Kane*, 520 F.2d 255, 268 n.10 (2d Cir. 1975).

43. 377 F. Supp. 518 (S.D.N.Y. 1974).

44. Rule 405 is set out in note 5 *supra*.

45. Rule 345.16 prohibits a registered representative from participating in transactions with customers by sharing in profits or by guaranteeing the customer against losses. [1979] NYSE GUIDE (CCH) ¶ 2345, at 3593-96.

46. *Starkman v. Seroussi*, 377 F. Supp. at 522.

47. 15 U.S.C. § 78aa (1976).

48. *Starkman v. Seroussi*, 377 F. Supp. at 524.

exclusively to the guidelines established by the *Colonial* case for finding a rule violation actionable.⁴⁹ The court found that the plaintiff met the *Colonial* standard because the rules alleged to have been violated were “an integral part in SEC regulation” in furtherance of the purpose to “insure fair dealing and to protect investors”⁵⁰ and were “precise.”⁵¹

Although the *Starkman* court referred to the likelihood that Seroussi’s conduct was part of a scheme to “defraud”⁵² the plaintiff, this reference does not indicate that the court would refuse to find a nonfraudulent violation actionable. The court did not state that the implication of a cause of action depends upon whether fraud was present. The court merely pointed to the possibility of employee fraud in emphasizing the importance of the NYSE rules under consideration in furthering the goals of fair dealing and investor protection.⁵³ Even if the court regarded Seroussi’s violation of NYSE Rule 345.16 as fraudulent,⁵⁴ the plaintiff’s ability to state a cause of action against the brokerage firm for its failure to supervise under Rule 405 was not made conditional upon any knowing participation on its part in the employee’s fraud.⁵⁵

The district court in *Bush v. Bruns Nordeman & Co.*⁵⁶ failed to take advantage of an opportunity to close the door to private actions based on negligent violations of NYSE Rule 405.⁵⁷ The plaintiff, a trustee in bankruptcy, sued for losses allegedly caused by the defendant’s use of the bankrupt’s wrongfully converted funds. The plaintiff alleged both Rule 10b-5 antifraud violations and noncompliance with Rule 405, stating that the defendant “knew or should have known that such funds had been wrongfully converted.”⁵⁸ The court refused to dismiss, noting that be-

49. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966). See text accompanying notes 11-14 *supra*.

50. *Starkman v. Seroussi*, 377 F. Supp. at 523-24.

51. *Id.* In *Colonial*, the court disapproved of implying a private action for violation of a broad, generalized rule that is something of a “catchall.” The vagueness of such a rule would indicate that Congress did not intend it to give rise to a civil claim. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

52. *Starkman v. Seroussi*, 377 F. Supp. at 524.

53. *Id.*

54. Perhaps a violation of this rule prohibiting a representative from participating in customer transactions is by its nature so calculated to generate excessive commissions for the representative that fraud may be inferred from any violation of the rule.

55. *Starkman v. Seroussi*, 377 F. Supp. at 524.

56. [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,674 (S.D.N.Y. 1972).

57. *But see* *Architectural League v. Bartos*, 404 F. Supp. 304, 314 (S.D.N.Y. 1972).

58. *Bush v. Bruns Nordeman & Co.*, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,674, at 93,007 (S.D.N.Y. 1972).

cause the alleged violations of Rule 10b-5 and Rule 405 were "inextricably linked" it was too early in the proceedings to determine whether the defendant had violated Rule 405 and whether such a violation gives rise to a private cause of action.⁵⁹ The holding does not necessarily authorize a cause of action when the defendant is merely negligent ("should have known") because the court sustained the plaintiff's claim on the alternative allegations that the defendant "*knew* or should have known"⁶⁰ the source of the customer's funds. However, the court's failure to indicate that the allegation of negligence standing alone would not support a cause of action suggests the lack of an established fraud requirement.

MERITS OF THE NONFRAUD CLAIM

The argument for allowing a private cause of action for a nonfraudulent rule violation must be considered before focusing on particular obstacles confronting plaintiffs. The case for recognizing a federal cause of action for negligent violations of NASD and NYSE rules is most persuasive when the rule in question by its terms imposes a negligence standard of care upon broker-dealers. NYSE Rule 405⁶¹ is the best example of such a rule. The rule directs every member broker-dealer to "[u]se due diligence to learn the facts relative to every customer, every cash or margin account accepted or carried" and to "[s]upervise diligently all accounts handled by registered representatives."⁶² This language prescribes a standard of conduct very similar to the "due care" concept imposed by tort law as the standard for determining whether behavior is negligent.⁶³ Rule 405 requires the investment firm to take certain steps to investigate customers, their source of funds, and their needs in order to determine whether the customer or the public may be jeopardized by a given transaction.⁶⁴ If these duties are not carried out with the requisite diligence, the rule is violated.

The due diligence requirement of Rule 405 appears to prohibit negligent as well as fraudulent or willful conduct. Rule 405 should

59. *Id.* at 93,008.

60. *Id.* at 93,007-08 (emphasis added).

61. Rule 405 is set out in note 5 *supra*.

62. *Id.*

63. See W. PROSSER, THE LAW OF TORTS § 31 (4th ed. 1971).

64. *Wolfson v. Baker*, 444 F. Supp. 1124, 1134 (M.D. Fla. 1978).

be contrasted with section 20 of the Exchange Act of 1934, which expressly provides a good faith defense for controlling persons who may otherwise be held responsible under this section for securities law violations by their controlled employees.⁶⁵ To hold that a violation of Rule 405 is actionable only when the violation is in some way fraudulent is to disregard the plain language of the rule and to rewrite it to include a good faith defense. What point is there in looking to a rule for a basis of liability when so little regard is paid to its specific provisions?

LIABILITY FOR NEGLIGENT VIOLATIONS IS CONSISTENT WITH THE
ACKNOWLEDGED PURPOSES OF SELF-REGULATION

The fraud/nonfraud distinction is particularly arbitrary in light of the reasons given for implying a federal cause of action for the violation of exchange and dealer association rules. Recognition of a cause of action for negligent rules violations would be consistent with the principles that have led courts to conclude that these rules may properly support some kind of private claim.

In *Colonial Realty Corp. v. Bache & Co.*,⁶⁶ the court stated that whether violation of a rule is actionable depends in part upon the rule's "place in the regulatory scheme."⁶⁷ According to *Colonial*, the rule violated must be specific and must amount to a substitute for an SEC regulation, as opposed to one that merely prescribes broad ethical standards.⁶⁸ The court settled upon this requirement in reliance upon the Supreme Court's decision in *J.I. Case Co. v. Borak*,⁶⁹ which held that the courts may imply private remedies to effectuate the congressional purpose and federal policy behind the Exchange Act.⁷⁰

The relevance of congressional purpose in implying federal remedies has since been reemphasized in *Cort v. Ash*.⁷¹ The

65. 15 U.S.C. § 78t(a) (1976). This section provides in relevant part:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter . . . shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

66. 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

67. *Id.* at 182.

68. *Id.*

69. 377 U.S. 426 (1964). The *Borak* case dealt with implication of a private cause of action for violation of an actual statutory provision of the Exchange Act. The *Colonial* court applied the principle of *Borak* to the analogous question of implied liability based on a rule of the NASD.

70. *Id.* at 433.

71. 422 U.S. 66 (1975). This case, like *Borak*, concerned implied remedies for violation of federal statutes. *Cort v. Ash* has been relied upon where an exchange rule was involved. *Wolfson v. Baker*, 444 F. Supp. 1124, 1135 (M.D. Fla. 1978).

Supreme Court in *Cort v. Ash* divided the congressional purpose inquiry into two questions. The first question is whether the plaintiff seeking an implied cause of action is a member of the class that Congress designed the law in question to benefit.⁷² The second question is whether implication of a remedy is consistent with the underlying purposes of the legislative scheme.⁷³

Accordingly, courts recognizing an implied cause of action under NYSE Rule 405⁷⁴ have first concluded that the rule's purpose is to protect the investor.⁷⁵ The NASD "suitability" rule⁷⁶ has also been found to serve this purpose.⁷⁷ The underlying purposes of the Exchange Act, which include protecting "the public and investors against malpractices in the securities and financial markets,"⁷⁸ support these conclusions. Self-regulation through exchange and dealer association rules was designed to further these underlying purposes without adding to the burden on the government bureaucracy.⁷⁹ If the foregoing considerations can lead courts to determine as a threshold matter that a private cause of action may be implied for violations of a given rule, the same considerations could justify remedies for negligent violations. A customer who is injured as a result of the brokerage firm's inadequate supervision of its registered representative is clearly within the class of investors needing protection whether the lack of supervision was caused by negligence or by fraud. Furthermore, the "malpractices in the securities and financial markets" that the Exchange Act was designed to prevent arguably encompass negligent as well as fraudulent behavior. Allowing a negligently injured customer to recoup his losses in federal

72. *Cort v. Ash*, 422 U.S. at 78.

73. *Id.*

74. Rule 405 is set out in note 5 *supra*.

75. See, e.g., *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *Wolfson v. Baker*, 444 F. Supp. 1124, 1135 (M.D. Fla. 1978). But see *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 167 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977).

76. Article III, § 2 of the NASD Rules of Fair Practice is set out in note 6 *supra*.

77. *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978).

78. H.R. REP. NO. 1418, 88th Cong., 2d Sess. 4, *reprinted in* [1964] 2 U.S. CODE CONG. & AD. NEWS 3013, 3016.

79. See S. REP. NO. 1455, 75th Cong., 3d Sess. 3-5 (1938); H.R. REP. NO. 2307, 75th Cong., 3d Sess. 4-5 (1938). But cf. *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 168 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977) (implying private actions from rules violations may discourage self-regulation).

court would not only be consistent with the Exchange Act's investor protection purpose, it would further such a purpose.

The courts obviously are not compelled to imply a cause of action each time Congress' goal of investor protection may thereby be advanced. However, judicial concern for investors has prompted courts to take the initiative in declaring the availability of civil remedies for violation of the self-regulatory rules⁸⁰ despite the failure of Congress to so provide. Given the judicially created nature of these remedies, it would not be too great a leap for courts to define the limits of liability to include claims for negligence.

DEVELOPMENT OF THE FRAUD REQUIREMENT

Although the same purposes that are served by recognizing private federal claims in general for supervision and suitability rules violations may be advanced by extending this right of action to negligently injured investors, the trend in several circuits has been to deny such relief in the absence of fraud.⁸¹ Such a serious limitation on the utility of exchange and dealer association rules as vehicles for civil liability can be traced to language in the *Colonial* decision.⁸² In that case Judge Friendly stated that although certain rules may give rise to a cause of action in appropriate circumstances, "the case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."⁸³ Although Judge Friendly did not formulate a precise test for determining how much of a departure from common law remedies is necessary to justify a federal cause of action, it is clear that the court was cautioning against the extension of exclusive federal jurisdiction "into preserves traditionally occupied by the states."⁸⁴ However, Judge Friendly's concern was not with the possibility of conflict between state and federal decisions. On the contrary, his

80. *Avern Trust v. Clarke*, 415 F.2d 1238 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969); *Starkman v. Seroussi*, 377 F. Supp. 518 (S.D.N.Y. 1974).

81. *See Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 168 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977); *Parsons v. Hornblower & Weeks-Hemphill, Noyes*, 447 F. Supp. 482, 494 (M.D.N.C. 1977), *aff'd per curiam*, 571 F.2d 203 (1978); *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd on other grounds*, 570 F.2d 38 (2d Cir. 1978).

82. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

83. *Id.* at 182.

84. *Id.* at 183 n.6. The Supreme Court has since indicated that implication of a federal cause of action for violations of federal statutes should depend in part upon whether "the cause of action is one traditionally relegated to state law." *Cort v. Ash*, 422 U.S. 66, 78 (1975).

concern was that federal courts might become flooded with "garden variety" customer-broker litigation even though "there was no indication that the case would be decided differently under state law."⁸⁵

Judge Friendly's reluctance to involve federal courts except "when the rule imposes an explicit duty unknown to the common law" has been interpreted as precluding a federal claim for negligent violations.⁸⁶ On its face, this interpretation seems persuasive. The general duty to refrain from negligent conduct is, of course, not "unknown to the common law." However, Judge Friendly's use of the word "explicit" should not be overlooked. The "explicit" duties imposed by certain exchange rules are not necessarily known to the common law. For example, it is uncertain whether all state courts would recognize the duties imposed by NYSE Rule 405 upon exchange members to use diligence in investigating their customers and selecting only securities suitable to their needs⁸⁷ without reference to the rule.

To prove an allegation of negligence in state court, an investor might find it necessary to introduce the rule as evidence of the standard of care in the professional community.⁸⁸ The rule itself becomes the ultimate source of duty to the extent that a state court must look to the specific duties imposed by the exchange rule before the trier of fact can determine whether the conduct was negligent. Because the rule is the product of the Exchange Act's self-regulatory scheme,⁸⁹ it can hardly be said that the question of liability based on the rule's unique duties is a "preserve traditionally occupied by the states."⁹⁰

Furthermore, it is doubtful that the federal courts actually refuse to recognize rights of action simply because the basis of relief is known to common law. For example, a district court recently allowed an independent cause of action against a broker-

85. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d at 183.

86. See S. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* 196 (1977).

87. Rule 405 is set out in note 5 *supra*.

88. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 697-99, 69 Cal. Rptr. 222, 228-29 (1968).

89. Section 4(b) of the Exchange Act provides that no exchange shall be registered unless it adopts rules "designed . . . to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest." 15 U.S.C. § 78f(b)(5) (1976).

90. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 183 n.6 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

age firm under the common law doctrine of respondeat superior.⁹¹

THE IMPACT OF THE SCIENTER REQUIREMENT IN ANTIFRAUD ACTIONS

The Supreme Court's attempt to check the proliferation of actions brought under the antifraud provisions of section 10(b)⁹² of the Exchange Act and SEC Rule 10b-5⁹³ may bolster the view that the dictum in *Colonial* should limit the implication of private actions to fraudulent violations of rules. The Supreme Court in *Ernst & Ernst v. Hochfelder*⁹⁴ held that a private cause of action under section 10(b) or Rule 10b-5 requires allegations of scienter or willful or intentional misconduct.⁹⁵ Although it is not clear whether recklessness satisfies the *Hochfelder* requirement,⁹⁶ mere negligence is insufficient.

At least one court of appeals has concluded that the scienter requirement of *Hochfelder* controls the implication of actions for breach of exchange and association rules. In *Utah State University v. Bear, Stearns & Co.*,⁹⁷ the Court of Appeals for the Tenth Circuit applied the Supreme Court's view of 10b-5 actions in *Hochfelder* to claims based on violations of NASD and NYSE rules. The court upheld the trial court's dismissal of these claims because the violations were not alleged to be tantamount to fraud. The court noted that "something more than mistake or negligence must be shown."⁹⁸ The court did not explain why the principles of *Hochfelder*, a 10b-5 case, should necessarily govern implied liability for rules violations.

In light of what has been called the climate of "retrenchment"⁹⁹ evidenced by the *Hochfelder* Court's curtailing of private claims brought under the Exchange Act, other courts might be expected to follow the *Utah State University* case. However, this decision's application of *Hochfelder* may be more far-reaching than is immediately apparent. Although it purports to circumscribe the private action for rules violations within the boundaries of the fraud requirement, *Utah State University* essentially undermines the in-

91. *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 214 (D. Mass. 1978).

92. 15 U.S.C. § 78j(b) (1976).

93. 17 C.F.R. § 240.10b-5 (1978).

94. 425 U.S. 185 (1976).

95. *Id.* at 201.

96. The Supreme Court did not expressly decide that recklessness satisfies the scienter requirement for actions under § 10(b) or Rule 10b-5. *Id.* at 193-94 n.12.

97. 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977).

98. *Id.* at 168-69. *See Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38, 56 (2d Cir. 1978) (dissenting opinion).

99. S. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* 253 (1977).

dependent viability of any action under these rules. If a broker's violation involves intentional or willful conduct tantamount to fraud, the injured investor will be able to make out a cause of action under SEC Rule 10b-5.¹⁰⁰ The availability of a cause of action derived from the rule violation itself is meaningless and superfluous for the plaintiff if the action depends on alleging the same facts necessary for a successful 10b-5 claim.

To conclude that a court's decision to apply the scienter requirement of *Hochfelder* to rules violations does more than merely limit a plaintiff's action to fraudulent violations would be logically consistent. The imposition of the *Hochfelder* scienter standard suggests that there can be no action based on the rules violations *as* rules violations. In other words, a violation would not support a private action *because* it is a violation, but only to the extent that the conduct which happens to constitute the violation is independently actionable under the antifraud provisions of Rule 10b-5.

The *Utah State University* case is puzzling because the court fails to reach the foregoing conclusion even after emphasizing the fraud requirement. Instead, the court insists that it recognizes "that in an appropriate case there may be an implied cause of action for private redress for violation of association or exchange rules."¹⁰¹ That the court conceives of such an action as existing independently of a 10b-5 action is suggested by the court's discussion of the plaintiff's 10b-5 claim in a separate section of the opinion.¹⁰²

In any given case in which a plaintiff successfully states a cause of action against his broker-dealer under section 10(b) and Rule 10b-5, the question whether an independent action exists for violation of self-regulatory rules is of course largely academic. As long as the plaintiff can recover under the antifraud provisions, the court may find it unnecessary to articulate clearly an alternative theory of liability or to stress the theory's independent nature. As a result, actions for rules violations for the most part have been allowed to subsist in the shadow of 10b-5 claims. The

100. A broker's fraudulent rule violation would fall under the provision of Rule 10b-5 that makes it unlawful "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 (1978).

101. 549 F.2d at 169.

102. *See id.*

two theories of liability are so often confused in the cases¹⁰³ that it is not only difficult to separate them, it is even more difficult to understand whether and to what extent they are meant to be separate. Although *Colonial* called for restraint in the creation of implied actions, the decision did not indicate that an action for rules violations should be recognized only as part of a Rule 10b-5 action. However, with the advent of *Hochfelder* and its definitive limitation of 10b-5 actions, to inquire whether the two theories of liability are distinct is now more than academic. If the two theories are distinct, to allow claims for negligent violations without running afoul of the precise holding of *Hochfelder* might be possible.¹⁰⁴

Hochfelder does not compel application of the scienter standard to actions for rules violations. In rejecting a cause of action for negligence under section 10(b) and Rule 10b-5, the *Hochfelder* Court based its decision in large part on the statute's use of the words "manipulative," "device," and "contrivance." The Court emphasized that these terms "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence."¹⁰⁵ In contrast, the "suitability" and "supervision" rules of the NYSE and NASD contain no such reference to willful or intentional conduct.¹⁰⁶ Furthermore, the *Hochfelder* Court's characterization of section 10(b) as a "catchall" provision suggests that the broad scope of unspecified conduct that may fall within this section necessitates a more restrictive approach.¹⁰⁷ To the extent the self-regulatory rules address themselves to the more finite duties of supervision and selection of suitable investments, the potential scope of liability is not as great as under section 10(b). Therefore, similar restrictions are not as warranted, and negligence should be recognized.

Perhaps sensing that outright recognition of negligent violations of self-regulatory rules runs counter to the spirit, if not the rule, of *Hochfelder*, the *Utah State University* court refused to go this far. However, the court did continue to treat actions under self-regulatory rules as existing independently of 10b-5 actions. What emerges from *Utah State University* is an expedient compromise. On the one hand, the court manages to avoid delivering the death-blow to actions brought under the rules. On the other hand, the court uses *Hochfelder* to obscure further these actions in the shadow of 10b-5.

103. E. BRODSKY, GUIDE TO SECURITIES LITIGATION 158 (1974).

104. I S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES 3-29.6 (1978).

105. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1975).

106. See notes 5-6 *supra*.

107. 425 U.S. at 206.

The imposition of the *Hochfelder* scienter requirement upon actions for violations of the suitability and supervision duties cannot be reconciled with the notion of a true cause of action based on these rules. The statement in *Utah State University* that avoids this ultimate conclusion¹⁰⁸ amounts to little more than lip service to the idea generated by *Colonial* and its progeny that self-regulatory rules may have a recognizable role as a basis for damages actions in furtherance of the Exchange Act's investor protection purpose. If *Hochfelder* controls, it is difficult to imagine what role the rules could properly play in an action for damages. One writer has suggested that the rules may serve as "adjuncts" in actions brought under the antifraud provisions, "refining the definition of fraud."¹⁰⁹ This suggestion raises the issue of the legal effect of an "adjunct." In what respects, if any, may a federal court's consideration of an exchange rule properly influence the court's determination of whether the plaintiff has stated a cause of action for fraud under Rule 10b-5?

Relegating the rules to "adjunct" status probably means that the rules would have no real influence on the outcome of an antifraud action against a broker. If the plaintiff alleges a failure to supervise under NYSE Rule 405, the court must first ignore the letter of the rule, which contemplates a violation by negligence¹¹⁰ or without scienter. Next, the court must decide whether the broker's conduct "operates or would operate as a fraud or deceit"¹¹¹ on the plaintiff with the requisite scienter. Resolution of this inquiry does not require resort to the rule at all. The conduct either does or does not operate as a fraud or deceit. As an adjunct, the rule is merely suggestive of one context in which a broker may perpetrate a fraud or deceit.

CONCLUSION

The fraud requirement effectively undermines the implication of private actions from violations of the self-regulatory rules as a means of protecting investors in furtherance of the purposes of the Exchange Act. So limited, this theory of recovery provides investors no advantage over section 10(b) and Rule 10b-5 actions.

108. See text accompanying note 101 *supra*.

109. S. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* 197 (1977).

110. See text accompanying note 62 *supra*.

111. See note 100 *supra*.

Thus, the propriety of the fraud requirement depends upon the larger question of the desirability of recognizing an implied cause of action for any manner of self-regulatory rule violation. No clear indication exists of legislative intent either to create or to deny any private action under the self-regulatory scheme.¹¹² Therefore, the courts must decide whether such an action merits preservation and, if so, whether its survival necessitates repudiation of the fraud standard. The Supreme Court has not yet addressed either of these questions.

The prospect of liability for negligent violations would promote the purpose of investor protection in several ways. The imposition of liability for negligence would protect investors prospectively by expanding the deterrent function of the rules. After a negligent violation, the negligently injured investor would be protected by the possibility of restitutionary relief in federal court. The availability of a federal court not only provides the plaintiff with a choice of forum but more importantly provides the *only* opportunity for trial when the brokerage agreement contains an arbitration clause.¹¹³

There is concern that any expansion of implied liability may discourage the formulation and retention of self-regulatory rules by member organizations.¹¹⁴ However, to the extent member organizations fear the prospect of expanded liability, they could be acknowledging that existing internal sanctions have been ineffective in bringing about a satisfactory level of compliance with existing rules.¹¹⁵ If the standards in the industry in fact do not conform to the rules, the legislative purpose of investor protection is thwarted. The courts might have a duty under such circumstances "to be alert to provide such remedies as are necessary to make effective the congressional purpose."¹¹⁶ The implication of private actions for both fraudulent and negligent violations may be necessary to effectively protect investors as long as internal sanctions remain inadequate.

The greatest appeal of the fraud requirement is its effect in curtailing the flood of federal litigation contemplated by Judge Friendly.¹¹⁷ However, other ways to manage the volume of ac-

112. Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633, 642 (1966). See generally *Cort v. Ash*, 422 U.S. 66, 78 (1975).

113. See *Starkman v. Seroussi*, 377 F. Supp. 518, 522-23 (S.D.N.Y. 1974).

114. *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 168 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977).

115. See Comment, *Implied Civil Liability Arising From Violation of the Rules of the NASD*, 8 LOY. L.A.L. REV. 151, 155-56 (1975).

116. *J.I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964).

117. See text accompanying note 85 *supra*.

tions brought under the self-regulatory rules exist. The courts could direct their focus to the chief purpose of particular rules, recognizing as actionable only violations of rules designed for the direct protection of investors and denying actions brought under rules that have only a "housekeeping function."¹¹⁸ With respect to a rule designed to protect investors, actionability could nevertheless be denied if the rule were a broad, generalized "catchall" and therefore inappropriate for civil liability.¹¹⁹ Ultimately only rules that have the requisite purpose and specificity would support a cause of action. By limiting the contours of actionability according to the foregoing guidelines, the courts might feel more free to permit actions based on negligence when the particular rule seems to contemplate negligent violations.¹²⁰

THOMAS MAGLIOZZI

118. See *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

119. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

120. See notes 61-64 and accompanying text *supra*.

