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Broker-Dealer Obligations to Customers— The NASD Suitability Rule†

Attempts at self-regulation by the National Association of Securities Dealers have been particularly unsuccessful with respect to the sale of "suitable" securities. The author examines the reasons for this failure, and suggests that under the Securities Acts Amendments of 1964, the Securities and Exchange Commission has the power to promulgate a rule which will adequately protect and enforce the principle that investment decisions can be made rationally only in relation to the investor's needs and goals.

Gerald L. Fishman*

I. INTRODUCTION

Article III, section 2 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (NASD) states that:

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.¹

This is the so called "suitability" rule or doctrine. Its purpose is to protect the increasing numbers of investors in publicly held corporations, many of whom perforce are unsophisticated, from sharp and devious practices of unscrupulous securities transactions experts. The rule is part of the self-regulatory ethical code governing NASD member broker-dealers and registered representatives in their dealings with the public and other members.² This paper points out that the NASD has not provided adequate standards, controls, or enforcement of the rule governing suitability of recommended securities for particular investors in light of the individual's financial capabilities, needs, and objectives. In other words, the NASD suitability rule has failed as an ethical standard.

† The author wishes to thank Professor David S. Ruder of the Northwestern University School of Law for his helpful comments.

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1. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., NASD MANUAL D-5 (Reprint 1965) [hereafter cited as NASD MANUAL].

2. NASD, THE NASD AND THE REGISTERED REPRESENTATIVE 8 (1964).

To fulfill the broad purposes of the federal securities laws of protecting the investing public, it is submitted that the Securities and Exchange Commission (SEC) should incorporate the suitability rule into its regulation of the securities industry, thus making compliance with the rule an express legal responsibility. The SEC, in fact, has promulgated a suitability rule covering only one small area of the securities business. This is Rule 15c2-5(a)(2) governing the sale of "equity funding programs" under the Securities Exchange Act of 1934. The rule states:

(a) It shall constitute a "fraudulent, deceptive or manipulative act or practice" as used in section 15(c)(2) of the Act for any broker or dealer to offer or sell any security to, or attempt to induce the purchase of any security by, any person, . . . unless such broker or dealer, before any purchase, loan or other related element of the transaction is entered into: . . . (2) Obtains from such person information concerning his financial situation and needs, *reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person*, and delivers to such person a written statement setting forth the basis upon which the broker or dealer made such determination.³

It should be noted that this SEC rule goes beyond NASD Rule 2 in that the broker-dealer has an affirmative duty to reasonably determine whether the transaction is suitable for the customer. The broker-dealer is subject to this duty even when a customer who is highly sophisticated in the financial world wishes to disregard the unfavorable recommendation. The duty also obtains in the situation of minimal or no prior contacts between broker-dealer and customer. Despite the far reaching nature of this rule, albeit in a limited area, only one letter opposed the suitability aspects of the rule when it was proposed to the industry for comment.⁴

The suitability concept in Rule 15c2-5(a)(2) can be adapted to the more general area of the securities business now covered by NASD Rule 2 by holding it incorporated into the Commission's so called "shingle theory," which developed in cases of broker-dealers charging excessive markups and unreasonable

3. 17 C.F.R. § 240.15c2-5 (1964). (Emphasis added.) These programs involve the purchase of mutual fund shares and the pledging of these shares to secure a loan, the proceeds of which are then used to pay the premiums on an insurance policy purchased at about the same time. The rule also applies to every situation in which a broker-dealer is involved in a money-lending arrangement in connection with the sale of a security that is not subject to Regulation T of the Federal Reserve Board. Very few such situations exist, however. Fed. Res. Bd. Reg. T § 1, 12 C.F.R. § 220.1 (1963).

4. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 455.

prices in securities transactions. It has long been held that fraud may be implied where the relationship between two parties, though not of a fiduciary nature, raises a duty to disclose facts and the disclosure has not been made.⁵ The SEC began developing its shingle theory violation of the federal securities laws along these same lines.⁶ The shingle theory is based on the notion that a broker-dealer, by virtue of his opening an office and "hanging out his shingle," undertakes to deal fairly with his customers in accordance with the standards of the profession. The theory was approved in *Charles Hughes & Co.*,⁷ where the Second Circuit upheld the Commission's position that any person, regardless of his knowledge or access to the market and market information, is entitled to rely on the implied representation made by a broker-dealer that customers will be treated fairly.⁸ The shingle theory has recently been utilized to support the growth of the "reasonable basis doctrine," which requires that the broker-dealer make an adequate investigation of the company and its security prior to recommendation to customers,⁹ and that he must supply to the investor the material facts upon which he bases his recommendation.¹⁰ Use of the shingle theory to evolve a Commission promulgated suitability rule could be equally successful. It is suggested that the only reason why such an evolution has not taken place is the reluctance to expose the broker-dealer to possible civil liability for a suitability rule violation in the case in which the broker-dealer has had only minimal contacts with the customer, as opposed to a long standing relationship.¹¹

5. See *Strong v. Repide*, 213 U.S. 419 (1909); *Arleen W. Hughes*, 27 S.E.C. 629 (1948), *aff'd*, *Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949). In the opinion of SEC Chairman Cohen, this theory cannot be distinguished from the "shingle" theory, and is merely a choice of language in a particular context. CONFERENCE ON SECURITIES REGULATION 61 (Mundheim ed. 1965).

6. *Duker & Duker*, 6 S.E.C. 386 (1939). This was an "excessive markups" case where the broker-dealer charged his customers for securities at prices bearing no reasonable relation to the then current market prices for the securities. The court revoked *Duker & Duker's* registration.

7. *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *affirming*, 13 S.E.C. 676 (1943).

8. 13 S.E.C. 676, 681 (1943).

9. See *Charles E. Bailey & Co.*, 35 S.E.C. 33 (1953).

10. See *D. F. Bernheimer*, SEC Exchange Act Release No. 7000, Jan. 23, 1963.

11. The question of civil liability under the suitability doctrine will be discussed in connection with the issue of whether the doctrine should impose an ethical standard or a legal obligation. See text accompanying notes 78-87 *infra*.

II. THE BROKER-DEALER AS AN ADVISER AND THE NASD

Before any discussion of the suitability doctrine can be undertaken, two preliminary matters must be considered: first, how the broker-dealer acts as an adviser and, second, the NASD's relation to the suitability doctrine.

A. THE BROKER-DEALER AS AN ADVISER

The broker-dealer fulfills diverse functions in the investment community. At various times he is the banker, the dealer, the broker, the adviser, the market maker, and the professional of securities transactions.¹² As an adviser he counsels as to what securities a given customer should or should not own. If he is engaged only in advising the public *as an adviser for a fee*, he is subject to the Investment Advisers Act of 1940¹³ and the attendant special duties arising therefrom. Although most investment advisory firms do not also engage in the sale of securities,¹⁴ the broker-dealer who advises only incidentally to the conduct of his business as such and receives no special compensation is specifically exempted from that act.¹⁵ Nonetheless, certain obvious parallels between advisers and broker-dealers exist. Both groups want to be known as "professional."¹⁶ Both groups are also loosely covered by the phrase "fiduciary and quasi-fiduciary obligations," indicating their special obligations to deal fairly with the public above and beyond the ordinary obligations imposed on sellers of other types of merchandise.¹⁷ As for broker-dealers, unlike advisers, their obligations to the purchasers of securities they recommend may well be the area in which legal and ethical obligations have been most frequently defined and least effectively achieved.¹⁸ "Suitability" as to broker-dealers is still "a judicial quest for the holy grail."¹⁹

12. Hed-Hofmann, *The Maloney Act Experiment*, 6 BOSTON COLLEGE INDUS. & COM. L. REV. 187, 188 (1965).

13. 54 Stat. 847 (1940), 15 U.S.C. § 80b-1 (1964).

14. SEC, *Report of Special Study of the Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 381 (1963) [hereafter cited as *Special Study*].

15. 54 Stat. 849, 15 U.S.C. § 80b-2(11)(c) (1964).

16. Compare SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 190 (1963); NYSE, *ETHICAL CONDUCT: A STUDY GUIDE FOR REGISTERED REPRESENTATIVE TRAINEES OF NEW YORK STOCK EXCHANGE MEMBER FIRMS 1*, with *Special Study*, pt. 1, at 240-42.

17. *Special Study*, pt. 1, at 237.

18. *Special Study*, pt. 1, at 238.

19. CONFERENCE ON SECURITIES REGULATION 70 (Mundheim ed. 1965).

B. THE NASD

Self-regulation in the securities industry began in 1933 with an Investment Bankers Code under the ill-fated NRA.²⁰ It was soon realized that the desired objectives could not be achieved without appropriate legislation.²¹ Senator Maloney, sponsor of the proposed legislation stated:

The machinery of [the securities] business is delicate. It can be dislocated either by corruption from within or by unwise and burdensome regulation from without. Our task is to prevent the former without the risk of the latter. The [proposed] Act provides . . . that external restraints should be rendered unnecessary as a result of the exercise of self-restraint.²²

In 1939, the NASD was duly registered and approved pursuant to the Maloney Act²³ as a national securities association²⁴ and is, in fact, the only association so registered.²⁵ Among the purposes of the NASD are the promotion of high standards of commercial honor, the adoption and enforcement of rules of fair practice in the securities industry, the promotion of just and equitable principles of trade for the protection of investors, and the encouragement of self-discipline among members.²⁶ Today, over eighty per cent of all registered broker-dealers in the United States belong to the NASD.²⁷

A principal function of the NASD is that of self-regulation of the membership by constant enforcement of its rules and interpretations together with certain rules and regulations of the SEC and the Federal Reserve Board.²⁸ Trade practice complaints

20. *Special Study*, pt. 4, at 605; NASD, *THE NASD AND THE REGISTERED REPRESENTATIVE 4* (1964).

21. *Special Study*, pt. 4, at 605-06.

22. NASD, *NASD: WHAT IT IS, WHAT IT DOES TO PROTECT THE PUBLIC 4* (1959), quoting Senator Francis T. Maloney, sponsor of the Over-the-Counter Market Act, 52 Stat. 1070 (1938), 15 U.S.C. § 780-3 (1964). See S. REP. No. 1455 and H.R. REP. No. 2307, 75th Cong., 3d Sess. (1938).

23. Over-the-Counter Market Act, 52 Stat. 1070 (1938), 15 U.S.C. § 780-3 (1964).

24. Application by NASD, Inc., 5 S.E.C. 627 (1939).

25. COMMODITY RESEARCH PUBLICATIONS CORP., *UNDERSTANDING THE OVER-THE-COUNTER SECURITIES MARKET 19* (1960).

26. See NASD Certificate of Incorporation (Del.) reprinted in *NASD MANUAL* at C-1. Note the similarity to the language of the act, cited *supra*, note 23.

27. *Special Study*, pt. 1, at 16.

28. See *Special Study*, pt. 4, at 646. The NASD exercises controls in underwriting, over-the-counter retail and wholesale business, mutual fund distributions, and to some extent over business in listed securities. Areas not generally covered by NASD surveillance are § 5 of the Securities Act of 1933, the anti-manipulative provisions of the Securities Exchange Act of 1934, Rule 10b-6 of the Exchange Act, and state securities

against a member may be brought either by the NASD District Business Conduct Committee²⁹ or by "any person feeling aggrieved."³⁰ It should be noted that formal, publicly generated complaints have played a very minor role in NASD enforcement functions primarily for three reasons. First, if the complaint has merit the District Business Conduct Committee itself will initiate the proceedings.³¹ Second, the burden of going forward is on the complainant and there is no incentive for an individual to so proceed since NASD procedures do not presently, and never have provided for restitution.³² Third, the NASD has operated for a quarter-century in comparative anonymity, thus, it is submitted, seriously hampering the fulfillment of its purposes. The association restricts its members from advertising their membership in the NASD³³ and, the NASD itself does very little public relations work.³⁴ Further, only limited publicity is given to the results of NASD disciplinary proceedings.³⁵

Pursuant to sections 15(A)(b)(9), and (10) of the Securities Exchange Act, the NASD has promulgated a Code of Procedure for Handling Trade Practice Complaints,³⁶ providing for procedural due process. On application of a person aggrieved or on the SEC's own motion,³⁷ review by the Commission is provided

laws violations. See also, Boren & Co., SEC Exchange Act Release No. 6367, Sept. 19, 1960; *Special Study*, pt. 4, at 661.

29. NASD MANUAL at D-23.

30. *Ibid.*

31. Of the 809 disciplinary proceedings disposed of by district business conduct committees in the period 1959-61, only 28 were based on formal public complaints. Ten of these complaints were dismissed, three were withdrawn by the complainant prior to decision, and only four led to a penalty greater than censure. *Special Study*, pt. 4, at 663.

32. *Special Study*, pt. 4, at 664. NASD MANUAL at D-25 provides for a maximum fine of \$1,000. The other penalties there provided are censure, suspension, and expulsion from membership pursuant to § 15(A)(b)(9) of the Exchange Act.

33. NASD MANUAL at H-11.

34. *Special Study*, pt. 4, at 616-617.

35. NASD MANUAL at H-9. In a personal interview at the Chicago district office of the NASD on February 15, 1966, the writer was politely told he could not gain access to any such information. Until 1962, only expulsions were made "public." Now, suspensions are also "publicized" after the appeal period has expired. See generally, *Special Study*, pt. 4, at 666, 672.

36. NASD MANUAL, pt. E.

37. See *Special Study*, pt. 4, at 667, 714-718. In only one instance has the SEC exercised its power of review on its own motion. See NASD, Inc., 19 S.E.C. 424 (1945). It is also interesting to note that the majority opinion in *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963), referred to the provision for review of NASD disciplinary action

for, both in the Code of Procedure,³⁸ and in section 15(A) (g) of the statute. Most NASD proceedings are not reviewed because no appeal is taken and those cases that are appealed rarely involve the question of the suitability doctrine. In fact, over the years there have been relatively few violations of rule 2 resulting in NASD disciplinary proceedings.³⁹ As a result, the limits of the suitability rule have not been defined.

III. THE SUITABILITY RULE OF THE NASD

The NASD suitability rule derives its basis from a simple, universally accepted fact—that investment decisions can be made rationally only in relation to the needs and goals of the person for whom they are made. This involves both the broker-dealer's investment judgment and circumstantial knowledge about the customer's investment-risk limit. In effect, the rule is an attempt to shift the responsibility for making inappropriate investment decisions from the customer to the broker-dealer.⁴⁰

A. THE NEED FOR THE SUITABILITY RULE

There are two reasons why a suitability rule is needed in the securities business. First, disclosure requirements and practices have not protected the investor completely. In fact, there can be situations where disclosure is not enough to protect the investor even from his own greed. In *Phillips & Co.*,⁴¹ the SEC upheld NASD suspension of a member for violation of Rules 1 and 2 of the Association's Rules of Fair Practice when it was shown that the broker-dealer knew of the limited financial condition of his customers and yet urged purchase of a highly speculative security. The SEC said that the test of a rule 2 violation is whether the broker-dealer fulfilled the obligation he assumed, when he undertook to counsel customers, of only making such recommendations as would be consistent with the customer's financial

as possibly distinguishing it (NASD) from *Silver* and possibly exempting it from the antitrust laws.

38. NASD MANUAL at E-10.

39. Through 1961, there were a total of 35 proceedings for rule 2 violations, an average of only 2.3% of the total fair practice violations in each membership year since the inception of the NASD. *Special Study*, pt. 1, at 165. The New York Stock Exchange "know your customer" rule, NYSE, *op. cit. supra* note 16, ¶ 2405 (better known as NYSE Rule 405), has only recently had the suitability rule interpreted into it. See, *Special Study*, pt. 1, at 315-16.

40. Mundheim, *supra* note 4, at 449.

41. 37 S.E.C. 66 (1956).

situation and needs.⁴² Thus, no matter what is disclosed to the customer, the suitability rule is needed to help restrain what has become known as "boiler-room" tactics. A "boiler-room" is a high pressure broker-dealer engaged solely in the sale of "low-priced," "speculative," "obscure," "promotional," or "unseasoned" securities via the telephone to people he does not know (people on the so called "sucker list"), attempting to persuade them to make a hasty decision to buy.⁴³ Although the boiler-room cases have, for the most part, been concerned with violations of the reasonable basis doctrine, in more recent boiler-room decisions⁴⁴ the Commission has said that such high pressure tactics are not consistent with unhurried and careful presentation and disclosure of the facts, investment factors applicable to the security recommended, *and to a determination of its suitability for purchase by the customer in light of his particular financial situation and investment objectives*. Thus, the need for greater enforcement of rule 2 is evidently beginning to be recognized.

Second, as has been pointed out, broker-dealers have a special relation with the investing public.⁴⁵ The public is encouraged to, and does, rely on the superior skill of the broker-dealer community in its security transactions.⁴⁶ The principles of rule 2 place the burden of guarding against inappropriate investment decisions on those who claim to, and in most cases do, have superior skill. The net effect of invoking NASD Rule 2 is to raise the presumption that the customer has relied on the broker-dealer, thus making proof of such reliance unnecessary. The broker-dealer can, of course, rebut the presumption by showing that he was merely an order clerk in the transaction.⁴⁷ The findings of the *Special Study* have shown that because of the complex nature of the securities markets, and the reliance which the investing public places upon the competence and character of professionals in those markets, the investing public is subjected to undue hazards.⁴⁸ Use and enforcement of the suit-

42. *Id.* at 70. On inadequacy of disclosure in relation to the Securities Act of 1933, see the bizarre *Tucker Corp.*, 26 S.E.C. 249 (1947).

43. CONFERENCE ON SECURITIES REGULATION 69 (Mundheim ed. 1965). Boiler-rooms and the expansion of the suitability doctrine will be discussed at a later point. See text accompanying notes 61-62, *infra*.

44. See, e.g., Norman Joseph Adams, SEC Exchange Act Release No. 7072, April 30, 1963; Mac Robbins & Co., SEC Exchange Act Release No. 6846, July 11, 1962, *aff'd sub nom.*, Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Best Sec., Inc., SEC Exchange Act Release No. 6282, June 3, 1960.

45. See notes 16-17 *supra* and accompanying text.

46. Mundheim, *supra* note 4, at 450.

47. *Ibid.*

48. See, S. REP. No. 379, 88th Cong., 1st Sess. 43 (1963).

ability rule would greatly aid in the elimination of undue hazards growing out of reliance on broker-dealers in securities transactions.

B. SEC TREATMENT OF NASD RULE 2 DISCIPLINARY PROCEEDINGS

Among the earliest NASD Rule 2 disciplinary proceedings reviewed by the SEC were the "excessive trading" cases. In *E. H. Rollins & Sons, Inc.*,⁴⁹ the funds of a religious and charitable corporation were "churned" by the broker-dealer, that is, the officers reposed complete trust and confidence in the broker-dealer who abused that trust and confidence by causing an excessive number of transactions with the funds at prices not reasonably related to the market. In upholding the NASD's finding of a rule 2 violation, the Commission said that the test was not one of power given to the broker-dealer, but rather one of his *status* in relation to his customer and how he used that status to induce churning.⁵⁰

Two recent Commission decisions reviewing NASD findings of suitability rule violations involved the recommendation of the broker-dealer's own high risk securities to customers. In *Powell & McGowan, Inc.*,⁵¹ the self-serving recommendation was held so grossly inappropriate and such a high risk as to constitute overreaching. In *C. Gilman Johnston*,⁵² the Commission "dismissed review"⁵³ of an NASD Rule 2 violation finding, even though no evidence concerning customers was offered. The Commission said that since the salesmen were inexperienced, there were no reasonable grounds for them to believe that they could make a suitability determination for their customers and, under these circumstances, this was enough for the NASD to find the suitability rule violated. The broker-dealer's motivation or intention was held to be of no consequence by the Commission, agreeing with an NASD ruling in *First Securities Corp.*⁵⁴ In the

49. 18 S.E.C. 347 (1945). The Commission has treated excessive trading cases as anti-fraud violations of the securities laws.

50. In another excessive trading case, where the SEC held that the NASD suitability rule had been violated, the NASD rules generally were held not to be an unconstitutional delegation of power to the association. *R. H. Johnson & Co.*, 33 S.E.C. 180, *aff'd*, *R. H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir.), *cert. denied*, 344 U.S. 855 (1952); *accord*, *Boren & Co.*, SEC Exchange Act Release No. 6367, Sept. 19, 1960.

51. SEC Exchange Act Release No. 7302, April 24, 1964.

52. SEC Exchange Act Release No. 7390, Aug. 14, 1964.

53. Procedurally, when the SEC affirms the findings of the NASD disciplinary proceeding, it dismisses review of that proceeding.

54. SEC Exchange Act Release No. 6497, March 20, 1961.

latter case, the broker-dealer had intimate knowledge of the limited financial circumstances and needs of his elderly widow customer and yet proceeded to "churn" her portfolio. The standard set in applying rule 2 was based on the financial situation, holdings, and needs of the particular customer involved. Thus, in the relatively few cases where the Commission has dealt with NASD Rule 2, the suitability test has become the use by the broker-dealer of his special status in relation to the particular customer, with a de-emphasis of any element of broker-dealer intent.

The high-water mark of NASD Rule 2 was reached in *Gerald M. Greenberg*,⁵⁵ where a boiler-shop, selling low-priced, speculative securities, was held to have violated the suitability rule. It was conceded by the respondent that at least some of the sales may not have been suitable. The Commission, in upholding the respondents' expulsion from the NASD, indicated that since the broker-dealer had no knowledge of and made no attempt to obtain information concerning the customer's other security holdings, his financial situation, and his needs and objectives, the broker-dealer was not in a position to judge the suitability of the recommendation.⁵⁶ Thus, the NASD and the SEC were seemingly placing an affirmative duty on the broker-dealer to attempt to obtain such information, abrogating the language of NASD Rule 2 that recommendations be suitable "upon the basis of the facts, if any, disclosed" by the customer. The NASD's recent decision in proceedings against *Shearson, Hammill & Co.*,⁵⁷ though, raises a question of whether there has been a retreat from the *Greenberg* holding. In that case the NASD Board of Governors dismissed charges of a rule 2 violation against a salesman found to have no knowledge of his customer's financial situation and needs while upholding the charge against a salesman who did have such knowledge. The *Special Study* has concluded,⁵⁸ and it is submitted here, that under this latter holding, the NASD is defeating the purpose of its own suitability rule by effectively permitting recommendations of low priced, speculative securities to unknown customers.

55. 40 S.E.C. 133 (1960).

56. *Id.* at 137, 138.

57. See *Special Study*, pt. 1 at 280-299, *aff'd* by SEC, SEC Exchange Act Release No. 7743, Nov. 12, 1965.

58. *Special Study*, pt. 1 at 312. In the affirmance by the Commission, it was held to be an anti-fraud violation where known facts should have caused further inquiry on the part of the salesman. See SEC Exchange Act Release No. 7743, 21-23, Nov. 12, 1965.

The last few years, in fact, have seen standards of broker-dealer responsibility under the suitability concept expand beyond the simple situation where fraud was easily found⁵⁹ into two main areas. The first area is where no degree of disclosure would permit the investor involved to make a rational investment. Such was the case in *Powell & McGowan, Inc.*,⁶⁰ where the broker-dealer knew he was recommending high risk securities to a 79 year old customer who was senile, retired, and living alone. One more element of responsibility was placed on the broker-dealer by this case—that of determining whether his customer can utilize any information disclosed in reaching an investment decision as part of the suitability rule.⁶¹ Thus expanded, the suitability rule in this area would not allow the broker-dealer to relieve himself of its requirements by mere disclosure.

The second area wherein there has been expanded use of the suitability rule, apart from the trust and confidence situations and cases of obvious overreaching, is in the boiler-room cases as represented by *Greenberg and Shearson, Hammill & Co.*, discussed earlier. It has been this area, and, indeed, these two cases, that seemingly has given rise to the current and probably most important issue with respect to the suitability rule—whether it should be a legal responsibility or a self-regulatory ethical standard.

IV. SUITABILITY—ETHICAL PRINCIPLE OR LEGAL DUTY?

The concept of suitability originated with the NASD as an ethical principle,⁶² and the association has taken the leadership in its development.⁶³ However, until after the *Special Study* was released, the NASD did not materially act to set any gen-

59. See, e.g., *Hammill & Co.*, 28 S.E.C. 634 (1948), where non-disclosure in violation of rule 10b-5 was found when the broker-dealer, knowing the financial circumstances and needs of a 61 year old widow who completely relied on his recommendations, sold his customer a partnership interest in his failing securities firm.

60. SEC Exchange Act Release No. 7302, April 24, 1964.

61. Cf. note 41 *supra* and accompanying text, implying that the test is not whether the customer has made a considered investment, but whether the broker-dealer has fulfilled his obligation of making only suitable recommendations. *Accord*, *First Securities Corp.*, SEC Exchange Act Release No. 6497, March 20, 1961.

62. CONFERENCE ON SECURITIES REGULATION 103 (Mundheim ed. 1965).

63. See *Special Study*, pt. 4, at 669.

eral standards for this ethical principle. Then, on November 1, 1964, the association promulgated a three page *Interpretation on Fair Dealing with Customers*.⁶⁴ The *Interpretation* begins by stating that:

[I]mplicit in all . . . relationships with customers . . . is the fundamental responsibility for fair dealing [S]ales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.⁶⁵

Then follow five examples of practices that violate this responsibility: recommending speculative, low-priced securities, especially in "high pressure telephonic sales campaigns;"⁶⁶ churning or excessive trading; short term trading in mutual funds; "fraudulent conduct;" and recommending purchases beyond the customer's capability to meet such a commitment.⁶⁷ The *Interpretation* ends by stating that the enumerated practices are not all inclusive and that "Usually, any breach of the obligation of fair dealing as determined by the Securities and Exchange Commission under the anti-fraud provisions of the securities laws could be considered a violation of the Association's Rules of Fair Practice."⁶⁸

This Interpretation has served only to confuse the basic issue at hand. Although promulgated as an ethical standard, it has legal overtones when it uses "churning" as one of its major examples.⁶⁹ Further, the *Interpretation* does not really set up a general suitability doctrine except that confined to speculative, low-priced securities, even though the *Special Study* recommended a general expansion of the rule.⁷⁰

A. CHANGING AN ETHICAL STANDARD INTO A BASIS FOR LEGAL RESPONSIBILITY

At the present time, it can be argued that the broker-dealer

64. NASD MANUAL at G-7.

65. *Ibid.*

66. *Ibid.* This example bears a close resemblance to the *Greenberg* situation. See CONFERENCE ON SECURITIES REGULATION 99 (Mundheim ed. 1965).

67. "This [last] example was drafted to cover the situation where shares in a mutual fund are sold under a contractual plan to persons who cannot afford the monthly payments." Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 461 n.44.

68. NASD MANUAL at G-9.

69. See E. H. Rollins & Sons, Inc., 18 S.E.C. 347 (1965).

70. See *Special Study*, pt. 1, at 328 for the full recommendation.

has no duty to affirmatively seek information on his customer's resources and needs,⁷¹ save, possibly, for the boiler-room situation described in the Interpretation's first example and *Greenberg*. "There is, however, no reason to anticipate that the Commission and its staff will necessarily treat it [the Interpretation] as the final word over the long run."⁷² Various problems can be foreseen if this affirmative duty is placed on broker-dealers. First, "the Commission would be passing on the merits of securities on a qualitative basis"⁷³ every time it reviewed an NASD Rule 2 violation proceeding. Second,

the regulatory bodies will not be concerned merely with the conduct of the broker-dealer in effecting the transaction (which is where regulation has had its impact in the past), but they will be passing upon the terms of the transaction, for if a broker-dealer sells a security which is unsuitable, the purchaser would have a right of rescission or at least a right to recover damages.⁷⁴

Thus by using an ethical standard as a basis for legal responsibility⁷⁵ the Commission would be "opening the floodgates" of litigation.

Regarding the question of the passing on the merits of securities, although the Commission has no authority to do so,⁷⁶ it can be said that it has been engaged in this activity, at least indirectly, in the past.⁷⁷ Admittedly, the SEC has never passed on the merits of a particular security as it relates to an individual or class of individuals, which would be the result of extending the suitability rule, but such is not inconceivable or unacceptable, for state governments do it frequently under the so-called Blue Sky Laws.

The only instances where the suitability concept has been carried over into a legal responsibility is in the context of a boiler-room sale⁷⁸ where rule 2 violations are readily discernable. As yet, there appears to be no case holding a broker-

71. NASD, *1964 Report to Members* 8 (1964).

72. CONFERENCE ON SECURITIES REGULATION 99 (Mundheim ed. 1965).
But see Mundheim, *supra* note 67, at 463 n.54.

73. *Ibid.*

74. *Id.* at 100.

75. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 187, 190, 191 (1963), where a conversion of an ethical standard into a duty, the violation of which amounted to fraud, seems to have been made.

76. See 1 LOSS, *SECURITIES REGULATION* 130 (2d ed. 1961).

77. Cf. *Tucker Corp.*, 26 S.E.C. 249, 251 (1947), where, in another context, the Commission deemed it "necessary to warn the investing public" of the quality of the security there involved.

78. CONFERENCE ON SECURITIES REGULATION 103 (Mundheim ed. 1965).

dealer civilly liable in damages on the ground that unsuitable securities were recommended and sold to a customer.⁷⁹ In *Colonial Realty Corp. v. Bache & Co.*,⁸⁰ it was held that NASD rules do not give rise to a federal private claim upon which relief can be granted. However, there remains the possibility that if the NASD does not expand the suitability rule, the courts will. This was done in *Anderson v. Knox*,⁸¹ an analogous insurance case where the defendant insurance agent was held liable for recommending an unsuitable insurance plan to plaintiff and his wife. Liability there was predicated on: (1) the fact that insurance is a complex business; (2) a holding out of the agent as an expert in the field; and (3) the relative lack of sophistication of the customer. As pointed out earlier,⁸² the securities industry is extremely complex, and the broker-dealer is heavily relied upon as an expert by the investing public.

There appear to be factors warranting the conclusion that the courts would and should become involved in enforcement of the suitability doctrine. First, the NASD has no power to assure that the customer injured by a suitability violation will be made whole.⁸³ This fact alone may be enough to persuade a court that the association, contrary to the purpose of the federal securities laws, is unable to effectively protect investors in this area. Second, and more importantly, notwithstanding the industry's long promotion of an image of professionalism, the primary emphasis of the securities business is on selling securities.⁸⁴

79. Mundheim, *supra* note 67, at 465. It has been intimated to the writer that there is at least one such suit pending.

80. CCH FED. SEC. L. REP. ¶ 91351 (S.D.N.Y. March 20, 1964), *aff'd*, 358 F.2d 178 (2d Cir. 1966). In affirming, however, Judge Friendly indicated that some rules, especially when the rule imposes an explicit duty unknown to the common law, may indeed give rise to an implied federal right of action. See also *O'Neill v. Maytag*, 339 F.2d 764 (2d Cir. 1964).

81. 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962). In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F. Supp. 373 (S.D. Tex. 1965), the court implied that it would place such a duty on broker-dealers to affirmatively seek information on the customer's resources and needs. The actual question was not reached because the court held the NASD suitability rule satisfied in this case since the defendant customer had "demonstrated his financial acumen . . . and that he was a suitable person and a prudent one in which to make a transaction of the size of the short sale" involved. *Id.* at 376.

82. See notes 16, 17, 46 *supra*, and accompanying text.

83. NASD MANUAL at D-25. Under present rules the largest fine that the NASD can impose is \$1,000. This is not restitutionary, but is penal in nature.

84. This is conceded by the Vice-President and General Counsel of the NASD, Marc A. White, in CONFERENCE ON SECURITIES REGULATION 28 (Mundheim ed. 1965).

In reality, registered representatives are salesmen, and clients are customers. In this light, the conflict between the broker-dealer's merchandising function and his "special obligations" to his customers⁸⁵ in the suitability area becomes readily apparent. The NASD has not succeeded in defining meaningful standards of conduct in this area because of this conflict in the functions of the securities business itself. When the NASD has acted, its actions have been initiated for the most part by the SEC.⁸⁶ One student of the subject has concluded:

[T]he NASD is essentially a trade organization; and like every trade organization, should possess self-regulating powers. It is doubtful whether at this stage the NASD should be expected to do more than regulate the relations between its members under the supervision of the SEC. In a decade, it had proved incapable of establishing accepted standards of behavior for the activities of the trade. Neither was it capable of solving problems in a selfless manner. It has acted like a trade organization and should be recognized as such.⁸⁷

B. A PROPOSED SEC RULE ON SUITABILITY

Under the Securities Acts Amendments of 1964,⁸⁸ the SEC is given the responsibility, identical to that imposed on the NASD, of promulgating rules and regulations designed to promote just and equitable principles of trade with regard to broker-dealers not members of a registered securities association. Thus, the Commission may now expressly articulate its own suitability rule for this limited group of broker-dealers, and under the reasoning of *J. I. Case Co. v. Borak*,⁸⁹ civil liability may ensue against them. If, however, the basic investor protection purpose of the securities laws is not to be lost, the SEC should actively evolve a suitability concept for the entire broker-dealer community. The Commission could do so under the anti-fraud provisions and the shingle theory,⁹⁰ and in this way preserve the basic purpose of the securities laws where the NASD has failed. First, such a rule need not make the broker-dealer a virtual insurer and no attempt need be made to provide a standard for evaluating various systems of security analysis or the decisions

85. See note 14 *supra* and accompanying text.

86. Hed-Hofmann, *The Maloney Act Experiment*, 6 BOSTON COLLEGE INDUS. & COM. L. REV. 187, 217 (1965).

87. *Ibid.*

88. Securities Exchange Act of 1934 §§ 15(b)(8)-(10), as amended, 78 Stat. 572-573 (1964), 15 U.S.C. § 780 (Supp. 1965).

89. 377 U.S. 426 (1964), 59 Nw. U.L. REV. 809 (1965).

90. See text following note 8, *supra*. See also CONFERENCE ON SECURITIES REGULATION 99 (Mundheim ed. 1965).

made as a result of such analyses. The rule, rather, should be procedural in nature. Second, since a suitability concept relates suitability of a particular security to the investment risk limit of a particular customer, the broker-dealer should be required to make a reasonable effort to obtain such information from the customer as a matter of routine in the course of doing business. Third, the rule should make it abundantly clear that suitability at the time of recommendation is the issue and that subsequent performance of the security is not relevant to the inquiry. This would act as a stop-gap to any potential protracted litigation by disgruntled investors who, when the market takes a turn to their detriment, tend to blame their broker-dealer instead of the outside forces involved. Fourth, when the customer decides to change his investment objectives (which changes his suitability requirements), the broker-dealer should at least ascertain that the customer understands the investment risks involved in the changed objectives. These risks should be explained by the broker-dealer in relation to the customer's financial situation as known to him. If, nevertheless, the customer persists on adherence to the changed objectives, the broker-dealer should be allowed to advise him about securities that, in the broker-dealer's judgment, conform to the new objective and purchase for him the securities which the customer selects. However, the broker-dealer should not, as long as he thinks that the securities are inappropriate in light of the customer's financial situation as known to him, be permitted to solicit the customer's purchase of any such inappropriate securities. If the broker-dealer complied with the minimal requirements of this proposed rule, there would be no violation of the rule upon which to ground civil liability. Beyond these standards the broker-dealer would be no more than an order clerk to whom the suitability rule would not apply.

V. CONCLUSION

In early 1962, over 17 million individuals held shares in publicly held corporations⁹¹ and were serviced by over 6,000 broker-dealer firms.⁹² These figures are probably greater today, leading to the conclusion that, without additional rules and standards of conduct in this vast and complex segment of our economy, chaos could result. To a great extent the NASD has been successful in carrying out its responsibilities to provide

91. *Special Study*, pt. 1, at 10.

92. *Id.* at 16.

such rules and standards of conduct for broker-dealers.⁹³ In the area now covered by NASD Rule 2, however, it is clear that the NASD has not and cannot succeed in its enforcement responsibilities due to the inherently conflicting position in which the self-regulatory body finds itself. The suitability concept seems to be so bound up with the shingle theory and the anti-fraud provisions in the securities laws that the SEC would probably be a better source from which such a rule should emanate, due to the "delicate fiduciary nature of an investment advisory relationship."⁹⁴ Such a rule need not be an onerous burden or threat to the broker-dealer community, if carefully drafted and enforced as herein proposed. It may, in fact, lead to acceptance of that status of professionalism that the broker-dealer community has been claiming for so many years.

93. See 2 LOSS, *SECURITIES REGULATION* 1389-91 (2d ed. 1961); Grant, *The National Association of Securities Dealers: Its Origin and Operation*, 1942 WIS. L. REV. 597; Westwood & Howard, *Self-Government in the Securities Business*, 17 LAW & CONTEMP. PROB. 518 (1952); White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959). *But see* Hed-Hofmann, *supra* note 86.

94. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (1963); 2 LOSS, *SECURITIES REGULATION* 1412 (2d ed. 1961).

