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# BROKERS' LIABILITY FOR VIOLATION OF EXCHANGE AND NASD RULES

HARRY N. MACLEAN*

*In this timely article, the author offers insight into an expanding area of securities litigation: recovery for violations of rules promulgated not by the Securities and Exchange Commission but by non-governmental self-regulatory bodies. MacLean summarizes the statutory framework of the Securities Exchange Act of 1934, discusses the recent case law, and concludes with an analysis of the policy and rationale behind the self-regulatory scheme.*

## INTRODUCTION

WHEN the Supreme Court recently denied certiorari[1] in the case of *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[2] it left standing a decision upholding a cause of action against a brokerage firm based on a violation of a New York Stock Exchange rule. The contra result was reached in *Mercury Investment Co. v. A. G. Edwards & Sons, Inc.*,[3] where the district court dismissed that portion of the complaint alleging a violation by the broker of a rule of the National Association of Securities Dealers.[4] These two decisions indicate the present state of judicial uncertainty concerning a vital issue in the area of civil liabilities in the securities business.

While it is settled that civil actions lie for violation of the antifraud provisions of the securities laws and rules passed thereunder,[5] there are many rules adopted by the self-regulatory agencies in the securities industry which proscribe conduct falling far short of fraud.[6] Simply stated, the issue is: Can an aggrieved customer sue a broker-dealer in federal court for violation of a rule of one of the self-

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*Partner, Cunningham & MacLean; J.D., University of Denver, 1967.

[1] 396 U.S. 838 (1969).

[2] 410 F.2d 135 (7th Cir. 1969). Plaintiff sued a brokerage firm for *inter alia* violation of the "know your customer" rule of the NYSE. *See* n. 38 *infra* for a discussion of the "know your customer" rule.

[3] 295 F. Supp. 1160 (S.D. Texas 1969). Plaintiff sued for violation of the "suitability rule" of the NASD. *See* n. 6 *infra* for discussion of the suitability rule.

[4] *Id.* at 1163.

[5] See discussion of cases in III LOSS, SECURITIES REGULATION 1763-97 (1961); VI LOSS, SECURITIES REGULATION 3869 (1969 Supplement to Vol. III).

[6] One example of such a rule is the NASD "suitability rule" which 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." NASD Rules of Fair Practice, Article III § 2. A discussion of this rule in light of the standards and practices of the brokerage community is found in Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L. J. 445.

regulatory bodies to which that broker-dealer belongs? If so, can the customer sue for a violation of any of the rules or just specific ones? The ultimate disposition of these questions not only affects the civil liabilities of broker-dealers but also the future role of the self-regulatory bodies in the regulation of the securities industry. This article will deal with these questions in terms of the statutory framework of the securities laws, an analysis of the case law, and an examination of the function of the self-regulatory bodies. Finally, the effect that civil liability under these rules would have upon the securities industry will be considered.

## I. STATUTORY FRAMEWORK

It would seem logical to analyze the statutory structure of the Securities Exchange Act of 1934 in hope of finding a definitive answer to the question of civil liability for violation of exchange or NASD rules. This has been done in detail[7] and the results do not appear conclusive or even persuasive. The only statement that can be made with confidence is that the Act does not contain a clear grant of a private right of action for violation of association or exchange rules and the courts which have found such rights have relied primarily on policy grounds or interpretation of Congressional intent.[8] For these reasons, this examination will consider only briefly some of the sections of the Act which have been relied on to give force to arguments on either side of the issue.

Section 27 of the Act sets forth the jurisdiction and venue requirements for suits under the Act,[9] and much of the statutory argument for imposition of civil liabilities rests upon an interpretation of a particular phrase therein stating that the district courts shall have "exclusive jurisdiction . . . of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."[10] It seems clear to at least one author that the rules passed by the NASD and the exchanges are "rules and regulations passed thereunder," and even if they are not, they could be considered to be a "duty created by this chapter."[11] It would seem equally arguable, however, that the phrase "rules and regulations" refers only to such rules and regulations

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[7] Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L. Q. 633, 635-50 (1966); Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate; Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 964-70 (1966).

[8] *See* text, § II for discussion of the cases.

[9] Securities Exchange Act § 27, 15 U.S.C. § 78aa (1964).

[10] *Id.*

[11] Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 16-19 (1966).

passed by the Securities and Exchange Commission and the Board of Governors of the Federal Reserve Board pursuant to Section 23 of the Act[12] and the "duty" mentioned refers to the duty of the associations and exchanges to pass rules and enforce them through disciplinary actions against their members. In any event, no authority has been cited for the proposition that it was the intention of Congress in the use of the above phrase to include the rules and regulations passed by the registered securities associations and exchanges.

Secondly, the Securities Exchange Act of 1934 provides for the registration of stock exchanges and national securities associations.[13] It is argued that because of this registration requirement and the fact that the Commission must approve the rules of the securities associations[14] and exchanges[15] prior to registration, these rules are, in fact, the rules of the SEC. This idea is further supported by the fact that the SEC must give prior approval to any change of existing association rules[16] and can abrogate the rules of the association if it

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[12] Securities Exchange Act § 23, 15 U.S.C. § 78w(a) (1964).

[13] Section 5 of the Act (15 U.S.C. § 78e (1964)) requires that all exchanges engaging in interstate commerce must register under Section 6 of the Act. 15 U.S.C. § 78f (1964). An exchange must file an agreement to comply and enforce compliance among its members with the Act and of the Securities and Exchange Commission rules. 15 U.S.C. § 78f(a) (1) (1964). Section 6(b) of the Act requires that for registration to be granted and to remain in force the rules of the exchange shall "include provision for the expulsion, suspension or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade . . . . " 15 U.S.C. § 78f(b) (1964). Section 6(c) provides that nothing in the Exchange Act precludes an exchange from "adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder . . . . " 15 U.S.C. § 78f(c) (1964). Section 6(d) provides that the Commission shall grant the registration if it appears that the exchange will be able to comply with the provisions of the Act and the rules thereunder and if "the rules of the exchange are just and adequate to insure fair dealing and to protect investors . . . . " 15 U.S.C. § 78f(d) (1964). The Commission also has the authority to suspend or withdraw an exchange registration, (15 U.S.C. § 78s(a)(1) (1964)) and to alter or supplement exchange rules in certain specific areas. 15 U.S.C. § 78s(b) (1964).

The Maloney Act (15 U.S.C. § 78o — 3 (1964)) was passed in 1938 to provide for comparable self-regulation in the over-the-counter market and provides for the registration of national securities associations with the Commission requiring, among other things, that:

"[T]he rules of the association [be] designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest . . ." 15 U.S.C. § 78o — 3(b)(8) (1964).

In addition, the association must have adequate procedures for fining, censuring, suspending or expelling its members for violation of its rules. 15 U.S.C. § 78o — 3(b) (9) (1964). The Commission has the authority to abrogate any rule of an association if the requisite findings are made (15 U.S.C. § 78o — 3(k)(1) (1964)) and to suspend the registration of an association if necessary in the public interest. 15 U.S.C. § 78o — 3 (1) (1964). To date, the National Association of Securities Dealers, Inc. (NASD) is the only association registered pursuant to the Act, and its membership consists of most of the broker-dealers in the country. Many NASD members are also members of one or more exchanges, and brokers who are not are still subject to regulation by virtue of the 1964 amendments. 15 U.S.C. § 78o(b)(10) (1964).

[14] Securities Exchange Act § 15A(b), 15 U.S.C. § 78o — 3(b) (1964).

[15] Securities Exchange Act § 6, 15 U.S.C. § 78f(d) (1964).

[16] Securities Exchange Act § 15A(j), 15 U.S.C. § 78o — 3(j) (1964).

is necessary "to assure fair dealing by the members of such association . . . or otherwise to protect investors or effectuate the purpose of this chapter."[17] Since suits can be brought for violation of SEC rules, then they should be able to be brought for violation of NASD rules.[18] This limited view of the NASD as merely an extension or alter-ego of the SEC with little independent responsibility or initiative would undoubtedly be contested by the NASD.[19] This view is also contrary to the basic theory of self-regulation in the securities industry, as explained in a later section of this article,[20] which holds that it is to the advantage of the regulators, the regulated, and the investing public, for the regulated to assume primary responsibility for the conduct of its members, with the residual power to override vested in the SEC if such self-regulation is considered inadequate.

## II. THE CASES

Considerable confusion in the consideration of the case law in this area can be avoided by distinguishing the cases involving civil suits against stock exchanges. It is fairly well settled that a cause of action against an exchange for failure to enforce its rules will be upheld.[21] This result is based on the reasoning that an investor may sue to enforce a duty imposed by statute and is consistent with the opinion in *J. I. Case Co. v. Borak*[22] and other cases implying that one for whose benefit or protection a statute is passed may sue for violation of the duty required

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[17] Securities Exchange Act § 15A(k)(1), 15 U.S.C. § 78o — 3(k)(1) (1964).

[18] Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules,* 51 CORNELL L. Q. 633 (1966). The writer concludes: "Where the SEC has such sweeping powers over association rules, these rules are virtually rules of the SEC itself, and should grant the same rights to investors as SEC rules grant." *Id.* at 636.

[19] In any event, the NASD has felt independent enough to sue the SEC in Federal court. *National Ass'n of Sec. Dealers, Inc. v. Securities & Exch. Comm'n,* 420 F.2d 83 (D.C. Cir. 1969), CCH FED. SEC. L. REP. ¶ 92, 438.

[20] *See* text, § III *infra.*

[21] It was held in *Baird v. Franklin,* 141 F.2d 238 (2d Cir.) *cert. denied* 323 U.S. 737 (1944), that the New York Stock Exchange violated Section 6(b) of the Securities Exchange Act when it failed to expel a member who had violated the rules of the exchange in the conversion of its customers' securities (recovery was denied since plaintiffs failed to demonstrate that such failure was the proximate cause of their injuries). In *Butterman v. Walston & Co.,* 387 F.2d 822 (7th Cir. 1967) plaintiffs alleged that the New York Stock Exchange violated its rules in not expelling a registered representative of Walston & Co. In dismissing the complaint against the exchange on the grounds that the exchange had no duty to enforce its rules unless it had knowledge of the improper conduct, the clear implication is that the court recognized the right of an individual to such an exchange for failure to enforce its rules.

[22] 377 U.S. 426 (1964). Borak, as a Case stockholder, sued the company to void a merger and obtain damages alleging among other things violations of the proxy rules passed by the Commission. The Court, in affirming the claim for relief, stated: "It appears clear that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Act. Indeed, this section specifically grants the appropriate district courts jurisdiction over 'all suits in equity and actions at law brought to enforce any liabilities or duty created under the Act.' " *Id.* at 430-31. *See* Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak,* 12 U.C.L.A. L. REV. 1150 (1965).

by that statute.[23] The statutory duty involved here is to pass rules promoting just and equitable principles of trade and to discipline members for the violation thereof. Thus, this theory would allow a suit against the NASD or an exchange for failure to pass or enforce adequate rules or against the SEC for failure to abrogate or supplement existing ones.

The first case to deal directly with the issue of whether a brokerage firm could be held liable to a customer for a violation of an exchange or NASD rule was *Colonial Realty Corp. v. Bache.*[24] The plaintiff in *Colonial* alleged a violation of Article XIV, Section 6 of the New York Stock Exchange Constitution[25] and Article III, Section 1 of the Rules of Fair Practice of the NASD.[26] The lower court dismissed the federal claim[27] indicating that violation of association exchange rules do not give rise to suits in federal courts. The second circuit upheld the dismissal, but only after analyzing the rule thoroughly, creating a test requiring a judicial investigation of the particular rule involved and its function in the over-all scheme of securities regulation as provided for in the 1934 Act.[28]

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[23] *See* 2 LOSS, SECURITIES REGULATIONS, 934-36 (1961) and the cases and articles cited therein. The statutory tort theory is explained by the RESTATEMENT (SECOND) OF TORTS as follows:

> "The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part
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> (a) to protect a class of persons which includes the one whose interest is invaded, and
>
> (b) to protect the particular interest which is invaded, and
>
> (c) to protect that interest against the kind of harm which has resulted, and
>
> (d) to protect that interest against that particular hazard from which the harm results."

RESTATEMENT (SECOND) OF TORTS § 286 (1965). *See generally* Note, 77 HARV. L. REV. 285 (1963).

[24] 358 F.2d 178 (2d Cir. 1966). In *Colonial,* a customer brought suit against a brokerage firm alleging that the firm violated an oral agreement not to sell the securities in plaintiff's margin account unless necessary to meet the minimum margin requirements of the New York Stock Exchange.

[25] *Id.* at 180. This rule states that: "A member . . . who . . . shall be adjudged guilty . . . of conduct or proceeding inconsistent with just and equitable principles of trade may be suspended or expelled as the Board may determine." New York Stock Exchange Constitution Art. XIV § 6, CCH New York Stock Exchange Guide.

[26] This rule states that: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." National Association of Securities Dealers, Inc. Rules of Fair Practice Art. III § 1.

[27] Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 180 (2nd Cir. 1966).

[28] What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. *Id.* at 182.

It is important to note that there was no specific reliance on an interpretation of Section 27 of the Act in adopting this flexible test. The court relied instead on its understanding of the regulation of the securities industry and the function of self-regulation.[29] The court stated that "the difficulty [in determining civil liability] lies in the scope of the unique statutory scheme of supervised self-regulation by exchanges and dealers' associations."[30] However, the court then adopts the rationale of the "substitute rule" stating: [W]e cannot ignore that the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC itself."[31] The opinion then indicated that the court would not say that there could never be a basis for implying a private right of action based on an exchange or association rule.[32]

The concept underlying the flexible test adopted by the court appears to be that self-regulation is not really a separate approach in itself but rather is merely one aspect of attempting to achieve investor protection sanctioned by the SEC. If this concept is accurate, there is no reason for denying association and exchange rules the same status as those of the SEC.

The court then limited the effect of this concept by denying civil liability for violation of the rules prohibiting conduct which is "inconsistent with fair and equitable principles of trade."[33] In the court's opinion, the scope of these rules includes "unethical behavior which Congress could well not have intended to give rise to a legal claim"[34] and that there was no reason to believe that merely by requiring adoption of rules assuring fair and equitable conduct "Congress meant to impose a new legal standard on members different from that long recognized by state law."[35] Moreover, the

[29] *Id.* at 181-82.

[30] *Id.* at 181.

[31] *Id.* at 182. The rationale of the so-called "substitute rule" is that the investor should not be deprived of a private right of action in an instance when the SEC has not adopted a particular rule in deference to the exchange adopting the rule. The court in *Colonial* cites Lowenfels, *Implied Liability Based Upon Stock Exchange Rules,* 66 COLUM. L. REV. 12, 17 (1966) commenting with approval: "The author points out that, doubtless because of the exchange rules, the SEC terminated a rule-making procedure of its own." *Id.* at 182 n.4.

[32] If an exchange or association rule plays an "integral part in SEC regulation notwithstanding the Commission's decision to take a backseat role in its promulgation and enforcement, [the court] would not wish to say that such a rule could not provide the basis for implying a private right of action." *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

court states that to allow federal civil liability would disrupt the present system of adjudication of customer claims.[36]

In the application of this test, the above considerations would appear to exclude the "suitability" rule of the NASD[37] and the "know your customer" rule of the New York Stock Exchange,[38] both of which deal with the recommendation of securities to customers based on knowledge of the customer's financial situation. Phrases such as "reasonable care," "due diligence," and "suitable" certainly encompass negligence or unethical conduct, and the court in *Hecht v. Harris, Upham & Co.*,[39] in applying the *Colonial* test to the suitability rule, rejected it stating:

> Conceivably, a broker might honestly think that his "ground" for believing his recommendation "suitable" is "reasonable" only to find himself overruled in a lawsuit and found guilty of fraud notwithstanding his good faith. As pointed out by Friendly, J., in *Colonial,* p. 182, the practical consequences of allowing private federal damage suits based on rules of this kind, and involving judicial review of market judgments, would be considerable.[40]

The court also stated that the securities acts are essentially directed at *fraud* — not against mere negligence or errors of judgment on the part of the brokers.[41]

In *Mercury Investment Co. v. A. G. Edwards & Sons*,[42] the court dismissed the claim based on a violation of the suitability rule, relying specifically on the *Hecht* interpretation of the *Colonial* test.

> Adopting the reasoning of *Hecht*, the Court must conclude that Article III, Sec. 2 of the N.A.S.D. rules seek to regulate a much broader

[36] The court then gives several examples in which this might be the case: The arbitration procedures now in common use to settle disputes between brokers and customers could be avoided whenever the customers chose to rely on a violation of "fair and equitable" conduct rather than negligence or breach of contract. *Id.* Additionally, "mere recitation of the statutory watchword by an aggrieved investor, would saddle the federal courts with garden-variety customer-broker suits, [and Congress could scarcely have] contemplated judicial creation of a new body of federal broker-customer law whenever a complaint in what would otherwise be an action under state law alleged conduct inconsistent with just and equitable principles of trade. *Id.* at 183. Finally, "if § 27 were read to include exchange rules, the jurisdiction of the federal courts would be exclusive . . . and the state courts would be altogether stripped of power to adjudicate claims so pleaded even between their own citizens." *Id.*

[37] *See* note 6, *supra.*

[38] New York Stock Exchange Rule 405, CCH New York Stock Exchange Guide ¶ 2405. This rule provides in part that: "Every member organization is required through a general partner or an officer who is a holder of voting stock to (1) use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and evey person holding power of attorney over any account accepted or carried by such organization." *Id.*

[39] 283 F. Supp. 417 (N.D. Calif. 1968). The complaint essentially charged "churning" or excessive trading in plaintiff's account by the registered representative of Harris, Upham and also alleged a violation of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder. *Id.* at 422.

[40] *Id.* at 431.

[41] *Id.*

[42] 295 F. Supp. 1160 (S.D. Texas 1969). The plaintiff in *Mercury* sought damage against the employee and brokerage firm for alleged violation of Section 10(b) of the Securities Exchange Act, as well as the "suitability rule." *Id.* at 1161.

> spectrum of broker activities than is envisioned by security regulations. Thus a violation of this N.A.S.D. rule *per se* does not give rise to federal civil liabilities . . . .[43]

Interestingly, the Court did state that a violation of the rule would be admissible as evidence of negligence.[44]

This trend in interpreting the *Colonial* test to deny civil suits based on rules that encompass unethical or negligent conduct appears to be interrupted by two cases which allowed the claim without an independent consideration of the issue,[45] and more importantly by the court in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[46]

The plaintiff in *Buttrey*, a trustee in bankruptcy of a brokerage firm, alleged a violation of NYSE Rule 405[47] in that defendant Merrill Lynch allowed the firm to open cash and margin accounts and to engage in speculative trading techniques without making adequate investigation into the financial status of the firm when it had grounds, by reason of past experience, to suspect that the firm was not in good financial condition. In upholding the lower court's refusal to dismiss this claim, the court relied in part on the reasoning of *Colonial*, in part on the reasoning of *Hecht*, and in part on the test set forth by Lowenfels,[48] to reach a conclusion essentially distinct from all three.[49] The court "did not decide that an alleged violation

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[43] *Id.* at 1163.

[44] "But the Court reiterates that violations of Art. III, Sec. 2, would be admissible as evidence of negligence, if any." *Id.*

[45] Avern Trust v. Clarke, CCH FED. SEC. L. REP. ¶ 92,441 at p. 98096 (7th Cir. 1969). The plaintiff sued the brokerage firm alleging violation of the anti-fraud provisions and Sections 1, 2 and 18 of Art. III of the Rules of Fair Practice of the NASD in regard to the purchase of securities from the firm in an underwriting. The lower court had dismissed the claim based on a violation of the NASD rules, and the Circuit Court relied on its holding on *Buttrey* in concluding that the lower court had erroneously dismissed the claim. The court held, however, that the plaintiff was not prejudiced by the dismissal since "the same theory was incorporated under the claim for violation of Section 15 of the Securities and Exchange Act, 15 U.S.C. § 78*o*." *Id.* at p. 98,099. In *Stevens v. Abbott, Proctor & Paine,* 288 F. Supp. 836 (E.D. Va. 1968), the plaintiff sued the brokerage firm and its employee alleging churning and excessive trading. With no discussion, the court held: "The court finds that the defendants' conduct represents violations of the rules of fair practice of the N.A.S.D.; that plaintiff's account was not properly supervised in accordance with paragraph 2 of Rule 435 of the Rules of the New York Stock Exchange; and that her account was not properly supervised as required by Rule 405 of the New York Stock Exchange." *Id.* at 846-47.

[46] 410 F.2d 135 (7th Cir. 1969).

[47] *See* note 38, *supra*.

[48] Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules,* 66 COLUM. L. REV. 12, 24-25 (1966). Simply stated, exchange rules which are promulgated for the direct protection of the investing public should give rise to private actions against an exchange and other private parties, while rules promulgated merely as "housekeeping" devices to guide the membership should not." *Id.* In regard to NASD rules, Lowenfels urges the same test. Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules,* 51 CORNELL L.Q. 633, 650-54 (1966).

[49] The Court agreed with Lowenfels in concluding that Rule 405 could fit under Section 27 as a "duty increased by this chapter," *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 410 F.2d 135, 142 (1969), and adopted his test that the determining factor is whether the rule is "for the direct protection of the investors." *Id.* It joined with this factor relied on in *Colonial* as to whether the rule "play[s] an integral part in SEC regulation." *Id.* The court agreed with the opinion in *Hecht* that "mere errors in judgment by the defendant might not support a federal cause of action . . . ." *Id.* at 143.

of Rule 405 is *per se* actionable,"[50] but looked to the alleged conduct of the defendant and found it "tantamount to fraud on the bankrupt's customers, thus giving rise to a private civil damage action."[51] Consequently, under the *Buttrey* decision, whether a particular rule of the NYSE can be the basis for a civil liability depends on the nature of the alleged violation of the rule. If the violation is mere unethical conduct, it appears that it would not give rise to civil liability, while if it is "tantamount to fraud," liability will be imposed,[52] and this decision cannot be made until the case has been heard on its merits.[53]

The result in *Buttrey* is clearly in conflict with *Hecht* and *Mercury* in that these cases denied liability under a rule if its scope included merely unethical or negligent conduct. The *Buttrey* view would presumably fail to satisfy author Lowenfels who urges civil liability for violation of a rule if it was passed for the protection of investors,[54] without any requirement that the alleged activity be "tantamount to fraud." Additionally, *Buttrey* essentially ignores the considerations behind the rule by rule approach set forth in *Colonial* to prevent excessive federal civil actions.[55]

## III. THE SELF-REGULATORY SCHEME

Since it appears that there is no controlling precedent or clear statutory mandate to resolve the issue of broker's civil liability for violation of an exchange or association rule, it is logical to examine the structure of the regulatory scheme and the roles and functions of the self-regulatory bodies to determine if such liability is consistent with the scheme.

The Securities Exchange Act of 1934 provides for three distinct but complimentary methods of achieving the protection of the public investor in the securities markets. The first, of course, is the Securities and Exchange Commission[56] which has statutory responsibility

[50] *Id.* at 142.

[51] *Id.* at 143.

[52] *Id.*

[53] "Until this case is actually tried, it will be impossible to ascertain whether defendant has violated Rule 405, and if so, whether the violations justify the imposition of liability." *Id.*

[54] *See* note 48, *supra.*

[55] *See* note 36, *supra.*

[56] The Commission was established pursuant to Section 4(a) of the Securities Exchange Act of 1934. 15 U.S.C. § 78d(a) (1964).

for enforcing the Act.[57] Secondly, the Act provides for civil liability for violation of several of its sections.[58]

The third method of achieving investor protection is the regulation of broker-dealers through self-regulatory bodies registered with the Commission. The courts in *Colonial, Hecht* and *Buttrey* all relied on their understanding of the concept of self-regulation in reaching their conclusions, and thus it is important to examine the rationale behind the concept and the present understanding of its function in the overall scheme.

According to the Report of Special Study of the Securities Markets of the Securities and Exchange Commission,[59] there are three primary reasons for self-regulation in the securities industry:

(1) Expediency and practicality in recognition of "the sheer ineffectiveness of attempting to assure [regulation] directly through Government on a wide scale;"[60]

(2) The value of the expertise and experience that members of a complex and intricate industry can bring to bear;[61] and,

(3) The necessity of going beyond the reaches of the law and regulating the ethical behavior of the member of the industry.[62]

Coupled with these reasons was the assumption that the self-regulators would require a quasi-independent status to operate effectively. In *Silver v. New York Stock Exchange*,[63] the only major judicial exploration of the concept of self-regulation in the securities industry, the Supreme Court was faced with the problem of the applicability of the antitrust laws to self-regulation under the Act.[64] In its con-

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[57] The Commission has the power to pass rules and regulations necessary to carry out its function under the Act. Securities Exchange Act § 23(a), 15 U.S.C. § 78w(a) (1964). To enforce the statute and the rules and regulations the SEC has the authority to: (1) Seek injunctive relief in United States District Court, Securities Exchange Act § 21(e), 15 U.S.C. § 78u(e) (1964); (2) Refer the matter to the Department of Justice with a recommendation of criminal prosecution; Securities Exchange Act § 21(e), 15 U.S.C. § 78u(e) (1964); (3) Institute administrative proceedings against registered broker-dealers to deny, suspend or revoke their registration, Securities Exchange Act § 15(a)(3) 15 U.S.C. § 78o(a)(5) (1964).

[58] Section 9 of the Act gives a cause of action to any person buying or selling a security at a price affected by the manipulative actions described therein. 15 U.S.C. § 78i (1964), Section 18(a) gives a cause of action to anyone damaged by reliance on false reports or petition required by the Act to be filed with the Commission, the exchanges or the NASD. 15 U.S.C. § 78r(a) (1964). And Section 16(b) of the Act sets forth civil liabilities relating to insider trading. 15 U.S.C. § 78p(b) (1964).

[59] H.R. Doc. No. 95 Pt. 4, 88th Cong., 1st Sess. (1963) [hereinafter referred to as *Special Study*].

[60] *Special Study*, 693, *quoting* Hearing on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess., p. 514 (1934).

[61] *Special Study* at 693-94.

[62] *Id.* at 694-95.

[63] 373 U.S. 341 (1963).

[64] *Id.* at 342-43.

sideration of the issue, the Court affirmed the principle that the self-regulators must be allowed to take the initiative and be given the primary responsibility for the regulation of their members' conduct. The government should retain a residual control but act with restraint in employing it only when the exchanges and the NASD fail to meet their responsibility.[65]

The Special Study approves the principle of self-regulatory autonomy with governmental oversights. The term "cooperative regulation"[66] is used to express the idea that "the roles of the self-regulatory agencies and the Commission are essentially complementary, and it would follow that self-regulatory agencies must enjoy such degree of autonomy as will enable them to act as responsible, dynamic partners in a cooperative enterprise."[67]

Stated very simply, if the self-regulatory bodies are to perform their purpose, they must operate within a structure allowing them to assume the initiative and responsibility for the task. They "cannot be expected to exercise the full measure of responsibility if the Commission is looking over their shoulder[s] and directing or second-guessing each individual action"[68] that they take.

The purpose of self-regulation thus conceived is to delegate part of the regulatory function to a second regulatory body in the securities industry, with its areas of responsibility and its powers delineated. Its function of supervised independence is distinct from, but complementary to, the role of the Commission. The correct balance of government control and self-regulatory independence must be maintained if the self-regulators are "to act as responsible, dynamic partners in a cooperative enterprise,"[69] the ultimate goal of which is investor protection.

The essential question then is what effect will the imposition of civil liability for violation of the rules of these agencies have upon

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[65] The Court quoted in full Mr. Justice (then Commission Chairman) Douglas' remark that the intention of self-regulation was one of "letting the exchanges take the leadership with government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used." *Id.* at 352. The quote is from W. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed. 1940). The Court then quoted a Senate Committee report stating that "[T]he initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs remain with the exchanges themselves. It is only where they fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so." *Id., citing* S. Rep. No. 782, 73d Cong., 2d Sess. 13 (1934). Mr. Justice Stewart in a dissenting opinion affirmed the principle in his statement that "[t]he purpose of the self-regulation provisions of the Securities Exchange Act was to delegate governmental power to working institutions which would undertake, at their own initiative, to enforce compliance with ethical as well as legal standards in a complex and changing industry." *Id.* at 371.

[66] *Special Study* at 701.

[67] *Id.* at 702.

[68] *Id.* at 703.

[69] *Id.* at 702.

this balance of supervision and independence. One of the inherent limitations in the concept of self-regulation is the potential reluctance of the members of the industry to enforce their rules and discipline themselves. The fact that the motivation of the industry may be one of self-interest coupled with what the Special Study refers to as "the weakness of human nature"[70] raises the real possibility that "self-regulators might not always be as diligent as might be desired, might indeed use self-regulation as a device to avoid regulation altogether."[71] One can only speculate what the effect would be on the rule making of the Board of Governors of the New York Stock Exchange if they were aware that in adopting a rule they were in effect creating new grounds on which their members could be sued in federal court. Common sense dictates that such a consideration would not exactly encourage their taking the initiative in adopting new rules regulating the conduct of their members, and it is not unlikely that it would have a definite restrictive effect. The Special Study evidenced a similar concern over the effect of the *Silver* decision on the effectiveness of self-regulation. The application of the antitrust laws to "what the Exchange asserted to be a necessary exercise of its self-regulatory responsibilities [presented] a grave threat to the scope and viability of self-regulation . . . ."[72] The threat lay in exchanges being "subject to the inflexible and potentially harsh sanctions of ordinary lawsuits, particularly treble damage suits in performing what they may in good faith regard as necessary self-regulation."[73] The spectre of unlimited lawsuits against their members based on their own rules would appear to pose a similar threat to the independence and integrity of the self-regulatory bodies. Whether the regulators want to create a new civil liability should not be relevant to the deliberative process in considering the adoption of a new rule.

Another basic principle of self-regulation is that it encompasses and regulates the ethical behavior of the members. The use of the phrase "just and equitable principles of trade" has been previously mentioned as one of the primary statutory standards of self-regu-

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[70] *Id.* at 722.

[71] *Id.* at 695. The *Special Study* is replete with instances of laxity in rule-making and enforcement by the self-regulators. *See, e.g., id.* at 669-70. The most notorious example, of course, was the condition of the American Stock Exchange in 1961 as detailed in a Commission Staff Report. Staff Report on Organization, Management, and Regulation of Conduct of Members of the American Stock Exchange. This report is contained in the *Special Study* as Appendix XII-A, at 751. The conclusion of the report is harsh: "There can be little doubt that in the case of the American Stock Exchange the statutory scheme of self-regulation in the public interest has not worked out in the manner originally envisioned by Congress. The manifold and prolonged abuses . . . make it clear that the problem goes beyond isolated violations and amounts to a general deficiency of standards and a fundamental failure of controls." *Id.* at 53, *Special Study* at 805.

[72] *Special Study* at 707.

[73] *Id.*

lation,[74] and it is apparent from the history of the Act that it was intended to place the obligation of passing and enforcing rules governing legal but unethical behavior on the self-regulators.[75]

There were two major reasons for initially delegating the responsibility of regulating ethical conduct to the self-regulators: (1) There was a growing recognition of the need to professionalize the securities industry; and (2) it was clear that the government was unable to establish and enforce ethical standards of conduct for that purpose.[76]

The Special Study concluded that professionalization of the industry through promulgation and enforcement of high ethical standards "represents the highest of all goals of self-regulation"[77] and the study recognized that "[a]lmost by hypothesis, this goal is beyond the reach of law and regulation in the ordinary sense."[78]

Two cases have recognized this role of self-regulation in refusing civil liability for violation of the "suitability rule" on the basis that it proscribed ethical as well as non-fraudulent conduct.[79]

The combination of these principles of self-regulation yields the conclusion that in order to effectively regulate ethical conduct in the securities industry, the self-regulatory bodies must operate in a structure of supervised independence. The issue of civil liability for violation of these rules must be viewed in terms of the effect it would have on self-regulation thus conceived and on the over-all regulatory scheme. The results of lax self-regulation have already been seen.[80] It is improbable that holding members of an exchange or association civilly liable for the violation of their rules could have any sort of positive or constructive effect on the performance by the self-regulatory bodies in promulgating such rules. It is more probable, rather,

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[74] *See* note 13, *supra*.

[75] As one court has put it: "There is a large area for the operation of exchange rules on the level of business ethics rather than law and in that sphere the statute leaves it to the exchanges to carry on the necessary work of preventive discipline." Avery v. Moffatt, 187 Misc. 576, 55 N.Y.S.2d 215, 228 (1945).

[76] Mr. Justice Douglas pinpointed the purposes of self-regulation in a speech in 1938: "First, self-discipline in conformity to law — voluntary law obedience so complete that there is nothing left for government representatives to do; — second — . . . obedience to ethical standards beyond those any law can establish." In explanation of the second purpose, Justice Douglas said:

> By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.

Address before the Bond Club of Hartford, Conn., January 7, 1938, as cited in *Special Study* at 694-95.

[77] *Special Study* at 695.

[78] *Id.*

[79] *See* notes 39 & 42, *supra* and accompanying text.

[80] *See* note 71, *supra.*

that it could have an inhibitive effect similar to that envisioned by the Special Study.

## IV. APPLICATION OF THE TEST

Although to date most of the suits against broker-dealers for violation of exchange or association rules have been based on the violation of the "suitability" and "know your customer" rules, the decision in the *Buttrey* case will most certainly lead to an examination of the remainder of the rules for possible use as grounds for civil action. The test proposed by author Lowenfels and partially adopted by the court in *Colonial* and *Buttrey* requires a determination of whether a particular rule was adopted for the "direct protection of investors" or was merely a housekeeping rule. If the former, there is a strong if not controlling reason for allowing the investor to sue for a violation of the rule. However, what seemingly would be a relatively easy factual determination becomes more difficult in application and in some instances leads to incongruous results.

For example, Rule 403 of the NYSE provides in part that no member shall be directly or indirectly associated with or transact business with "any bucket shop."[81] It is easily arguable that one of the purposes of this rule is to protect the members of the member firm by prohibiting the firm from dealing with bucket shops, which generally are defined as firms engaging in questionable selling practices in speculative securities.[82] Assume that a NYSE firm purchases a security for a customer at his request, and that the security can only be obtained from bucket shops. The price of the security falls rapidly and the customer sues the representative and the firm for violation of Rule 403. Assuming that the court would somehow be able to fashion a definition of a "bucket shop" should the customer be allowed to recover solely on the basis that he could not have purchased the security if the firm had obeyed the rule?[83]

For instance, one of the difficult areas which may arise concerns rules adopted by the exchange which the Commission is without

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[81] New York Stock Exchange Rule 403, CCH New York Stock Exchange Guide ¶ 2403.

[82] *See* 1 LOSS, SECURITIES REGULATION 39 (1961).

[83] Another example would be Rule 346 of the New York Stock Exchange which generally provides that a registered representative shall not engage in any other business without exchange approval and must devote his full time during business hours to the business of the member firm. New York Stock Exchange Rule 346, CCH New York Stock Exchange Guide ¶2346. Here again, it could easily be concluded that one of the purposes of the rule was to protect the customers on the theory that a representative would be better informed and provide better service if he devoted all of his energies to the brokerage business. Assume that an unexpected low earnings report for a security held by a customer was announced on an afternoon when the representative was interviewing for a position with another brokerage firm. Assume that the price fell rapidly and the customer could demonstrate that those who sold that afternoon did not suffer near the loss of those who sold, as he did, the next morning. Should he be allowed to sue and recover solely on the grounds that had the representative been in the office at the time of the announcement and informed the customer, he would have sold sooner and not suffered such a loss?

authority to adopt. Where such a rule is clearly promulgated for the protection of investors, a customer could theoretically sue in federal court on a rule which at least in some instances Congress has refused to give the Commission the authority to adopt.[84]

## CONCLUSION

Since there appears to be no controlling or even persuasive statutory theory or case law regarding the question of civil liability for brokers for violation of association and exchange rules, the broader area of public policy must be relied on for guiding principles. The primary goal of regulation in the securities field is the protection of the public investor, and as stated earlier, Congress has attempted to achieve this by a combination of civil liability, government enforcement, and self-regulation. It is a relatively intricate regulatory scheme with its over-all effectiveness depending in large measure on an integrated balance of the three segments. Imposing civil liabilities for violation of exchange and association rules raises the very real possibility of upsetting this balance by affecting the vigor and motivation with which the self-regulators perform their functions.

No case has been made that the ultimate goal of investor protection is being obstructed by inadequate civil remedies for investors against brokers. In view of this, and in view of the possible consequences of accomplishing this goal by further expanding civil liabilities, it is urged that public policy does not require the imposition of civil liabilities for violations of self-regulatory rules. To the contrary, policy considerations would seem to weigh against imposition of such liabilities if self-regulation, particularly in regard to the ethical conduct of the members, is to function effectively to achieve maximum investor protection.

[84] The Commission has never adopted rules regulating physical segregation of customers' securities by brokerage firms, although it proposed legislative amendments in 1941, 1956 and 1959 requesting the authority to do so. However, the New York Stock Exchange has adopted rules requiring segregation of customers' fully paid and excess margin securities. There can be little question that these rules requiring identification of customers' securities were passed for the direct protection of investors.

Under the test, a customer could sue a broker for the losses resulting from the broker's failure to properly segregate his securities in violation of the rule.