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# Economic Suicide: The Collision of Ethics and Risk in Securities Law

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## ECONOMIC SUICIDE: THE COLLISION OF ETHICS AND RISK IN SECURITIES LAW

*Barbara Black\* and Jill I. Gross\*\**

In retrospect, it is clear that many investors, caught up in the frenzy of the trading markets of the past decade, engaged in risky trading and investing strategies without an understanding of the risks involved. Lack of portfolio diversification<sup>1</sup> and, in particular, over-concentration in technology or “microcap” stocks,<sup>2</sup> over-leveraging through margin borrowing,<sup>3</sup> and excessive trading<sup>4</sup> are well-publicized examples of the “irrational exuberance”<sup>5</sup> that affected many participants in the trading markets, including

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1. The Enron employees whose retirement portfolios were heavily invested in Enron stock are recent and tragic examples. See Kathy Chen, *Pension Allocations Are Adjusted After Fallout of Enron*, WALL ST. J., Jan. 29, 2002, at A2, available at <http://www.wsj.com> (last visited Jan. 23, 2003) (stating that sixty percent of total assets of Enron employees' 401(k) plans were invested in Enron stock at the end of 2000).

2. See Kate Zernike, *Stocks' Slide is Playing Havoc with Older Americans' Dreams*, N.Y. TIMES, July 14, 2002, at A1 (discussing the plight of older investors with undiversified retirement portfolios that have plummeted in value).

3. See Gretchen Morgenson, *One Investor. Two Brokers. An Account Runs Dry*, N.Y. TIMES, July 22, 2001, § 3, at 1 (former Microsoft employees allege brokers recommended unsuitably speculative stocks and excessive use of margin borrowing). In February 2000, the New York Stock Exchange (“NYSE”) and National Association of Securities Dealers (“NASD”) issued a joint statement expressing concern over the continuing growth in investor margin debt and asking member firms to advise investors about the risks, to take appropriate action when investors significantly increase their level of margin borrowing, and to review their incentive programs for soliciting margin accounts. NYSE & NASD, Joint Statement by NYSE and NASD on the Continuing Growth in Investor Margin Debt, at [http://nasdr.com/joint\\_state.asp](http://nasdr.com/joint_state.asp) (last visited Jan. 23, 2003).

4. Day traders, and the day-trading firms established to facilitate them, were the most extreme example. See North American Securities Administrators Association, *Report of the Day Trading Project Group* (Aug. 9, 1999), at <http://www.nasaa.org/daytradingreport.htm> (last visited Jan. 23, 2003) (because of high overhead costs, day trading firms need to attract new customers).

5. Alan Greenspan, the Chair of the Federal Reserve Board, used the phrase that came to epitomize the era in a speech in late 1996. ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* 3 (2000).

both sophisticated and unsophisticated investors. It is not clear, however, whether brokers owe any duty to protect their unsophisticated customers<sup>6</sup> from excessively risky trading strategies.

A broker owes certain well-established duties to his customer, the breach of which may give rise to a private claim for damages.<sup>7</sup> If the broker recommended a security that his customer purchased, the customer may have a claim if the recommendation was unsuitable in light of his financial situation and investment objectives.<sup>8</sup> If the broker exercised control over his customer's account, the customer may have a claim for excessive trading or churning.<sup>9</sup> If the broker made a misstatement of material fact that caused his customer to purchase or sell a security, the customer may be able to recover in fraud or negligence.<sup>10</sup> It is settled law, however, that brokers are not liable for their customers' losses unless they made an unsuitable recommendation, exercised control over the account, or made a material misstatement of fact. A broker can stand by even if he knows that the customer is engaged in an unsuitably risky investment strategy without an understanding of the risks involved. A broker has no duty to protect his customer from "economic suicide."<sup>11</sup>

The most commonly given explanation for not imposing such a duty on brokers is that it would be paternalistic and contrary to the strong sense of

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6. The issue of brokers' duties to sophisticated customers raises additional issues outside the scope of this article. For example, in *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293 (2d Cir. 2002), the Second Circuit threw out a \$164.5 million recovery in favor of a wealthy businessman who lost an estimated \$215 million in a few weeks in 1995 trading in foreign currency futures contracts, in part because "his vast wealth, his trading experience, his business sophistication, and his gluttonous appetite for risk" weighed strongly against heightened duties on the part of the broker. *Id.* at 1309. For a discussion of these issues, see Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493.

7. Private claims for federal securities fraud, including suitability violations, churning, and misrepresentations, require scienter, which excludes negligence, see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). State securities laws or common law may allow investors to recover on negligence grounds. See, e.g., *R.J. O'Brien & Assocs. v. Forman*, 298 F.3d 653 (7th Cir. 2002) (affirming a jury verdict for a customer based on negligent misrepresentation) (commodities futures). For a fuller discussion of the legal theories, see Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006-13 (2002).

8. See *infra* notes 42-44 and accompanying text.

9. See *infra* notes 70-74 and accompanying text.

10. See *infra* notes 75-77 and accompanying text.

11. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd mem.*, 647 F.2d 165 (6th Cir. 1981); *Powers v. Francis I. DuPont & Co.*, 344 F. Supp. 429 (E.D. Pa. 1972); *Chee v. Marine Midland Bank*, No. 88 CIV. 0557, 1991 WL 15301 (E.D.N.Y. 1991) (stock options); *T-Bill Option Club v. Brown & Co.*, No. 92-2737, 1994 U.S. App. LEXIS 11976 (7th Cir. May 23, 1994) (stock options).

individual responsibility that is the American tradition.<sup>12</sup> Investors should take care of themselves, armed with the information that federal securities laws require to be disclosed to them and aided in their investment choices by securities professionals who provide financial expertise, if the investors seek their assistance.<sup>13</sup> Otherwise, careless investors who have nobody but themselves to blame would have an “insurance policy” against their losses<sup>14</sup> and would lack incentives to educate themselves about investing and market risk, and to avoid excessive risk.<sup>15</sup>

Has anything changed over the years to warrant reconsideration? Sadly, to many, the securities markets have never appeared so corrupt. First, disclosure requirements have become increasingly complex, and compliance by many corporations is questionable.<sup>16</sup> In the wake of recent corporate

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12. “One word encompasses all the grandeur and majesty of western civilization. That word is ‘freedom’ . . . . Not as well recognized, but equally true is that the absolute concomitant of freedom is responsibility . . . .” *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 278 (Miss. 1991) (discussing a self-directed investor who lost over \$2 million, including his retirement fund, in commodities futures trading).

13. “No amount of disclosure in a prospectus can be effective to protect investors unless the securities are sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells.” SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SEC, pt. 1, at 588 (1963). For development of this principle, with much discussion that remains relevant today, see Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445.

14. “[T]o permit [the customer to recover] . . . would provide an ‘insurance policy’ to the unscrupulous investor who would obviously be given an incentive to assume greater risks in the securities market, engaging in excessive activity far beyond his means.” *Powers*, 344 F. Supp. at 433 (discussing a self-directed investor who suffered losses from speculative overtrading).

15. On the importance of investor education, see James A. Fanto, *We’re All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105 (1998) (discussing that investor education is consistent with the American culture’s emphasis on individual responsibility) and Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279 (2000) (arguing that licensing requirements will serve to educate investors).

16. Tom Gilroy, *Enforcement: Enforcement Chief says SEC Investigating Record Number of Fortune 500 Corporations*, SEC. LAW DAILY, May 31, 2002 (stating the SEC opened sixty-four fraud investigations in the first quarter of 2002, compared with thirty-one in the first quarter of 2001). See also *Accounting: Study Finds Increase in Restatements Despite Drop in Number of Public Companies*, SEC. LAW DAILY, June 14, 2002 (according to a report by consulting group, the number of public companies has dropped by 6.5% over the past two years, while the number of restatements of earnings during the same period increased by 25%). Accounting scandals involving major corporations in 2002 include Enron, Tyco, Global Crossing, Microsoft, Adelphia, Sunbeam, Xerox, Qwest, Sears Roebuck, AOL Time Warner and Rite Aid, in addition to WorldCom, one of the largest accounting frauds in history, with an estimated \$9 billion in accounting problems. See Susan Pulliam & Jared Sandberg, *WorldCom to Revise Results Again*, WALL ST. J., Sept. 19, 2002, at A3, available at <http://www.wsj.com> (last visited Jan. 23, 2003). Since the SEC’s requirement that CEOs and CFOs certify their company’s financial statements, a number of corporations have announced restatements of earnings, see *As the SEC Deadline Approached, Earnings Restatements Trickled In*, WALL ST. J., Aug. 23, 2002, available at <http://www.wsj.com> (last visited

scandals, Mr. Justice Brandeis' view of the deterrent value of disclosure<sup>17</sup> seems exaggerated, perhaps even naïve. Second, the recommendations of many brokers and analysts seem biased, driven not by an assessment of the investment opportunity, but by the lure of commissions or the lucrative investment banking business.<sup>18</sup> Third, the corruption and conflicts of interests have been fueled by large infusions of funds into the securities markets by investors who had never previously traded in securities, many of whom were lured into the market by the "get rich quick" advertising of many discount brokers.<sup>19</sup> This "democratization" of the securities industry may be viewed as a growth of the spirit of rugged individualism embodied in the securities laws, and the inexperience and naiveté of these investors may be yet another occasion for P.T. Barnum<sup>20</sup> cynicism, and no reason to change the philosophical bent of the law. However, the widespread abuses by all participants—issuers, securities analysts, and brokers—in an industry that is heavily regulated for the protection of investors is troubling.

What impact should these developments have on the law resolving disputes between customers and broker-dealers? While courts have declined to find a duty on the part of the broker to try to stop a customer's financial suicide when the customer is making his own trading decisions and the broker has not recommended the specific investment,<sup>21</sup> arbitrators<sup>22</sup> sometimes permit customers to recover damages from brokers in these circumstances.<sup>23</sup> Indeed, many commentators assert that arbitrators disregard the law in a quest for equity.<sup>24</sup>

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Aug. 27, 2002).

17. "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY* 92 (Augustus M. Kelley 1986) (1914).

18. Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?*, 2002 COLUM. BUS. L. REV. 631 (2002).

19. Barbara Black, *Securities Regulation in the Electronic Age: Online Trading, Discount Broker's Responsibilities and Old Wine in New Bottles*, 28 SEC. REG. L.J. 15, 18-19 (2000).

20. P.T. Barnum is commonly credited with saying that "there's a sucker born every minute," although this may be unfair to him. R.J. Brown, *P.T. Barnum Never Did Say "There's a Sucker Born Every Minute,"* at <http://www.historybuff.com/library/refbarnum.html> (last visited Jan. 23, 2002).

21. See *supra* note 11 and accompanying text.

22. Most disputes between customers and brokers are arbitrated before the NYSE or NASD Dispute Resolution, Inc. (NASD-DR), the dispute resolution subsidiary of NASD. The NYSE and NASD are both Self-Regulatory Organizations (SROs) under Securities Exchange Act § 19; 15 U.S.C. § 78s (2000).

23. See *infra* notes 200-53 and accompanying text.

24. Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1593-97 (1999).

The first part of this article looks at whether there are any legal principles derived from regulation or the case law to support an “economic suicide” claim. The second part of the article reviews arbitrators’ awards to determine whether arbitrators do, in fact, decide favorably on economic suicide claims. The article also looks at some arbitrators’ awards that appear to recognize an economic suicide claim to identify any factors that may lead arbitrators to award damages to the claimant. Finally, in the third part, we address whether policy considerations support an extension of recognized brokers’ duties to include a duty to prevent the customer from economic suicide.<sup>25</sup>

## I. JUDICIAL AND REGULATORY OPINIONS ADDRESSING AN ECONOMIC SUICIDE CLAIM

### A. *Background on Brokers’ Duties to Customers Regarding Unsuitable Investments or Strategy*

In this section, we summarize the well-established duties of securities brokers to their customers with respect to unsuitable investments or trading strategies.

#### 1. *Type of Account*

Most judicial discussions delineating the scope of a broker’s duties to a customer emphasize the importance of the type of account relationship the customer maintained with the broker. Where the broker acts merely as an order-taker for the customer who manages his own portfolio, the broker assumes no responsibility for assuring that the investment, either singly or as a component of the customer’s portfolio, is suitable for the customer. Rather,

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25. This article focuses on brokers’ duties to their customers who purchase securities, including stock options, the investments of choice for unsophisticated investors in the 1990s. There are many other types of products traded in the market with different characteristics and regulatory requirements. Because much of the discussion about brokers’ duties is based on common law principles, courts frequently apply the same principles regardless of the customer’s choice of investment. *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293 (2d Cir. 2002) (foreign currency futures contracts); *Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933 (2d Cir. 1998) (CMOs); *Prudential Bache Sec., Inc. v. Pitman*, 1991 WL 160039 (N.D. Ga. 1991) (index futures); *Puckett v. Refenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273 (Miss. 1991) (commodities futures); *Wasnick v. Refco, Inc.*, 911 F.2d 345 (9th Cir. 1990) (commodities futures); *J.E. Hoetger & Co. v. Ascencio*, 572 F. Supp. 814 (E.D. Mich. 1983) (commodities futures). There are differences, however, in the type and regulation of investments that make a more nuanced analysis of brokers’ duties warranted. For this reason, when citing a case, we indicate in parentheses the type of investment if it is other than stock.

his duty is to execute the order in accordance with the customer's instructions, and he discharges his duty upon completion of the individual transaction.<sup>26</sup> At the other end of the spectrum, in instances where the customer confers discretionary authority on the broker,<sup>27</sup> the broker assumes the responsibility of managing the customer's portfolio in accordance with the customer's needs and objectives. He is responsible for ensuring that each investment and the overall investment strategy are suitable for the customer, and his obligations include explaining the risks of the investment strategy to the customer and monitoring the account to ensure that the portfolio remains consistent with the customer's objectives.<sup>28</sup>

The relationship between the broker and the customer, in many instances, lies between these two extremes, where the broker has some participation in the customer's investment decisions, either because he makes recommendations to the customer or because he exercises some degree of control over the account. Control in a nondiscretionary account may be established by showing that the investor, because of his inexperience or lack of financial acumen, reasonably relied on the broker to make trading decisions and exercised no independent investment decision-making.<sup>29</sup> The cases are intensely fact specific.<sup>30</sup>

*Leib v. Merrill Lynch, Pierce Fenner & Smith, Inc.*<sup>31</sup> is a case frequently cited for the proposition that a broker owes a limited duty to a customer. In that case the court found that, since the customer controlled his account, the broker had no duty to warn the customer that his heavy trading was not likely to be profitable.<sup>32</sup> Yet, according to the court, even the limited duties of brokers handling accounts they do not control include "the duty to inform the

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26. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952-53 (E.D. Mich. 1978). This is especially true when it is a discount broker. See *Unity House, Inc. v. N. Pac. Inv., Inc.*, 918 F. Supp. 1384, 1390-91 (D. Haw. 1996).

27. De facto discretionary authority may exist in instances where the broker controls the account, even though it is not denominated "discretionary." *Leib*, 461 F. Supp. at 954.

28. *Id.* at 953.

29. *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970) (stock and commodities futures). Courts have identified several factors in determining if the broker had control: whether personal characteristics of the customer (age, education, intelligence and investment experience) or the existence of a social and personal relationship between the customer and broker make it likely that the customer will invariably follow the broker's advice. If the broker frequently executed transactions without the customer's prior approval, this suggests his control over the account; conversely, if the customer and broker spoke frequently about investment decisions, this suggests the customer maintained control. See, e.g., *Leib*, 461 F. Supp. at 954-55.

30. See NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION* § 2.02[B] (3d ed. Supp. 2002).

31. *Leib*, 461 F. Supp. 951 (E.D. Mich. 1978).

32. *Id.* at 956-57.

customer of the risks involved in purchasing or selling *a particular security*," the extent of the duty depending upon the customer's intelligence and experience.<sup>33</sup> Since, under the limited view, a broker's duty ends upon execution of each transaction, the duty would not extend to warning about a strategy or pattern of trading.

In contrast, two California decisions, *Twomey v. Mitchum, Jones & Templeton, Inc.*<sup>34</sup> and *Duffy v. Cavalier*,<sup>35</sup> are frequently cited for the proposition that California articulates, as a general principle, an expanded view of the broker's duties. In both cases, however, the courts found that the brokers made unsuitable recommendations.<sup>36</sup> Declaring that "[g]ood ethics should not be ignored by the law,"<sup>37</sup> *Twomey* stated that the broker has a duty to determine the customer's financial situation and needs and, if the customer wishes to follow an unsuitable investment strategy, to warn the customer.<sup>38</sup>

## 2. Recognized Brokers' Duties

### a. Duty of Fair Dealing

National Association of Securities Dealers ("NASD") Rule 2110 states that members shall observe "high standards of commercial honor and just and equitable principles of trade" in the conduct of business.<sup>39</sup> In an interpretation of this rule, the NASD has stated that the "fundamental responsibility for fair dealing" is implicit in all relationships with customers and that "[s]ales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the [NASD's] Rules, with particular emphasis on the requirement to deal fairly with the public."<sup>40</sup> Similarly, the broader

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33. *Id.* at 953 (emphasis added).

34. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222 (Cal. Ct. App. 1968).

35. *Duffy v. Cavalier*, 264 Cal. Rptr. 740 (Cal. App. 1 Dist. 1989) (stock options).

36. *Petersen v. Sec. Settlement Corp.*, 277 Cal. Rptr. 444 (Cal. Ct. App. 1991), makes this point.

37. *Twomey*, 69 Cal. Rptr. at 244.

38. *Id.* at 242. *Duffy v. Cavalier* affirmed these principles and refused to limit *Twomey's* application to unsophisticated investors.

39. NASD Conduct Rule 2110, NASD Manual (CCH) 4111 (1998) [hereinafter NASD Manual], available at [http://www.nasdr.com/nasd\\_manual.asp](http://www.nasdr.com/nasd_manual.asp) (last visited Jan. 29, 2003). The NASD is the largest securities SRO. Similarly, NYSE Rule 476(a)(6), 2 N.Y.S.E. Guide (CCH) 4057 [hereinafter NYSE Guide], available at <http://www.nyse.com/regulation/regulation.html> (last visited Jan 29, 2003), provides that brokers can be disciplined for "conduct or proceeding inconsistent with just and equitable principles of trade" and is the basis for NYSE disciplinary proceedings for unauthorized trading, churning and unsuitable recommendations.

40. NASD Manual, *supra* note 39, at Rule IM-2310-2, Fair Dealing with Customers (2000).



“shingle theory” of liability of broker-dealers to their customers “presume[s] that a broker-dealer that hangs out a shingle and solicits customers makes an implied representation of fair dealing.”<sup>41</sup> These statements of general principle have not, however, led to the development in the case law of an expansive view of brokers’ duties.

*b. Suitability*

*i. Securities*

A broker has a duty to recommend only securities that he reasonably believes are suitable for the customer, based on facts disclosed by the customer about his other security holdings, his financial status, and his investment objectives.<sup>42</sup> The broker has a concomitant obligation to make some sort of investigation into the customer’s circumstances and not to rely simply on the customer’s declarations.<sup>43</sup> It is important to remember that the broker’s suitability obligation is premised upon the broker’s making a recommendation, however broadly that may be construed.<sup>44</sup>

What constitutes a recommendation, and specifically the dividing line between the broker’s providing information about investments<sup>45</sup> and the broker’s making recommendations, has not been addressed in the case law. While arguments continue to be made for a narrow definition,<sup>46</sup> regulators

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41. Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1271 (1995).

42. NASD Manual, *supra* note 39, at Rule 2310(a) (2000). The NYSE has a suitability rule governing recommendations in stock options. See NYSE Guide, *supra* note 39, at Rule 723 (2002). In addition, some states have adopted suitability obligations by regulation. See, e.g., CAL. CODE REGS. tit. 10, § 260.218.2 (2003); MINN. R. 2875.0910(2) (2001).

43. NASD Manual, *supra* note 39, at Rule 2310(b) (2000).

44. *In re Warren*, Exch. Act Release No. 34-33677, 56 SEC DOCKET (CCH) 329, at 332 n.19 (Feb. 24, 1994), *aff’d*, 69 F.3d 549 (10th Cir. 1995).

45. Most discussion has arisen in the context of discount brokers’ providing information and research tools to investors on their websites. So, for example, it is generally accepted that a brokerage firm that has a search engine on its website that allows customers to review data about a broad range of stocks (not limited to stocks in which the firm makes a market or has made a “buy” recommendation) is not making a recommendation about those stocks. In contrast, a firm that uses data-mining technology to analyze a customer’s financial or online activity and then sends the customer specific investment suggestions would, in the view of the NASD, be making a recommendation. These and other examples are discussed in NASD Notice to Members 01-23, *Suitability Rule and Online Communications 1* (Mar. 19, 2001), available at <http://www.nasdr.com/pdf-text/0123ntm.txt> (last visited Jan. 30, 2003).

46. For expression of the view that the “historical understanding” is “that a recommendation is a specific communication from a broker to a customer at a specific time,” see the comments of the Federal Regulation Committee, Discount Brokerage Committee, and Ad Hoc Committee on Technology and Regulation of the Securities Industry Association, *quoted in* North American Securities Administrators

have articulated a “facts and circumstances” test.<sup>47</sup> This test, while providing little guidance, makes it clear that a broker may have made a recommendation, even though not denominated as such, if he provides the investor with information that amounts to a “call to action,” particularly if the information is targeted to an individual customer or group of customers.<sup>48</sup> Moreover, although regulators have previously assumed that “general advertisements” do not constitute recommendations,<sup>49</sup> the NASD has stated that where a broker widely disseminates information to investors of varying financial sophistication and resources, the broker should confirm that the investment is suitable for each investor who responds before effecting the transaction.<sup>50</sup> If the NASD intended this statement to announce a significant change in its policy, it has not followed up on it to date.

The suitability obligation also encompasses a duty not to recommend certain investment strategies to customers for whom they are unsuitable (and necessarily a duty to make a determination about the customer’s suitability).<sup>51</sup>

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Association (NASAA), *Report of the Day Trading Project Group* 20 (Aug. 9, 1999), at [http://www.nasaa.org/nasaa/scripts/fu\\_display\\_list.asp?ptid=16](http://www.nasaa.org/nasaa/scripts/fu_display_list.asp?ptid=16) (last visited Jan. 30, 2003).

47. NASD Notice to Members 01-23, *supra* note 45, at \*8; *see also* Computer Brokerage Systems, Exchange Act Release No. 34,21383, 49 Fed. Reg. 40159, at 40161 (Oct. 15, 1984) (providing research and analysis through a computer brokerage system may amount to a recommendation); Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Release No. 34-27160, 54 Fed. Reg. 35468, at 35476-77 (Aug. 28, 1989) (stating guidelines for determining if a transaction is a recommendation); NASD Notice to Members 96-50, *Supervisory and Other Obligations Related to Use of Electronic Media*, 1996 NASD LEXIS 60, at \*4 (July 1996) (stating suitability determinations must be made for each customer who responds to electronic medium messages); NASD Notice to Members 96-60, *Clarification of Member’s Suitability Responsibilities Under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities*, 1996 NASD LEXIS 76 (Sept. 1996) (clarifying the definition of an unsolicited transaction); NASD Notice to Members—For your Information, *Clarification of Notice to Members 96-60*, 1997 NASD LEXIS 20 (Mar. 1997) (stressing that recommendations can be “made in a variety of ways”); Laura S. Unger, *On-Line Brokerage: Keeping Apace of Cyberspace* 24-25 (Nov. 22, 1999), at <http://www.sec.gov/pdf/cybrtrnd.pdf> (last visited Jan. 30, 2003) (stating that NASD Rule 2310 requires “customer-specific suitability”).

48. NASD Notice to Members 01-23, *supra* note 45, at \*18. Earlier the NASD stated that a recommendation includes any instance in which the broker “brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.” NASD Notice to Members 96-60, *supra* note 47, at \*4. *See also* National Committee of Discount Securities Brokers, SEC No-Action Letter, 1980 WL 15131 (S.E.C. No-Action Letter) at \*2 (June 26, 1980) (stating that a “recommendation may be found to have been implied even where one had not been made expressly”).

49. *Sales Practice Requirements for Certain Low-Priced Securities*, Exchange Act Release No. 34,27160, 54 Fed. Reg. 35468, at 35477 (Aug. 28, 1989).

50. NASD Notice to Members 96-50, *supra* note 47, at \*4.

51. *See* *Cruse v. Equitable Sec. of New York, Inc.*, 678 F. Supp. 1023, 1031-32 (S.D.N.Y. 1987) (options); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1152 (S.D.N.Y. 1979) (margin); *In re Rangen*, Exch. Act Release No. 34,38486, 64 SEC Docket (CCH) 628, at 630-31 (Apr. 8, 1997) (margin); *In re Bruff*, Exch.

Trading on margin, for example, is not a suitable investment strategy for those who need or want to limit their risks.<sup>52</sup> Even where a customer expresses interest in highly speculative or aggressive trading, the broker cannot make recommendations incompatible with the customer's financial profile—at least in the context of disciplinary proceedings against brokers.<sup>53</sup>

Notably, NASD Rule 2310 specifically directs the broker to consider the customer's other securities holdings in making a recommendation, thus providing support for a customer's complaint that a broker's recommendation was unsuitable if it failed to take into account the risks of over-concentration or resulted in a non-diversified portfolio.<sup>54</sup>

### *ii. Commodities Futures*<sup>55</sup>

Neither the Commodities Futures Trading Commission ("CFTC")<sup>56</sup> nor the National Futures Association ("NFA")<sup>57</sup> has adopted a rule that corresponds to NASD Rule 2310, requiring commodities futures and commodities options brokers to have a reasonable belief that a recommendation is suitable for the customer.<sup>58</sup> Both the CFTC and courts

Act Release No. 34,40583, 68 SEC Docket (CCH) 562, at 565 (Oct. 21, 1998) (excessive trading); *In re Bruff*, Exch. Act Release No. 34,31141, 52 SEC Docket (CCH) 1266, at 1269-70 (Sept. 3, 1992) (options).

52. How trading on margin increases the risk of loss to the customer is explained in *In re Rangen*, Exch. Act Release No. 34,38486, 64 SEC Docket (CCH) 628, 630-31 (Apr. 8, 1997).

53. See *In re Howard*, 2000 WL 1736882 (N.A.S.D.R.), at 5 (Nov. 16, 2000); *In re Kernweis*, Disc. Proceeding No. C02980024 (N.A.S.D.R.) (Feb. 16, 2000); *In re Holland*, Exch. Act Release No. 34,36621, 60 SEC Docket (CCH) 2507, at 2509-10 (Dec. 21, 1995); *In re Venters*, 51 S.E.C. 292, 295 (1993).

54. For an argument that a broker who fails to recommend diversification is recommending an irrational trading strategy, see Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599, 1606 (1999).

55. There are many other complex instruments that are being marketed today. Some raise questions as to whether they should be regulated as securities or as commodities futures. See, e.g., *Caiola v. Citibank*, N.A., 295 F.3d 312, 331 (2d Cir. 2002) (holding that cash-settled OTC options on the value of a security were "securities"; whether the Commodities Futures Modernization Act of 2000 (CFMA) should be applied retroactively to bring customer's swap transactions within Securities Exchange Act § 10(b) was not preserved for appellate review). Many OTC derivatives are unregulated. 13A JERRY W. MARKHAM, COMMODITIES REGULATION, FRAUD, MANIPULATION AND OTHER CLAIMS § 27:1 (2002). Since these products are marketed primarily to institutional investors, they are outside the scope of this article.

56. The CFTC was established in 1975 as part of a major regulatory reform of the commodities futures markets and is an independent agency with exclusive jurisdiction over commodity futures trading. For background, see 23 JERRY W. MARKHAM & THOMAS L. HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 2:18 (2002).

57. The NFA is the futures industry's equivalent of the NASD. 3 MARKHAM & HAZEN, *supra* note 56, at § 9.18.

58. The CFTC proposed such a rule in 1977, but, after considerable industry opposition, decided not to adopt it and instead adopted § 1.55, see discussion *infra* notes 93-96 and accompanying text,

have held that the Commodities Exchange Act (“CEA”) does not require brokers to determine a customer’s suitability to trade futures contracts. Therefore, brokers may recommend commodities futures trading without making any determination that it is suitable for the customer.<sup>59</sup> An affirmative misrepresentation of suitability would, however, constitute fraud, assuming scienter and reliance.<sup>60</sup>

c. “*Know Your Customer*”

New York Stock Exchange (“NYSE”) Rule 405 requires its member firms “to use due diligence to learn the essential facts relative to every customer [and] every order.”<sup>61</sup> While the literal language could support an intent to protect customers, in fact, the rule’s purpose is primarily to protect the firm from irresponsible customers who may not honor their commitments on placed orders.<sup>62</sup> The NYSE has charged registered representatives with violations of Rule 405 in disciplinary proceedings only when the individual has not

requiring brokers to provide customers with written disclosure of the risks of futures trading. For background, see Jerry W. Markham, *Fiduciary Duties Under the Commodity Exchange Act*, 68 NOTRE DAME L. REV. 199, 238-40 (1992). The NFA has adopted a suitability rule applicable only to recommendations of securities futures. Nat’l Futures Ass’n, Compliance Rule 2-30(j), NFA Manual (2001) [hereinafter NFA Manual], available at [http://www.nfa.futures.org/compliancemanual/M6Compliance\\_b.html](http://www.nfa.futures.org/compliancemanual/M6Compliance_b.html) (last visited Jan. 30, 2003).

There is a significant difference between securities and commodities futures transactions. Customers engaging in securities transactions may have a wide range of different investment objectives ranging from conservative to speculative. Customers engaged in futures transactions are not long-term investors; they are speculators. It has been argued, therefore, that a broker making securities recommendations has to know his customer’s investment objectives, while a broker making commodities futures recommendations knows his customer’s objectives; hence, the only relevant inquiry is whether he understands the risks. See Walter C. Greenough, *The Limits of the Suitability Doctrine in Commodity Futures Trading*, 47 BUS. LAW. 991, 992 (1992); Allen D. Madison, *Derivatives Regulation in the Context of the Shingle Theory*, 1999 COLUM. BUS. L. REV. 271, 289-91 (1999). On the other hand, Professor Markham argues that there is a greater need for a suitability requirement in the futures industry, given the complicated nature of the instrument and vulnerability of unsophisticated traders. Markham, *supra*, at 266-67.

59. E.g., *Phacelli v. Conticommodity Servs., Inc.*, CFTC No. R80-385-80-704, 1986 WL 68447 (C.F.T.C.) (Sept. 5, 1986); *Kearney v. Prudential-Bache Sec.*, 701 F. Supp. 416 (S.D.N.Y. 1988) (commodities futures). But see *CFTC v. R.J. Fitzgerald & Co.*, 310 F.3d 1321 (11th Cir. 2002) (finding material misrepresentations in marketing commodity options trading strategy to unsophisticated customers; the dissenting judge found adequate disclosure of the risks).

60. *FDIC v. UMIC, Inc.*, 136 F.3d 1375, 1383-84 (10th Cir. 1998) (involving misrepresentations that the trading strategy was low-risk hedging); *Phacelli*, 1986 WL 68447, at \*8.

61. NYSE Guide, *supra* note 39, at Rule 405 (2002). For background on the rule, see G. Thomas Fleming III & Usman S. Mohammed, *NYSE Rule 405, the “Know Your Customer” Rule: Current Application and Limitations*, SEC. ARB. COMMENTATOR, Mar. 2002, at 1.

62. 8 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3848 (3d ed. 1991).

recorded accurate information about the customer, so that the firm cannot "know the customer."<sup>63</sup> We have not found any disciplinary proceeding where the NYSE interpreted the rule to include a duty on the part of the broker to prevent a customer from engaging in an unsuitable transaction where the broker has not recommended the transaction.

Courts also have resisted invitations to create a suitability obligation under Rule 405 if the broker has not made a recommendation.<sup>64</sup> Since the current judicial trend is not to imply a federal cause of action under Rule 405 or other Self-Regulatory Organization ("SRO") rules,<sup>65</sup> many courts simply dismiss customers' claims based on Rule 405 on this basis.<sup>66</sup> While a broker's violations of SRO rules can support a federal securities fraud claim under Securities Exchange Act ("SEA") § 10(b) and Rule 10b-5 if the customer can establish scienter,<sup>67</sup> a customer's claim against a broker for failing to prevent economic suicide is not premised on fraud, but on violation of a state law duty owed to the customer.<sup>68</sup> Courts do, however, treat Rule 405 synonymously with NASD Rule 2110 in holding that brokers can be liable for unsuitable recommendations.<sup>69</sup>

#### *d. Churning*

A broker has a duty not to churn a customer's account.<sup>70</sup> Churning is defined as excessive trading in an account, done not to effect the investor's

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63. See, e.g., *In re Silberman*, NYSE Disc. Action 01-229, 2001 NYSE Disc. Action LEXIS 165 (Dec. 19, 2001); *In re Fehlig*, NYSE Disc. Action 2001-19, 2001 NYSE Disc. Action LEXIS 99 (June 15, 2001).

64. *Unity House, Inc. v. N. Pac. Invs., Inc.*, 918 F. Supp. 1384 (D. Haw. 1996), specifically rejects Rule 405 as a basis for an economic suicide claim.

65. See, e.g., *Spicer v. Chicago Bd. of Options Exch., Inc.*, 977 F.2d 255 (7th Cir. 1992) (reviewing the case law on implying causes of action under SRO rules, specifically Rule 405).

66. E.g., *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990).

67. *Utah State Univ. of Agric. & Applied Sci. v. Bear, Stearns & Co.*, 549 F.2d 164, 169 (10th Cir. 1977); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969).

68. See *Grey v. Gruntal & Co.*, No. 84 Civ. 5036, 1987 U.S. Dist. LEXIS 4031 (S.D.N.Y. 1987) (granting defendants' motion for summary judgment on federal securities fraud claims and concluding that only a breach of fiduciary duty claim could be based on Rule 405).

69. See, e.g., *Boettcher & Co. v. Munson*, 854 P.2d 199 (Colo. 1993).

70. SEC Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (2002), defines churning in the context of a discretionary account, but it is clear that brokers may have de facto control over nondiscretionary accounts. See Patricia A. O'Hara, *The Elusive Concept of Control in Churning Claims under Federal Securities and Commodities Law*, 75 GEO. L.J. 1875 (1987) (stating that the control test is the functional equivalent of the reliance test in misrepresentation cases). The NASD has identified excessive trading activity as a violation of a broker's responsibility of fair dealing, NASD Manual, *supra* note 39, at Rule IM-2310-2(b)(2) (2002), and it is also prohibited by NASD Rule 2510(a), *id.* at Rule 2510(a) (2001).

trading strategy but to generate brokers' commissions.<sup>71</sup> Sometimes referred to as "quantitative unsuitability,"<sup>72</sup> churning requires proof that the broker controlled the account.<sup>73</sup> Excessive trading by itself does not, therefore, establish churning.<sup>74</sup>

*e. Material Misstatements; Failure to Disclose*

A broker has a duty not to make a misstatement of material fact and to disclose material facts necessary to ensure that none of his statements are misleading.<sup>75</sup> Accordingly, if the customer asks the broker about the risks and the broker does not explain them fully, he may be liable.<sup>76</sup> Moreover, the broker may have an obligation to correct or update the previously given information, although this obligation does not continue after the customer completes the investment.<sup>77</sup> Courts have, however, frequently limited liability for material misstatements by finding that the statement is not a fact, but an opinion, sales talk, or "puffery."<sup>78</sup>

71. *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416 (11th Cir. 1983) (stock options); *Saxe v. E.F. Hutton & Co.*, 789 F.2d 105, 112 (2d Cir. 1986) (commodities futures).

72. *In re Howard*, 2000 WL 1736882 (N.A.S.D.R.), at \*6 (Nov. 16, 2000) (Nat'l Adjudicatory Council); *In re Bruff*, Exchange Act Release No. 34-40583, 68 SEC Docket 562, 565 (SEC Oct. 21, 1998) (stating "excessive trading is itself a form of unsuitability").

73. See *supra* notes 29-30 and accompanying text.

74. *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1386 (10th Cir. 1987).

75. See *supra* note 7 and accompanying text.

76. In *Union Bank of Switzerland v. HS Equities, Inc.*, 457 F. Supp. 515, 522 (S.D.N.Y. 1978), the court stated the broker had a duty "to keep [the bank] fully informed as to material matters that could affect [the bank's] judgment with respect to transactions which were the subject of its account" where the broker provided the bank, the holder of an "omnibus" brokerage account, with misleading and confusing information about the tax liability of one of the bank's customers. See also *In re Catanella*, 583 F. Supp. 1388, 1404 (E.D. Pa. 1984) (misrepresentations about risks of margin trading); *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 9 (D.D.C. 1998) (holding that minimal boilerplate risk disclosure was not adequate disclosure of risks in a speculative "trading program"); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454 (9th Cir. 1986) (holding that when recommending a short-selling strategy, a broker has a duty to explain the risks); *Crook v. Shearson Loeb Rhoades, Inc.*, 591 F. Supp. 40 (N.D. Ind. 1983) (discussing the failure to explain fully the risks of commodities futures trading to an inexperienced investor). But see *Thompson v. Smith Barney, Harris Upham & Co.*, 539 F. Supp. 859, 864 (N.D. Ga. 1982), *aff'd*, 709 F.2d 1413 (11th Cir. 1983) (ruling that the customer should have understood that high risk accompanies extraordinary gains) (stock options).

77. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 377 N.W.2d 605, 143 (Wisc. 1985) (commodities futures).

78. See, e.g., *De Kwiatkowski*, 306 F.3d at 1293, 1312-13 (statement that broker could liquidate positions "on a dime" was hyperbole); *Shamsi v. Dean Witter Reynolds, Inc.*, 743 F. Supp. 87, 91-92 (D. Mass. 1989) (brokers are not liable for general promises of profitability, as opposed to promises of specific returns). See generally Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence*

Whether a broker has a duty to disclose any information depends on the nature of his relationship with the customer.<sup>79</sup> A customer may argue that his broker had a contractual duty to disclose the risks.<sup>80</sup> Customers are, however, likely to have difficulty establishing a duty to warn under this test. First, as stated earlier,<sup>81</sup> courts are likely to limit any duty to the specific transaction and not to the customer's portfolio or overall strategy. Second, courts frequently find that the risks of the trading or investment strategy were, or should have been, readily available to the customer.<sup>82</sup> A forceful statement of both these views is found in *De Kwiatkowski v. Bear, Stearns & Co.*,<sup>83</sup> where the Second Circuit held that a broker owed no duty to a customer with a non-discretionary account to provide him ongoing advice about market conditions and increased risks, particularly where the customer should have been well aware of the risks from his previous trading experience.

*f. Specific Disclosure Duties*

*i. Securities*

There are certain investments and investment or trading strategies that, in the view of the regulators, are sufficiently risky to warrant specific disclosure to the investor about the risks: penny (microcap) stocks,<sup>84</sup> day

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*of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697 (1998).

79. *Compare* *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972) (holding that brokers violated § 10(b) and Rule 10b-5 because they had a duty to disclose that they were selling shares purchased from plaintiffs at a higher price in a different market) *with* *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (holding that failure to disclose does not violate § 10(b) and Rule 10b-5 absent a duty to disclose).

80. *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1290-91 (S.D. Ohio 1996) (applying New York law that an implied contractual duty to disclose exists where one party in a business relationship has superior knowledge, the information is not readily available to the other party, and the first party knows the other is operating on the basis of mistaken knowledge) (interest rate swaps).

81. *See supra* notes 31-33 and accompanying text.

82. Courts have held that reasonable investors should understand, among other things, principles of risk and diversification, *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 351 (2d Cir. 1993), and the nature of margin accounts, *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984).

83. 306 F.3d 1293, 1311-12 (2d Cir. 2002).

84. Sec. Exch. Act Rules 15g-1 through g-9, 17 C.F.R. §§ 240.15g-1 through 15g-9 (2002). There is an exemption for "transactions not recommended by the broker or dealer," *id.* § 240.15g-1(e). The SEC has previously made clear that recommendations may be broader than "solicited orders," Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Release No. 34-27160, 44 SEC Docket (CCH) 600, at 613-14 (Aug. 22, 1989), but the rule does not apply when the broker-dealer "functioned solely as an order taker and executed securities for persons who on their own initiative decided to purchase a [penny stock] without a recommendation from the broker-dealer." *Id.* The Rule also does not apply to

trading,<sup>85</sup> margin trading,<sup>86</sup> and options trading.<sup>87</sup> While the regulatory detail varies, in general, the broker must provide the customer with a statement that discloses the risks involved. The penny stock and options trading rules also require that the broker obtain the customer's signature acknowledging receipt of the risk disclosure statement.<sup>88</sup> At least if the broker recommends a risky options strategy, it is not enough that he obtains the customer's signature on the required disclosure statement; he should make sure that the customer reads and understands it.<sup>89</sup>

In addition, with respect to penny stocks,<sup>90</sup> day-trading,<sup>91</sup> and options trading,<sup>92</sup> the broker must make a determination that the transactions are suitable for the customer before effecting the transaction or opening the account. This obligation is not dependent upon the broker's making a recommendation.

## ii. *Commodities Futures*

A broker must furnish a risk disclosure statement to a customer who opens a commodities futures,<sup>93</sup> commodities options<sup>94</sup> or security futures<sup>95</sup>

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"general advertisements not involving a direct recommendation to [an investor]." *Id.* at 614. The NASD explicitly identifies recommending speculative low-priced securities to customers without at least attempting to obtain information to determine their suitability as a violation of the broker's fair dealing responsibility. NASD Manual, *supra* note 39, at Rule IM-2310-2(b)(1) (2000).

85. NASD Manual, *supra* note 39, at Rules 2360, 2361 (2002). The rules apply to firms promoting a day-trading strategy. The term is not defined, but the NASD did enumerate certain activities that, by themselves, would not trigger application of the rules, such as promoting efficient execution services or lower execution costs based on multiple trades. Self-regulatory Organizations; National Association of Securities Dealers, Inc., Order Approving Proposed Rule Change and Amendment No. 1 and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 Relating to the Opening of Day-Trading Accounts, Exchange Act Release No. 34,43021, 72 SEC Docket (CCH) 2047, 2048 (July 10, 2000). For a discussion of the rules, see *In re Rea*, 245 B.R. 77, 89-90 (Bankr. N.D. Tex. 2000).

86. NASD Manual, *supra* note 39, at Rule 2341 (2002).

87. See NASD Manual, *supra* note 39, at Rule 2860, IM-2860-2 (2001); Chicago Board Options Exchange, Inc. Rule 9.9, CBOE Constitution and Rules (CCH) 247 (2001). The particular disclosure requirements vary according to the level of risk.

88. Sec. Exch. Act Rule 15g-2, 17 C.F.R. § 240.15g-2 (requires customer's signature before a transaction is made); NASD Manual, *supra* note 39, at Rule 2860(b)(16)(D) (2001) (requires customer's signature within 15 days after approval of the account).

89. *In re Dale E. Frey*, Adm. Proc. File No. 3-10310, SEC Rel. No. 10-221, 2003 WL 245560 (Feb. 5, 2003).

90. See Sec. Exch. Act Rules 15g-9(a)-(b); 17 C.F.R. §§ 240.15g-9(a)-(b) (2002).

91. See NASD Manual, *supra* note 39, at Rule 2360(b) (2002).

92. *Id.* at Rule 2860(b)(16). There are additional procedures for approving customers for writing uncovered short option transactions. See *id.* at Rule 2860(b)(16)(E).

93. CFTC General Regulations under the Commodity Exch. Act § 1.55, 17 C.F.R. § 1.55; NFA



account and obtain the customer's signature acknowledging receipt of the risk disclosure statement.<sup>96</sup>

As discussed earlier,<sup>97</sup> there is no requirement that the broker determine that commodities futures and commodities options transactions are suitable for the customer; there is such a requirement for security futures.<sup>98</sup> Under the NFA Compliance Rule 2-30, commodities brokers do have an obligation to seek from all customers who are individuals information about their financial situation and prior investing and trading experience.<sup>99</sup> Moreover, brokers must provide additional risk disclosure if it is necessary to enable the customer "to make an informed judgment about whether he or she should be involved in the futures markets."<sup>100</sup> According to the NFA, if the broker believes that futures trading is too risky for a customer, he must tell a customer that "he has no business trading futures."<sup>101</sup> If the customer still decides to trade futures, the broker may open the account.<sup>102</sup>

Courts generally find adequate disclosure if the risk disclosure statements are delivered,<sup>103</sup> at least in the absence of the broker's telling the customer to disregard the warning.<sup>104</sup> Although the regulatory philosophy is to emphasize the importance of risk warnings to justify the lack of a suitability requirement, some courts have, paradoxically, held that since there is no suitability

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Manual, *supra* note 58, at Rule 2-30 (2001).

94. CFTC Regulation of Domestic Exchange-Traded Commodity Options Transactions, 17 C.F.R. § 33.7 (2002).

95. NFA Manual, *supra* note 58, at Rule 2-30 (2001).

96. CFTC Rule 1.55(a)(1)(ii) generally requires the customer's signature before opening the account. See 17 C.F.R. § 1.55(a)(1)(ii) (2002).

97. See *supra* note 59 and accompanying text.

98. NFA Manual, *supra* note 58, at Rule 2-30(j) (2001). Since both the SEC and the CFTC regulate security futures, the requirements for brokers opening security futures accounts for customers conform to the NASD requirements for opening accounts for customers that write stock options. See SEC Self-Regulatory Organization; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Futures Association Relating to Security Futures Products, 66 Fed. Reg. 49,439 (Sept. 27, 2001).

99. NFA Manual, *supra* note 58, at Rule 2-30(c) (2001).

100. Proposed Rule Change, 66 Fed. Reg. at 49,440, makes it clear that NFA Rule 2-30(d) sets forth the minimum disclosure requirements.

101. *Id.* The broker must warn the customer even if he makes no recommendations. See *id.*

102. *Id.*

103. See, e.g., *Purdy v. CFTC*, 968 F.2d 510 (5th Cir. 1992); *Hill v. Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817, 824 (10th Cir. 1986) (commodities futures). But see *Crook v. Shearson Loeb Rhoades, Inc.*, 591 F. Supp. 40, 44 (N.D. Ind. 1983) (ruling that even if customer received the risk disclosure statement, he would not have understood commodities futures trading).

104. In *Clayton Brokerage Co. v. CFTC*, 794 F.2d 573 (11th Cir. 1986), while the customer did read the risk disclosure statement and initially decided that futures trading was too risky, his broker persuaded him to ignore the warning.

requirement, commodities brokers have no duty to warn the customer about commodities trading so long as the customers received the risk disclosure statement.<sup>105</sup> Other courts have correctly followed the CFTC's position that the risk disclosure statement is only the minimum disclosure and does not relieve the broker of an obligation to provide more disclosure of the risks, depending upon the facts and circumstances, including the relationship between the broker and the customer.<sup>106</sup>

*B. Support for a More Expansive Judicial View of the Broker's Duties to Customers*

In this section, we look at case law to determine what support exists for the proposition that, despite the absence of recommendations or control over the account, brokers may have an obligation to protect their customers from financial suicide.

What would be the scope of such a duty? It could range from a simple duty to warn the customer about a specific investment decision before executing the customer's order to a more comprehensive duty to monitor the customer's account and to warn the customer about the effect of a specific investment decision on the customer's entire portfolio or even, more generally, on the effect of subsequent events on the customer's portfolio. Finally, the duty could be extended even to require the broker to refuse to execute transactions that, in his professional judgment, are too risky for the customer.

*Duty to Warn. Leib v. Merrill Lynch, Pierce Fenner & Smith, Inc.*,<sup>107</sup> while espousing the traditional view of the limited duties that a broker owes to a customer of a nondiscretionary account, nevertheless includes a duty to warn a customer about the risks involved in investing in a specific security. A few courts have recognized a broker's duty to warn customers about the dangers of certain risky investment choices. In *Quick & Reilly, Inc. v. Walker*,<sup>108</sup> the jury found the broker liable on a negligence theory, apparently for the broker's failure to warn the customer of the risks in options trading.

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105. See, e.g., *Wasnick v. Refco, Inc.*, 911 F.2d 345 (9th Cir. 1990); *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 903 F.2d 1014 (5th Cir. 1990).

106. *Clayton Brokerage Co.*, 794 F.2d at 580.

107. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd mem.*, 647 F.2d 165 (6th Cir. 1981).

108. *Quick & Reilly, Inc. v. Walker*, 930 F.2d 29 (9th Cir. 1991) (unreported decision), reported in full at 1991 U.S. App. LEXIS 5472.

Because the broker did not appeal this finding,<sup>109</sup> the appellate court provides little discussion except for the facts. The customer was an experienced options trader who selected the defendant, a discount broker, because it made no recommendations. Initially the firm limited her trades to reduce her risks, but this restriction was lifted when her account was transferred to a different account executive. Moreover, while the account executive did not make any recommendations, there were apparently frequent conversations with the customer in which he may have encouraged her activity. The appellate court concluded that the district court acted properly in concluding that a reasonable jury could find that the broker acted negligently, but not recklessly or fraudulently, in failing to warn the customer of the extent of her exposure to loss. Apparently a jury could reasonably find that given the change in the firm's treatment of the customer's account and the regular communications between customer and broker, it was not onerous to impose on the broker a minimal duty to warn.

We have found two other cases<sup>110</sup> where the customer recovered damages because the broker failed to provide adequate warnings about investment strategies. In *Beckstrom v. Parnell*,<sup>111</sup> an appellate court upheld the trial court's decision imposing liability on the broker for failure to warn adequately his elderly customer about the high costs of switching mutual funds. The customer had previously been a knowledgeable, informed investor, but had recently suffered a stroke and personality changes and told the broker he looked to him for guidance. The customer initiated the idea of switching funds; the broker provided information about various funds that met the customer's criteria. The customer then researched the funds, discussed his findings with the broker, and directed the broker to make the switches. The court held that since the switches were obviously contrary to the customer's best interests, the broker had a duty to provide the customer with an explicit written warning of the costs. Emphasizing that the broker was a full-service broker and that he was aware of the customer's diminished capabilities, the court held that the broker could not act simply as an order-taker.

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109. The customer appealed the directed verdict against her on the fraud claim, because a recovery on this theory would not be reduced by the jury's finding that she was 45% contributorily negligent and she might have been awarded punitive damages. *Id.*

110. *See also* *Memphis Housing Auth. v. Paine, Webber, Jackson & Curtis, Inc.*, 639 F. Supp. 108 (W.D. Tenn. 1986) (denying the defendant's motion for summary judgment, where the plaintiff claimed the broker breached a duty to warn the plaintiff's employee of the impropriety of speculative trading).

111. *Beckstrom v. Parnell*, 730 So. 2d 942 (La. Ct. App. 1998). The appellate court first reversed the trial court's decision, *Beckstrom v. Parnell*, 714 So. 2d 188 (La. Ct. App. 1998), but upon rehearing, a five-judge panel affirmed it.

Similarly, in *Gochnauer v. A.G. Edwards & Co.*,<sup>112</sup> the customers (husband and wife) had an account with the broker, primarily in municipal bonds; their investment objectives were on record as conservative. When they asked him if other investments would offer a higher return, the broker recommended that they consider options trading and suggested a consultation with a self-styled options expert who was not affiliated with his firm. The broker's recommendation was based on his personal observations and discussions with others about the expert's success, but he made no investigation into the expert's background and experience. The customers then entered a written agreement with the expert, who guaranteed them a 15% return. The trial court found that the customers did not rely on the broker's recommendation of the expert, but also found that the broker violated his duty when he advised and assisted them in establishing the speculative options trading account. Despite the ambiguity of those two findings, the appellate court affirmed, holding that, given the change from conservative to speculative investment strategies and the highly unusual 15% guarantee, the broker should have warned the customers of the risks.

In both *Beckstrom* and *Gochnauer*, the customer had long-standing relationships with the broker, who was sufficiently familiar with the customer's investment objectives and personal circumstances to appreciate the unsuitability of these investments. In each case, the broker provided advice about the unsuitable investment, although neither court premised its decision on a finding that the broker's advice constituted a recommendation. Rather, in each case the court emphasized the broker's professional responsibility to warn a customer who has decided on an investment strategy without an adequate understanding of the risks.

A customer could also argue that industry standards support a duty to warn. It is generally accepted within the brokerage industry that an ethical broker should warn his customer when, in the broker's judgment, the customer is engaging in speculative trading without an appreciation of the risks. A well-known study guide for the basic securities broker's license states: "Occasionally, a customer asks a registered rep to enter a trade that the rep believes is unsuitable. It is the rep's responsibility to explain why the trade might not be appropriate for the customer."<sup>113</sup>

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112. *Gochnauer v. A.G. Edwards & Co.*, 810 F.2d 1042, 1044 (11th Cir. 1987)

113. PASSTRACK® SERIES 7 GENERAL SECURITIES REPRESENTATIVES 670 (Dearborn 11th ed. 2000). We thank DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 5-27 (5th ed. 2001), for calling our attention to this.

At least some securities firms' compliance manuals contain similar language.<sup>114</sup> One arbitration award extensively quoted from a firm's compliance materials: "Account executives have an affirmative obligation and are expected to advise their customers accordingly when they believe a specific investment or strategy is not in their customer's best interest."<sup>115</sup> Even more specifically, the same firm stated in another compliance document:

[W]here customers initiate transactions that appear unsuitable, *you are not required to accept those orders*. In such situations, you may wish to advise clients why you believe the transactions may be unsuitable and apprise your branch manager of the situation. If the client insists on making a trade, record their decision in your Day-Timer.<sup>116</sup>

Some firms have even advertised that they will help the customer "avoid the wrong investments."<sup>117</sup>

Whether or not a customer can transform these ethical standards into enforceable legal obligations is an unsettled question. General agency and tort principles offer some support for using industry's professional standards to establish a standard of care for a negligence claim.<sup>118</sup> Restatement (Second) Agency § 379(1) provides that an agent is subject to a duty to the principal to act with the standard of care recognized within the industry,<sup>119</sup> *unless the agreement provides otherwise*.<sup>120</sup> Restatement (Second) Agency § 381(a)

114. Thomas R. Grady, *Trying the Financial Suicide Case*, in 2 SECURITIES ARBITRATION 1996 at 109, 111 (David E. Robbins Chair, PLI 1996); DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 5-27, at 5-185 (5th ed. 2001). Securities practitioners have told the authors of compliance manuals containing such language, but were not able to provide copies since the compliance manuals were produced to claimants' counsel in arbitration subject to a confidentiality order.

115. *Peterzell v. Dean Witter Reynolds, Inc.*, No. 32-136-0416-88-ID at 4 (A.A.A. Nov. 9, 1990) (Foley, Arb.), discussed *infra* notes 208-16 and accompanying text.

116. *Id.* at 7; *see also* *Kirchner v. Baraban Secs., Inc.*, No. 97-00461 (N.A.S.D. Jan. 13, 1998) (Devaney, Arb.) (quoting compliance manual instructing brokers to warn customers who wish to disregard recommendations and make unsuitable investments).

117. "Sometimes, NO is the most positive advice we can give. Helping you avoid the wrong investments is as important as finding the right ones." Smith Barney advertisement appearing in N.Y. TIMES, Dec. 21, 1994 (on file with authors).

118. *Mihara v. DeanWitter & Co.*, 619 F.2d 814 (9th Cir. 1980); *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160 (S.D. Tex. 1969); *see also* *Rupert v. Clayton Brokerage Co.*, 737 P.2d 1106 (Col. 1987) (referring to compliance manual provisions on discretionary authority in commodities accounts).

119. RESTATEMENT (SECOND) OF AGENCY § 379(1)(1958). *See* *Index Futures Group v. Ross*, 557 N.E.2d 344, 347 (Ill. App. Ct. 1990) (explaining that both contract and negligence claims can be based on breach of industry regulations) (commodities futures).

120. Brokerage firms, however, may include provisions in the customer's agreements exculpating them from negligence claims, and courts have enforced these provisions. *See, e.g.,* *Wolf v. Ford*, 644 A.2d 522 (Md. 1994).

establishes an agent's duty "to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have."<sup>121</sup> Finally, Restatement (Second) Torts § 299A requires individuals to exercise the degree of care and skill "normally possessed by members of that profession or trade in good trade in similar communities," unless the individual represents that he has greater or lesser skill or knowledge.<sup>122</sup>

Courts are divided on the significance of these professional and legal standards when customers seek damages from their brokers. Even violations of state regulations requiring suitable recommendations and prohibiting excessive mark-ups do not, in the view of one state supreme court, establish negligence *per se*.<sup>123</sup> Some courts state that to impose liability on the broker there must be some evidence that the broker made a commitment to the customer to observe the firm's or the industry's standards and that the customer relied on this.<sup>124</sup> This reflects a judicial view that the internal rules are for the protection of the firm, not the customer,<sup>125</sup> and a concern not to impose greater liability on firms that adopt higher standards.<sup>126</sup>

Where the broker has not observed internal rules that were clearly designed to protect customers from risks they have not agreed to assume, courts are more likely to allow recovery. For example, failure to follow internal operating rules designed to detect forged signatures on accounts can provide a basis for the customer's recovery.<sup>127</sup> In contrast, courts have consistently held that the margin requirements are primarily for the protection

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121. RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

122. RESTATEMENT (SECOND) OF TORTS § 299A (1965).

123. *Minneapolis Employees Ret. Fund v. Allison-Williams Co.*, 519 N.W.2d 176 (Minn. 1994).

124. *Puckett v. Rufenacht, Bromagen & Hertz*, 587 So. 2d 273, 281 (Miss. 1991) (commodities futures). For similar language, see *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1357 n.3 (10th Cir. 1987) (explaining that one may not unilaterally impose a fiduciary relationship on another without a conscious assumption of such duties by the one sought to be held liable as a fiduciary). See also *Hill v. Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817, 825 (10th Cir. 1986) (commodities futures); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 357 N.W.2d 287 (Wisc. Ct. App. 1984), *aff'd in part*, 377 N.W.2d 605 (Wisc. 1985) (commodities futures); *J.E. Hoetger & Co. v. Ascencio*, 572 F. Supp. 814 (E.D. Mich. 1983) (commodities futures); *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972) (commodities futures).

125. See, e.g., *J.E. Hoetger & Co.*, 572 F. Supp. at 822; *Prudential Bache Secs., Inc. v. Pitman*, No. 1:89-CV-85-JTC, 1991 WL 160039 at \*5 (N.D. Ga. Apr. 4, 1991).

126. *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d at 1293 (2d Cir. 2002); *J.E. Hoetger & Co.*, 572 F. Supp. at 822.

127. *Thropp v. Bache Halsey Stuart Shields, Inc.*, 650 F.2d 817 (6th Cir. 1981); *Miller v. Smith Barney, Harris Upham & Co.*, No. 84 Civ. 4307, 1986 WL 2762 (S.D.N.Y. Feb. 27, 1986).

of the firm and do not create any rights on which the customer can sue.<sup>128</sup> In instances where the broker does not control the account, the courts have limited the informational duty to factual information relevant to executing the specific transaction and not to a duty to warn.<sup>129</sup>

*Duty to Monitor.* Next, we have found no judicial support for imposing a duty to monitor on the broker where he does not control the account.<sup>130</sup> As previously discussed,<sup>131</sup> the prevailing view is that the broker's duty is transaction-specific and discharged when the customer's order has been executed. Accordingly, the broker has no duty to monitor the customer's account to advise him of market information that would affect his holdings.<sup>132</sup> Courts have even refused to find a duty to monitor where the broker recommended the purchase.<sup>133</sup> Furthermore, neither the SEC nor the SROs provide any guidance about a broker's duty to warn customers of the dangers of lack of diversification, over-concentration in volatile securities or (outside of day-trading) over-trading absent a recommendation.<sup>134</sup>

Industry practice, however, suggests that brokers understand that they have a responsibility to monitor. The NYSE's Content Outline for the

128. *Bennett v. United States Trust Co. of N.Y.*, 770 F.2d 308 (2d Cir. 1985); *Kearney v. Prudential Bache Sec., Inc.*, 701 F. Supp. 416 (S.D.N.Y. 1986) (commodities futures); *Merrill Lynch Futures, Inc. v. Sands*, 727 A.2d 1009 (N.H. 1999) (commodities futures).

129. *See De Kwiatkowski*, 306 F.3d at 1306; *Robinson*, 337 F. Supp. at 111 ("The affair entrusted to a broker . . . is to execute the order, not discuss its wisdom."). *See also Zimmerman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 391 N.W.2d 353 (Mich. App. 1986) (explaining that the broker had no duty to warn co-owner of account that the other co-owner was engaging in unsuitable trading). *But see* *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*, 794 F.2d 198 (5th Cir. 1986) (explaining that the broker had a duty to tell the customer that the size of his order would affect the market price).

130. Control may be established by contract, as the broker may promise to monitor the account. *Ahluwalia/Shetty v. Kidder, Peabody & Co.*, No. 93 Civ. 1261 (TPG), 1998 U.S. Dist. LEXIS 3286 (S.D.N.Y. Mar. 17, 1998), *aff'd mem.*, 173 F.3d 843 (2d Cir. 1999). In this instance, the broker may be treated as the equivalent of an investment adviser. *Erlich v. First Nat'l Bank of Princeton*, 505 A.2d 220 (N.J. Super. 1984).

131. *See supra* note 33 and accompanying text.

132. *De Kwiatkowski*, 306 F.3d at 1293; *Cooperativo Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 777 F. Supp. 153, 159 (D.P.R. 1991), *rev'd on other grounds*, 993 F.2d 269 (1st Cir. 1993); *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972) (commodities futures); *Walston & Co. v. Miller*, 410 P.2d 658 (Ariz. 1966) (commodities futures).

133. *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561 (9th Cir. 1985). *But see In re Merrill Lynch, Pierce, Fenner & Smith, Inc., Exch. Act Release No. 14149*, SEC Docket (Nov. 9, 1977) (explaining that the broker who recommended an unseasoned company on the basis of management projections has a duty to update recommendations and communicate adverse information to customers).

134. The NASD's suitability rule, Rule 2310, requires a broker to take into account the customer's portfolio when making a recommendation. *See supra* note 54 and accompanying text.

General Securities Registered Representative Examination (“Series 7”) identifies as a critical function and task of the registered representative to “monitor[] the customer’s portfolio and make[] recommendations consistent with changes in economic and financial conditions as well as the customer’s needs and objectives.”<sup>135</sup> The compliance materials quoted in one arbitration award<sup>136</sup> stated that “[s]uitability . . . should not be a static concept limited to the time the account is opened, but rather, an ongoing obligation . . . to review and update suitability determinations.”<sup>137</sup> Many brokers follow a practice of sending letters to customers when they see over-trading or other problematic patterns of trading in an account, sometimes seeking written acknowledgment from the customer that he understands the risks.<sup>138</sup> The principal beneficiary of written warnings may be the brokers themselves, since they may assert disclosure as a defense to customers’ claims. Even though one may be skeptical about the effectiveness of these formulaic disclosures, courts generally find that they provide customers with adequate warning.<sup>139</sup> If these warnings are to be meaningful, however, someone other than the customer’s account executive should have a conversation with the customer about the specific risks of the customer’s trading, to stress to the customer the risks involved.

*Duty to Stop Customer.* Finally, there is no judicial support for the proposition that a broker must refuse to execute an unsuitable trade for a customer who controls his own account. Absent control, the broker does not have a duty to execute only suitable investments for his customer.<sup>140</sup> Both *Twomey*<sup>141</sup> and *Leib*<sup>142</sup> state this explicitly; if the broker fulfills his duty to warn, he is not barred from executing the customer’s orders. Indeed, *Twomey*

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135. NYSE, CONTENT OUTLINE FOR THE GENERAL SECURITIES REGISTERED REPRESENTATIVE EXAMINATION (TEST SERIES 7) (1995), available at <http://www.nyse.com/pdfs/series7.pdf> (last visited Jan. 31, 2003). For background on the Content Outline, see Jay H. Salamon & Anthony J. Hartman, *The Broker’s Duty to Monitor Accounts and Recommend Protective Measures: Is There an Industry Standard?*, 9 PIABA BAR J. 23, 23 (Summer 2002).

136. See *Peterzell v. Dean Witter Reynolds, Inc.*, No. 32-136-0416-88-1D (A.A.A. Nov. 9, 1990) (Foley, Arb.), discussed *infra* notes 208-16 and accompanying text.

137. *Id.* at 4.

138. An example of such a letter is set forth as Exhibit G in Grady, *supra* note 114, at 181.

139. Most of the case law deals with risk disclosures made in offering materials that may be at odds with the brokers’ assurances. For a review of the case law, see *Kravetz v. United States Trust Co.*, 941 F. Supp. 1295 (D. Mass. 1996). See also *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1993); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983).

140. See, e.g., *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1387 n.3 (10th Cir. 1987).

141. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222, 243-44 (Cal. Ct. App. 1968).

142. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1973).



says that the broker can even advise the customer about various speculative securities, so long as the customer makes the selection.<sup>143</sup> Moreover, if a broker refuses to execute a trade for a customer, he may be found liable for failing to execute his customer's order.<sup>144</sup>

Industry practice is consistent with judicial precedent. According to the Series 7 study guide, if the customer insists upon making the purchase after the broker warned him, the broker should obtain written acknowledgment from the customer that he was warned against the trade, and the broker should mark the order ticket unsolicited.<sup>145</sup>

The argument that brokers should stop customers from trading when it should be clear that the customer is trading irrationally can be based on an expanded view of the broker's duty to know his customer. If it is clear to the broker that the customer is trading irrationally, this may demonstrate that the customer has an addictive personality and perhaps lacks the requisite mental capacity to enter into contracts. The court in *Beckstrom v. Parnell*<sup>146</sup> emphasized the full service broker's knowledge of his customer's incapacity in finding the broker liable for failing to warn the customer of the unsuitable transaction (but did not suggest that the broker could not follow the customer's instructions if he had been warned). Other courts have declined to hold that brokers have a duty to know the mental competence of their customers.<sup>147</sup>

Analogies have also been made to tort doctrines developed to protect against physical harm. Brokers, it has been asserted, like bartenders under "dram shop" statutes<sup>148</sup> and common law negligence principles, owe a duty to cut off the customer so that he cannot harm himself. The analogy, however,

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143. *Twomey*, 69 Cal. Rptr. at 243-44.

144. RESTATEMENT (SECOND) OF AGENCY § 385 (1958). See also *O'Malley v. Boris*, 742 A.2d 845, 849 (Del. 1999) ("A broker as an agent, has a duty to carry out the customer's instructions promptly and accurately."). At least one court has upheld a jury verdict that imposed liability on a broker for refusing to execute a trade that in its view was unsuitable for the customer. *Segars v. Dean Witter Reynolds, Inc.*, No. FO11225 (Cal. Ct. App. filed July 30, 1990).

145. PASSTRAK®, *supra* note 113, at 670. We have been informed that compliance manuals contain similar instructions.

146. *Beckstrom v. Parnell*, 730 So. 2d 942 (La. App. 1998). See also *supra* note 111 and accompanying text.

147. See, e.g., *Edward D. Jones & Co. v. Fletcher*, 975 S.W.2d 539 (Tex. 1998).

148. For a general discussion of dram shop liability, see DAN B. DOBBS, *THE LAW OF TORTS* § 332 (2000). See also *Pearlstein v. Scudder & German*, 527 F.2d 1141, 1145 (2d Cir. 1975) (where the court gave short shrift to the analogy); *Powers v. Francis I. DuPont & Co.*, 344 F. Supp. 429, 433 (E.D. Pa. 1972) (also rejecting the analogy although it expressed concern that the broker allowed the customer to continue his irrational trading).

is not persuasive. First, it requires an assumption that the probable economic harm from problematic trading is as obvious as the probable physical harm from intoxication. Second, states are divided on whether bartenders, under either dram shop statutes or common law negligence, can be held liable for injuries to the customer; many states interpret the law as providing protection only for the victims of the intoxicated person.<sup>149</sup>

Finally, scholars have invoked the duty to rescue<sup>150</sup>—the duty to intervene arising from the vulnerability of one party and the relative ease with which another party can intervene to prevent loss or injury.<sup>151</sup> In general, however, the law does not recognize a duty to rescue.<sup>152</sup> While there are exceptions, they are limited to emergency situations where there is a serious risk of physical harm.<sup>153</sup> To expand the exceptions to provide protection from economic harm that the investor, however misguided, has chosen is unwarranted given our strong national culture of investors' "freedom" and its concomitant "responsibility."<sup>154</sup>

## II. ARBITRATION AWARDS ADDRESSING AN ECONOMIC SUICIDE CLAIM

As detailed in Part I, there is little support in judicial opinions for imposing a duty on brokers to prevent their customers from engaging in financially disastrous trades and/or trading strategies, absent a broker's recommendation or control over the account. However, since the Supreme Court's 1987 decision in *Shearson/American Express, Inc. v. McMahon*,<sup>155</sup> most customer disputes with brokers are resolved in arbitration, usually in a dispute resolution forum sponsored by securities industry SROs. While it is widely understood that arbitration awards have no precedential value because they are so fact specific,<sup>156</sup> many commentators, as well as the media, have

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149. See DOBBS, *supra* note 148, at § 332.

150. Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties—Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DEPAUL L. REV. 709, 744-46 (1990).

151. Ernest J. Weinrib, *The Case for a Duty to Rescue*, 90 YALE L.J. 247, 279-92 (1980); James Barr Ames, *Law and Morals*, 22 HARV. L. REV. 97, 110-112 (1908).

152. See DOBBS, *supra* note 148, § 314. For an argument that contract law recognizes a duty to rescue, see Melvin A. Eisenberg, *The Duty to Rescue in Contract Law*, 71 FORDHAM L. REV. 647 (2002).

153. *Id.* But see *Bohan v. Hogan*, 567 N.W.2d 234 (Iowa 1997) (explaining that the printing company should have recognized risk to third parties when it printed certificates of deposit for an individual with no apparent connection to a financial institution).

154. *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 278 (Miss. 1991).

155. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

156. See, e.g., *El Dorado Tech. Serv., Inc. v. Union Gen.*, 961 F.2d 317, 321 (1st Cir. 1992).

reported that arbitrators issue awards to customers on the expanded ground that brokers owe a duty to customers to prevent their economic suicide.<sup>157</sup> Therefore, a review of arbitration awards<sup>158</sup> is necessary to explore whether arbitrators do, in fact, expand the law, as summarized in the prior section.

In an attempt to find support for this expanded duty imposed by arbitrators, we examined over 100 awards<sup>159</sup> resulting from brokerage customers' complaints against their firms and/or brokers where either the customer raised an economic suicide theory of liability or the panel seemed to consider such a theory, and either accept it or reject it in rendering its award.<sup>160</sup> As a result of this detailed review, we have concluded that, in fact, arbitrators are not expanding the scope of liability nearly as far as is publicly perceived.

Our review was necessarily limited by a number of factors. First, the overwhelming majority of arbitration awards do not include an explanation of the basis—either factual or legal—for the award. As a result, we could not categorize many awards because it was too difficult to discern the grounds for the arbitrators' ruling.<sup>161</sup> Second, most awards do not contain a summary of

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157. See DAVID E. ROBBINS, *SECURITIES ARBITRATION PROCEDURE MANUAL* §§ 5-27 (5th ed. 2001); Lewis D. Lowenfels & Alan R. Bromberg, *Beyond Precedent: Arbitral Extensions of Securities Law*, 57 *BUS. LAW.* 999, 1011-13 (2002); Richard Karp, *Goliath in Retreat: In Arbitration, Little Guys Score Some Big Wins Against Wall Street*, *BARRON'S*, Sept. 25, 1995, at 16; Michael Siconolfi, 'Dramshop' Awards Increasingly Slapped on Brokerage Firms, *WALL ST. J.*, Sept. 4, 1992, at A4B.

158. The *Securities Arbitration Commentator*, recognized as a complete database of securities arbitration awards, contains over 26,000 awards from all forums, including the NASD-DR, the NYSE and the American Arbitration Association ("AAA"). See SAC Awards Database, at [http://scan.cch.com/NASD/nasd\\_sac\\_start.asp](http://scan.cch.com/NASD/nasd_sac_start.asp) (last visited Jan. 23, 2003). The NASD-DR compiles annual statistics, which indicate that there were over 1600 Awards issued in 2001. "How Arbitration Cases Close," available at <http://www.nasdaq.com/statistics.asp> (last visited Jan. 23, 2003). The NYSE, a smaller arbitration forum, issues far fewer awards. Our study did not include awards involving commodities futures because, while the NFA publishes its panels' awards on its website, they cannot be searched by subject matter, only by case name. Moreover, because firms cannot compel commodities futures arbitrations before the NFA as those customers have an alternative procedure available to recover for broker misconduct—*i.e.* a reparations proceeding before the CFTC, the sample of awards publicly available may not adequately reflect the resolution of customers' disputes with their commodities futures' brokers.

159. We examined closer to 300 total awards where there was even the slightest suggestion that the customer relied on an economic suicide theory of liability, but we narrowed down the list to 100 awards where it was reasonably clear that the customer alleged the broker was liable in the absence of a recommendation or control over the account.

160. The authors gratefully acknowledge the assistance of the *Securities Arbitration Commentator* and its "Dram Shop" awards package which provided a number of the awards we relied on in this section.

161. Illustrative is the award in *Fulton v. A.G. Edwards & Sons, Inc.*, No. 32-136-00379-92 KG (A.A.A. May 5, 1995) (Murphy, Arb.), which is reported in the *Dramshop* article authored by Siconolfi, *supra* note 157. The article mentions the award, but does not provide details such as whether there was a recommendation, whether the trading was customer-directed, and who controlled the account.

the evidence presented at the hearing; rather, they typically contain a summary of each party's claims or defenses, and the summary is often prepared by the parties themselves and is not at all neutral. Thus, often we could not even determine whether the parties proffered any evidence at the hearing itself to support their allegations in the pleadings.<sup>162</sup> Third, the summaries of the claims often did not adequately explain the legal basis of the Claimants' claims for relief.<sup>163</sup> Correspondingly, we could not always decipher with certainty whether the Claimant was alleging that the broker had a duty to prevent the customer's economic suicide.<sup>164</sup> Fourth, some awards from securities arbitrations are not publicly available.<sup>165</sup> Therefore, our review was limited to awards published in legal databases or those gathered by commercial research services, primarily the *Securities Arbitration Commentator*. Despite these limitations, we concluded that the awards were useful to spot trends in arbitrators' application of the law in light of their sense of equity.

First, we address awards where the panel, in line with existing case law, denied a customer's economic suicide claim—further subdividing these claims into awards where the panel either expressly or implicitly denied such claims. Second, for awards where the panel apparently awarded a customer damages for economic suicide, we identified factors which appeared to play a role in generating the award and which help to provide some legal analogues for the awards. Finally, we identify a few anomalous awards, where we could draw no analogies to existing precedent. These awards support the conclusion that only infrequently do arbitrators expand opportunities for investors to recover damages.

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162. *E.g.*, *Sturman v. Shearson Lehman Bros.*, No. 93-01218 (N.A.S.D. June 6, 1994) (Ridolphi, Arb.) (imposing liability on firm, but not individual brokers, on claims that Respondents breached duties to customer in accepting his orders for margin trading when they should have known he was mentally incompetent; customer also alleged suitability violations and firm admitted warning customer of risks of margin trading); *Johnson v. Charles Schwab & Co.*, No. 92-03900 (N.A.S.D. May 27, 1993) (Godbolt, Arb.).

163. *E.g.*, *Walter v. Banc of America Investment Servs. Inc.*, No. 01-02086 (N.A.S.D. May 1, 2002) (Gottfried, Arb.); *Butrym v. Robert W. Baird & Co.*, No. 00-02463, 2001 WL 1409586 (N.A.S.D. Oct. 12, 2001) (Smith, Arb.); *DeFalco v. Charles Schwab & Co.*, No. 99-00408, 2000 WL 572531 (N.A.S.D. Mar. 9, 2000) (Greer, Arb.).

164. *See supra* note 163.

165. The NASD-DR website as well as Westlaw include NASD arbitration awards on their databases. LEXIS has both NASD-DR and NYSE awards. In contrast, awards from the AAA forum are not publicly available, unless one of the parties publicized it.

## A. Arbitration Awards Denying Economic Suicide Claims

### 1. Express Rejection of Duty to Prevent Financial Ruin

The majority of arbitrations in which the customer raised a claim of liability against the broker based only on an economic suicide theory resulted in no award to the customer.<sup>166</sup> In only a small number of these cases did the arbitrators explain the basis of the rejection of Claimant's theory of economic suicide. This small selection of awards demonstrates, however, that—by and large—arbitrators are following the existing law.

Several awards that contained reasoned opinions expressly reject the notion that the broker had a duty to the customer to prevent the customer from engaging in disastrous trading patterns—despite the absence of control or recommendations by the broker.<sup>167</sup> For example, in *Weinstein v. Brokers Exchange, Inc.*,<sup>168</sup> the customer alleged, among other claims, that there is “an affirmative duty on the part of the broker not only to approve and recommend transactions which meet the client's need, but also to object to those transactions which do not.”<sup>169</sup> The claimant also alleged that the broker and the firm were “liable for his losses because it was clear from his frequent and sudden requests to have short positions contrary to what was approved for his account that he was a compulsive gambler.”<sup>170</sup> The one-arbitrator Panel rejected Claimant's contentions as “outrageous” and “tak[ing] the issue of

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166. Excluded from this category are awards where customers raised alternative theories supporting their claim for relief and/or the Award suggested that the Panel did not base its decision on the economic suicide claim.

167. See, e.g., *Asseoff v. Advest, Inc.*, No. 13-169-00646-89 (A.A.A. Feb. 28, 1992) (Greenberg, Arb.) (ruling that there is no duty on broker who made no recommendations to advise customers of risks of options trading and concluding that customer had no private cause of action for violation of NYSE Rules). The award was confirmed in federal district court. *Advest, Inc. v. Asseoff*, 92 Civ. 2269 (S.D.N.Y. Apr. 12, 1993) [on file with authors]. See also *Stanger v. Morgan Stanley Dean Witter*, No. 2001-008885 (N.Y.S.E. June 28, 2001) (Weiss, Arb.) (finding no duty to warn of alternative, more profitable trade where customer's order was unsolicited); *Snyder v. Waterhouse Secs., Inc.*, No. 99-01684, 2000 WL 572828, at \*1 (N.A.S.D. Jan. 18, 2000) (Oberdank, Arb.) (denying Claimant's claim that firm had “duty to prevent execution of” . . . “option trades in which they were not eligible to participate”).

168. *Weinstein v. Brokers Exch., Inc.*, No. 93-04713 (N.A.S.D. Dec. 7, 1994) (Cohn, Arb.) (“1994 Award”). The United States District Court for the Northern District of Georgia vacated the Weinstein award in part on other grounds, but confirmed the award with respect to the denial of the claims discussed in the text. See Award following Remand, 1997 WL 741939 (N.A.S.D. Oct. 29, 1997).

169. 1994 Award at 2.

170. *Id.*

‘knowing your client’ to an absurd length.”<sup>171</sup> As a result, the arbitrator ruled that the customer was responsible for his self-directed risky trading strategy and the firm had no obligation to “save [the customer] . . . from himself.”<sup>172</sup>

Likewise, in *Russoniello v. Securities Research, Inc.*,<sup>173</sup> the arbitrator rejected the claims of the customer—a 19-year-old college student working part-time at \$5.50 per hour—that the firm should not have allowed him to place unsuitable options trades.<sup>174</sup> The arbitrator stated that Claimant failed to

demonstrate that Respondent actually recommended any of the other trades in question or that Respondent knew or should have known at the time of the trades in question that Claimant was so unintelligent, unsophisticated, disabled, peculiarly vulnerable, lacking in liquid or total net worth and/or otherwise unsuitable that he could not be allowed to trade stocks or options to the extent that he did.<sup>175</sup>

Panels also explicitly have denied a customer’s claim against an NYSE member firm under NYSE Rule 405 (know your customer rule)<sup>176</sup> where the customer’s trading was self-directed. For example, in *Michael v. Fidelity Brokerage Services*,<sup>177</sup> the Panel denied Claimant’s claims in their entirety and even assessed forum fees **against** the claimant.<sup>178</sup> Claimant was a successful

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171. *Id.* at 5.

172. *Id.* at 5-6.

173. *Russoniello v. Secs. Research, Inc.*, No. 96-02877 (N.A.S.D. Jan. 7, 1998) (Keeney, Arb.).

174. The arbitrator awarded the customer damages of \$6,400 for the losses in options trading before the firm had a signed options agreement in place, which was contrary to firm policy. *Id.* at 3.

175. *Id.* at 3-4. The arbitrator sardonically noted: “Claimant’s father apparently still thinks of his son as a child deserving per se of protection from all of the world’s dangerous temptations but the fact is under Florida law, he is of legal age and has the same rights and responsibilities as any other adult in similar circumstances with similar characteristics.” *Id.* at 4.

176. *See supra* notes 61-64 and accompanying text for a discussion of Rule 405.

177. *Michael v. Fidelity Brokerage Servs., Inc.*, No. 96-01526, 1997 WL 700454 (N.A.S.D. Sept. 11, 1997) (Grubb, Arb.).

178. *Id.* at \*5. In most arbitrations, in our experience, panels routinely assess forum fees equally against the claimant and respondent. As a result, parties view any assessment of fees against the claimant as punitive in nature or a suggestion that a claim was frivolous. We have found a few other awards where the Panel assessed costs against a losing Claimant who had pursued an economic suicide claim, suggesting a resounding rejection of that theory of liability. *See Salinas v. A.G. Edwards & Sons, Inc.*, No. 92-00710 (N.A.S.D. Dec. 4, 1992) (Myrin, Arb.) (denying Claimant’s claims and ordering the customer to pay all costs, expenses and fees; Claimant alleged, among other things, that Respondents had a fiduciary duty to stop him from ruinous options trading based on his gambling problem that should have been apparent to the Respondents); *see also* Letter from S. Sneeringer, Counsel for Respondents, to R. Ryder, *Securities Arbitration Commentator*, Dec. 30, 1992 (providing additional details about Salinas arbitration) [on file with authors]; *see also* “Award Profile: Fahnestock & Co. v. Tuttle,” *Securities Arbitration Commentator*, Oct. 1989. *Accord Fahnestock & Co. v. Tuttle*, No. 8909008 (N.Y.S.E. Sept. 28, 1989) (Katsoris, Arb.) (awarding firm damages for customer’s unsecured debit balance, rejecting customer’s claims that firm

accountant and businesswoman who controlled her own trading accounts.<sup>179</sup> She did not rely on the firm for advice or recommendations, did not have a broker assigned to her account and did not speak with a broker to place orders.<sup>180</sup> Rather, she placed trades on the firm's telephonic touchtone system.<sup>181</sup> Notwithstanding these facts, Claimant alleged that she had "changed-conditions" under the NYSE "know your customer" rule and that the firm should have stopped her from short-term risky trading after she suffered from chronic medical conditions that required hospitalization.<sup>182</sup> The firm, in response, alleged it had no duty to monitor her trading habits, to determine the suitability of her trades or to refuse to execute her transactions.<sup>183</sup>

The Panel agreed with the firm and denied Claimant's claims. The Panel ruled that the customer had complete control of the account and that the firm neither solicited nor recommended any trades.<sup>184</sup> As a result, the Panel concluded that the firm—as merely an order-taker—had no duty to determine the suitability of the customer-selected transactions.<sup>185</sup>

## 2. Arbitration Awards Implicitly Denying Economic Suicide Claims

In addition to awards where the arbitrators expressly addressed and rejected financial suicide claims, we reviewed additional awards where the panel considered and *implicitly* denied such claims. This category includes awards where panels rejected claims that the broker or firm had a duty to warn,<sup>186</sup> monitor<sup>187</sup> or prevent<sup>188</sup> a customer's disastrous self-directed trading.

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"wrongfully allowed [her] account to become excessively margined and wrongfully encouraged [her] to participate in unsuitable investments," and assessing all costs against the customer).

179. *Michael*, 1997 WL 70054, at \*3-4.

180. *Id.* at \*3.

181. *Id.*

182. *Id.* at \*3-4.

183. *Id.* at \*4. At the hearing, Claimant admitted that she had not notified the firm of the history or recurrence of her medical conditions but still claimed that it should have known something was wrong based on a change in her trading pattern, increasingly frequent withdrawals and short-term trading losses. *Id.*

184. *Id.* at \*3-4.

185. *Id.* See also *Stainbrook v. Prudential Secs., Inc.*, No. 97-03300, 1998 WL 1179499 (N.A.S.D. Oct. 14, 1998) (Larkin, Arb.) (rejecting Claimant's allegations that Respondents violated their duty "not to allow" their customers to engage in unsuitable trading under the NYSE "know your customer" rule and other applicable rules where Claimant acknowledged to the broker's supervisor that his trading activity—which resembled gambling—was suitable for him and that he was aware of its risks).

186. *E.g.*, *Conn v. Prudential Secs., Inc.*, No. 99-00074, 2000 WL 1805361 (N.A.S.D. Sept. 28, 2000) (Marlow, Arb.) (rejecting customer's claim that firm was liable for "induc[ing] Claimant to conduct high

Many of the awards in this category also suggest that the basis of the rejection of the economic suicide claim was the lack of a recommendation, although they do not so explicitly state.<sup>189</sup> For example, in *Pechnik v. Charles Schwab & Co.*,<sup>190</sup> the customer alleged that she inadvertently placed a trade for six sets of 200 options contracts worth between \$2,000-2,500, when she meant to place a much smaller trade for six sets of two options contracts. Due to her admitted error, she lost \$113,434, a far greater loss than she had anticipated.<sup>191</sup> She alleged that the firm breached its “duty of due diligence,” and that, had it adequately researched her investment history, it would have realized that such a large trade was “out of character” for her and would have prevented her from placing the trade.<sup>192</sup> The Panel denied Claimant’s claim, stating tersely that, while the firm’s branch manager should have “personally verified with the customer the implications of the large options order at issue,” the Claimant did place these orders and she did not object to the trade until one month later.<sup>193</sup> In other words, in line with existing authority, the Panel refused to impose on the firm a duty to prevent the customer from placing a potentially ruinous options trade, because the broker made no recommendation.<sup>194</sup>

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risk ‘short’ sales in his account without adequately warning Claimant of the risks of such activities”).

187. *E.g.*, *Kassel v. Fidelity Brokerage Servs., Inc.*, No. 92-00550 (N.A.S.D. Oct. 15, 1992) (Aaron, Arb.) (rejecting Claimant’s claim that Fidelity failed to monitor his account and prohibit him from making options trades in excess of 20% of his net assets).

188. *E.g.*, *Pellegrino v. Robert Thomas Secs., Inc.*, No. 97-02516 (N.A.S.D. Jan. 13, 1998) (Butler, Arb.) (no duty to prevent options trading); *Scioscia v. Fidelity Brokerage Serv., Inc.*, No. 95-01147, 1996 WL 403335 (N.A.S.D. May 20, 1996) (Dunay, Arb.) (awarding no damages to Claimant—disabled and suffering from a mental disease—who alleged that the firm failed to terminate his unsuitable options trading).

189. *E.g.*, *Scioscia*, 1996 WL 40335 (denying claim where firm claimed that it solicited the options account but made no trading recommendations). Fidelity has had similar success defeating other economic suicide claims. *See, e.g.*, *Larkrith v. Fidelity Invs.*, No. 94-02855 (N.A.S.D. Feb. 21, 1995) (Seltzer, Arb.) (dismissing claim that firm allowed him to buy speculative and allegedly unsuitable stock options); *Balasubramani v. Fidelity Invs.*, No. 93-04017 (N.A.S.D. June 29, 1994) (Sweeney, Arb.) (denying claim for damages, where Claimant, a retiree with two college-bound children, alleged that the firm encouraged and facilitated his margin trading causing financial hardship).

190. *Rechnik v. Charles Schwab & Co.*, No. 94-00540, N.A.S.D. Arb. LEXIS 782, at \*1 (N.A.S.D. Mar. 23, 1995) (Perillo, Arb.).

191. *Id.* at \*2.

192. *Id.*

193. *Id.* at \*3.

194. *See also* *Koch v. A.G. Edwards & Sons, Inc.*, No. 96-03577 (N.A.S.D. Feb. 20, 1998) (Allen, Arb.) (finding no liability for stopping unsuitable trading where broker made no recommendations); *Brandt v. Brown & Co. Secs. Corp.*, No. 94 Civ. 6640 (JSM), 1995 WL 334381 (S.D.N.Y. June 5, 1995) (confirming award dismissing claimants’ claims against discount brokerage for breach of fiduciary duty by failing to prevent risky trading and failing to monitor account; award gave no reasons for decision and opinion confirming award addressed procedural issues only), *aff’d*, 100 F.3d 942 (2d Cir. 1996); *Cistoldi*



Finally, we have found awards where the panel has imposed liability on the broker-dealer for failing to execute an order placed by a customer where the broker's defense was that the transaction would have been unsuitable for the customer.<sup>195</sup> These awards suggest that a brokerage firm has no choice but to execute an unsuitable order on behalf of a customer engaged in self-directed trading.<sup>196</sup>

### *B. Economic Suicide Awards*

We now turn to a consideration of a smaller category of awards where the panel, either explicitly or implicitly, awarded damages to the customer for the firm's failure to prevent financial disaster. We have identified factors which, in part, explain the awards within the context of existing case law, as discussed in Part I of this article. We have grouped these awards into five categories of awards involving: (1) a broker's recommendation to the customer; (2) options trading; (3) recommendations and options trading; (4) the "know your customer" obligation; and (5) margin liquidations. Almost every customer award we examined fit into one of these five categories, and thus can be understood not as a break from precedent, but as recognized exceptions to the general rule of not imposing liability on brokers for unsuitable investments in the absence of the broker's control or

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v. Charles Schwab & Co., No. 1993-003266 (N.Y.S.E. May 19, 1994) (denying claim that firm breached its fiduciary duty to customer and failed "to protect him from pursuing investment strategy that was destined to fail"); Scheer v. Citizens & Southern Secs. Corp., No. 92-00305 (N.A.S.D. Mar. 9, 1994) (Caldwell, Arb.) (ruling that there is no duty on broker who made no stock recommendations to advise customers regarding their trading strategy or patterns); Litt v. Shearson Lehman Bros., No. 92-04360, at \*2 (N.A.S.D. Nov. 5, 1993) (O'Neill, Arb.) (granting Motion to Dismiss Claimant's claim for breach of fiduciary duty for "failing to dissuade" Claimant—an elderly woman in poor health—from engaging in high-risk investments without explanation).

195. *E.g.*, Gleisinger v. Charles Schwab & Co., No. 91-00623 (N.A.S.D. Aug. 7, 1991) (Lautzenhiser, Arb.); Brumm v. McDonald & Co. Secs., Inc., No. 89-02881, 1990 WL 306966 (N.A.S.D. Apr. 10, 1990), *aff'd*, 78 Ohio App. 3d 96 (Ct. App. 4th Dist. 1992).

196. Some firms have successfully defeated claims that the broker had a duty to execute an unsuitable order, suggesting that some arbitrators are sensitive to the opposite argument. *See, e.g.*, Bala v. Smith Barney Inc., No. 96-03064 (N.A.S.D. Oct. 10, 1997) (Gwin, Arb.) (explicitly finding that firm breached no duty to customers by refusing to execute unsuitable trades); Gearen v. Charles Schwab & Co., No. 95-02665 (N.A.S.D. Nov. 14, 1995) (Andres, Arb.); Galoob v. Charles Schwab & Co., No. 94-5550 (N.A.S.D. Nov. 13, 1995) (Friedman, Arb.); Ciotola v. Spencer-Winston Secs. Corp., No. 90-02132 (N.A.S.D. Aug. 21, 1991) (Vallario, Arb.); Lutterbach v. Bear Stearns & Co., No. 88-03634 (N.A.S.D. Feb. 6, 1990) (Getzoff, Arb.) (denying customer's claim that Respondent improperly placed restrictions on his options trading account where firm alleged that it has the right to restrict customer trading to ensure against substantial losses).

recommendations. The remaining customer awards can be seen as anomalies, a not uncommon result in any area of decisional law.

### 1. Arbitration Awards Involving Recommendations

Several awards—while categorized as economic suicide awards by the media—when read closely are just a straightforward application of the well-settled rule<sup>197</sup> that, if a broker recommends a securities transaction to his customer, the broker has a duty to ensure that the recommendation is suitable for the customer's financial condition and investment objectives.<sup>198</sup> The fact that the customer might be sophisticated does not excuse the suitability obligation.<sup>199</sup> Thus, these awards do not suggest an expansion of the law.

### 2. Arbitration Awards Involving Options Trading

Several awards which fall under the general classification of economic suicide claims involved trading in stock options.<sup>200</sup> These awards have some notable similarities. First, in many of these arbitrations, the customer typically pursued an aggressive options trading strategy that the customer chose and directed, but that the broker facilitated through some affirmative acts.<sup>201</sup> Second, while the broker did not make a traditional recommendation

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197. See *supra* notes 42-44 and accompanying text.

198. See, e.g., *Beasley v. J.C. Bradford & Co.*, No. 94-01849 (N.A.S.D. Sept. 6, 1995) (Kagan, Arb.) (awarding damages to Claimant for seven recommended purchases where firm knew Claimant was financing margin calls with credit card debt and denying firm's counterclaim for debit balance in margin account); *Haltom v. Blunt, Ellis & Loewi*, No. 93-00950 (N.A.S.D. Sept. 14, 1994) (Hart, Arb.) (awarding \$567,000 to customers where Claimants alleged broker made unsuitable recommendations and broker, while denying a duty to warn and to monitor, conceded that he "frequently consulted with [Claimant] about the nature, quality and performance of the securities in the account").

199. E.g., *Tottenham Corp. v. Bear Stearns & Co.*, No. 90-02700 (N.A.S.D. May 21, 1992) (Vanberg, Jr., Arb.) (Claimant corporation, owned by one of richest families in the world, obtained almost \$2 million award plus \$1 million in punitive damages for alleged unauthorized and unsuitable trading); see also *Siconolfi*, *supra* note 157 (reporting on Tottenham arbitration).

200. Significantly, of the four economic suicide reported judicial opinions, two of them also involved stock options trading. See *Quick & Reilly, Inc. v. Walker*, discussed *supra* notes 108-09 and accompanying text; *Gochbauer v. A.G. Edwards & Co.*, discussed *supra* note 112 and accompanying text.

201. E.g., *Trans National Group Services, Inc. v. PaineWebber, Inc.*, No. 91-00770, 1992 WL 472902 (N.A.S.D. June 30, 1992) (Plimpton, Arb.). Claimant Belkin was a "successful entrepreneur, a Harvard MBA, and founder, chairman and majority shareholder of [Trans National Group Services] . . . a successful corporation." 1992 WL 472902, at \*2. Before he opened an account at PaineWebber, he had extensive investing experience in a wide variety of investments, although he had "no material experience in stock options." *Id.* The Panel expressly concluded that Claimants were suitable for the options trading program they utilized, and sufficiently understood the nature and risks of that program. *Id.* at \*6. Moreover, the

for any particular trade, the broker had extensive personal contacts with the customer and often provided general information to the customer about the technicalities of options trading.<sup>202</sup> Third, the arbitrators often noted the firm's heightened compliance rules governing options trades,<sup>203</sup> as well as the SROs' rules requiring an options disclosure statement,<sup>204</sup> in explicit recognition of the increased risk of loss and degree of sophistication required which the average customer did not possess.<sup>205</sup> Finally, the arbitrators imposed on the broker a duty to monitor a customer heavily trading in options, due to the volatile nature of such trading.<sup>206</sup> While each of these factors was not present in every arbitration we examined, they did play a pivotal role in most of them, individually or collectively, in generating an award for the customer.<sup>207</sup>

Illustrative are two arbitration victories for Joel Peterzell, an active options trader who lost a significant amount of money in the stock market crash of October 1987, against two different brokerage firms for failing to halt his disastrous options trades. In both cases, Mr. Peterzell claimed that the firm and several of its brokers were liable to him for failing to step in and stop

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Panel expressly found that the broker did not recommend the program, and viewed the broker's role as an order-taker. *Id.* The Panel still imposed liability on the firm for some of the Claimants' trading losses, ruling that while Claimants' conduct partially contributed to the losses, the firm still breached its duty to the customer to supervise its brokers, and to monitor trading in this customer's accounts. *Id.* at \*6-7. Thus, the Panel awarded each of the two Claimants \$1,000,000 in damages. *Id.* at \*8.

202. *Id.* at \*6. The Panel in *TNGS* expressly found that the personal relationship between the broker and the customer gave rise to a fiduciary duty by the broker to the customer, even though no recommendations were made and the customer controlled the account. *Id.*

203. *Id.* at \*3.

204. *See supra* note 87 and accompanying text.

205. *Peterzell v. Dean Witter Reynolds, Inc.*, No. 32-136-0416-88-1D (A.A.A. Nov. 9, 1990) (Foley, Arb.). Possible liability based on failure to follow a compliance manual's policies is discussed *supra* notes 113-29 and accompanying text.

206. *Cass v. Shearson Lehman Hutton*, No. 91-01484 at 4 (N.A.S.D. Jan. 31, 1994) (Dolan, Arb.).

207. There were a small handful of awards favoring customers trading in options where it was difficult to determine whether any of these factors were present, but where the summary of the claims suggested that one or more of these factors might have been present. *See, e.g., Guerreso v. J.B. Oxford Co.*, No. 98-01213, 1999 WL 1253753 (N.A.S.D. May 12, 1999) (Worcester, Arb.) (awarding damages to Claimant against discount broker for allowing customer to pursue risky options trading strategy; parties disputed issue of who had control over account); *Oliver v. Charles Schwab*, No. 93-00656 (N.A.S.D. July 6, 1994) (Jeroslow, Arb.) (awarding \$10,000 in damages to Claimant who—asking for more than \$40,000 in compensatory damages—alleged firm should have terminated his options trading privileges when he lost more than 35% of his stated net worth); *Quick & Reilly, Inc. v. Barton*, No. 90-2033, 1990 WL 306396 (N.Y.S.E. Feb. 15, 1990) (Grigsby, Arb.) (rejecting firm's claim for \$102,704 customer debit balance and instead awarding \$106,653 to customer on his suitability counterclaim for \$400,000 in losses stemming from trading of S&P Index options).

him from ruinous options trading.<sup>208</sup> In the AAA case, the Panel expressly found that the firm breached its fiduciary duty to Peterzell.<sup>209</sup> In their Award, the arbitrators held that, notwithstanding the fact that it was a nondiscretionary account and that Peterzell controlled his money, the firm had a duty to take appropriate steps once there was clear evidence that Peterzell was embarking on a “course which was destined to cause financial ruin.”<sup>210</sup> The Panel found that this duty stemmed from the firm’s internal compliance policies and procedures for executing customers’ options trades—expressly stating that those policies and procedures can establish a standard of care owed by the broker to the customer.<sup>211</sup> The Panel noted that the firm’s broker spoke with Claimant very often, was aware of his net worth, and even provided information and research with the purpose of facilitating additional options trading.<sup>212</sup> The firm’s Compliance Department had inquired about the activity in the account on several occasions, inquiries that the Panel concluded should have alerted the Florida branch office to monitor the account.<sup>213</sup>

Moreover, the Panel concluded that the firm had a duty to update the customer’s financial profile as trading progressed, and that if the customer continued to lose money in trades, then the customer was less suitable for subsequent similar trades, as suitability information is not “static.”<sup>214</sup> Based on all of these factors, the Panel concluded that, even in a nondiscretionary account, the firm had a duty to “take adequate steps when it became apparent that Peterzell was trading inappropriately, that he was losing large amounts of money and, that he was putting excessive amounts of his net worth at risk.”<sup>215</sup> As a result, the Panel awarded Peterzell almost \$150,000, including interest and costs.<sup>216</sup>

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208. See *Peterzell*, No. 32-136-0416-88-ID, at 2; *Peterzell v. Charles Schwab & Co.*, No. 88-02868, 1991 WL 202358, at \*1 (N.A.S.D. June 17, 1991) (Kennedy, Arb.) (alleging that Respondents “induced Claimant into purchasing options which were not suitable investments in light of Claimant’s investment objectives”).

209. *Peterzell*, No. 32-136-0416-88-1D, at 10. The Panel refused to impose liability on the individual brokers and supervisors, finding that the violation was not the result of any one individual acting alone, but the collective actions of the firm. *Id.* at 10-11.

210. *Id.* at 6, 8.

211. *Id.* at 3-4.

212. *Id.* at 4, 6.

213. *Id.* at 5, 8.

214. *Id.* at 4. The idea that suitability is not static came from the firm’s compliance manual. See *supra* note 137 and accompanying text.

215. *Id.* at 3.

216. *Id.* at 10. The arbitrators based their award of costs on the discovery abuses by Dean Witter before the hearing. *Id.* at 10-11. In a one-line order, the United States District Court for the Middle District of Florida denied Dean Witter’s motion to vacate the arbitration award. *Dean Witter Reynolds, Inc. v.*

In the second case, in a much shorter opinion, the NASD Panel similarly awarded Peterzell \$39,500 in compensatory damages.<sup>217</sup> A majority of the Panel stated: "Claimant . . . contributed to his losses by providing false information, devising a questionable strategy and continuing to trade as losses mounted. Suitability, however, is an ongoing obligation and, although Charles Schwab initially met its suitability obligations, it failed to maintain any ongoing supervision of the Claimant's suitability."<sup>218</sup>

These two awards in favor of Mr. Peterzell generated extensive media coverage, as the Panels' opinions appeared to endorse an expanded view of liability by brokers.<sup>219</sup> They both imposed on the brokerage firms a duty to monitor the financial condition of a customer who is engaging in a risky options trading strategy as losses occur. Because suitability is a constantly changing variable, these Panels reasoned, the broker has a duty to continuously update the suitability profile as additional financial information becomes available.<sup>220</sup> Therefore, a broker must prevent the customer from engaging in an overall risky trading strategy if it contradicts the customer's evolving suitability profile, and the broker has reason to know that the customer does not fully understand the risks of the options trades.<sup>221</sup>

As previously discussed,<sup>222</sup> there is no support in the case law for imposing a duty to monitor on a broker who does not control the account. In the area of options trading, however, regulations do require the broker to

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Peterzell, Case No. 90-891-Civ-Orl-18 (M.D. Fla. Dec. 13, 1990) (Unreported; Order on File with Authors).

217. Peterzell v. Charles Schwab & Co., No. 88-02868, 1991 WL 202358, at \*2 (N.A.S.D. June 17, 1991) (Kennedy, Jr., Arb.). As in the first case, the Panel found the firm and not the individual brokers to be liable.

218. *Id.*

219. See, e.g., Amy D. Marcus & Paul M. Barrett, *Dean Witter Should Have Tried To Stop Client Trades, Panel Rules*, WALL ST. J., Nov. 13, 1990, at B10. Subsequently, several claimants explicitly invoked—mainly unsuccessfully—one or both of the Peterzell Awards as precedent controlling their own arbitration. See, e.g., Dale City Anesthesia Med. Group v. Dean Witter Reynolds Inc., No. ARF-06122 (Pac. Stock Exch. Feb. 23, 1994) (Spalding, Arb.) (concluding that Respondents breached no duty to Claimants by permitting risky options trading); Pease v. Merrill Lynch, No. 90-03623, 1992 WL 390115 (N.A.S.D. Oct. 5, 1992) (Share, Arb.) (denying Claimant's claim that broker breached its fiduciary duty to recommend investments safer than commodities and to stop a customer from engaging in speculative commodities trades).

220. Case law has not yet recognized a duty to update recommendations. See *supra* note 132 and accompanying text.

221. See also Cass v. Shearson Lehman Hutton, No. 91-01484 (N.A.S.D. Jan. 31, 1994) (Dolan, Arb.) (concluding that the full-service broker who had a personal relationship with his customer was liable for the customer's "disastrous trading strategy" as broker had an ongoing duty to monitor the customer's trading activity, and had a duty to update the suitability information the firm gathered on the customer).

222. See *supra* note 130 and accompanying text.

determine the customer's suitability for options trading,<sup>223</sup> and there are increased disclosure requirements, reflecting the regulators' awareness that the complexity and volatility of options trading poses additional risks.<sup>224</sup> Thus, the outcomes can be explained on negligence grounds: the broker's failure to adhere to regulatory rules is a breach of the industry standard of care.<sup>225</sup>

### 3. Awards Involving Both Recommendations and Options Trading

A few arbitration awards espousing an economic suicide theory involved traditional recommendations of options trading. For example, in 1989, Leonard Aaron won a \$500,000 award against PaineWebber, Inc. based on the Panel's finding that PaineWebber violated California state securities laws<sup>226</sup> and was thus responsible, in part, for Aaron's \$2.2 million losses stemming from options trading.<sup>227</sup> The Panel, in its brief but precise opinion, found that Claimant—an "experienced and knowledgeable businessman and stock and options investor" who "devoted a substantial amount of his time to investments"—controlled his account, consented to all transactions, and "had a good understanding of the mechanics [and risks] of options trading."<sup>228</sup> However, the Panel also concluded that "[t]he nature of the risks involved and the extreme and frequent volume of trading was of such an unprecedented level that Mr. Aaron did not have a full knowledge and understanding of the risk to which he was exposing virtually all of his assets."<sup>229</sup> The Panel then concluded that the firm owed a fiduciary obligation to Claimant "to ensure

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223. See *supra* note 92 and accompanying text.

224. See *supra* note 87 and accompanying text.

225. See *supra* notes 118-29 and accompanying text. This theory could explain the outcome in *Mirabile v. Bear Stearns & Co.*, No. 95-01502 (N.A.S.D. June 12, 1996) (awarding Claimant damages for negligence of broker where customer claimed that broker "wrongfully induced and encouraged" the customer to "purchase various high risk securities, options and futures," but where Respondents alleged they warned customer of risks of his trading strategies and customer explicitly acknowledged his trading was self-directed).

226. *Aaron v. Paine Webber Inc.*, No. 72-136-1146-87, at 3 (A.A.A. June 28, 1989) (Wilson, Arb.). Specifically, the Panel found that Respondent violated rules 260.218.2 and 260.218.4 of the California Securities law, which precluded unsuitable recommendations and required broker-dealers registered in the state to diligently supervise its agents, respectively. *Id.*

227. The Panel explicitly rejected all other legal claims for relief, including claims for violations of the antifraud provisions of the federal securities laws and RICO, as well as the broker's counterclaim for the debit balance in Aaron's account (\$1.35 million). *Id.*; see also James T. Areddy, *PaineWebber Told To Pay \$500,000 To Options Client*, WALL ST. J., July 28, 1989, at B3C.

228. *Aaron*, No. 72-136-1146-87, at 1-2.

229. *Id.* at 2.

that the investments in his account were suitable and that he fully understood the risks involved.<sup>230</sup> The Panel ruled that PaineWebber violated its fiduciary duty to Claimant because it (1) did not have a reasonable basis to believe that Mr. Aaron's options trades were suitable; (2) did not comply with its own internal policies to limit the risk of losses; and (3) did not adequately supervise the options trading.<sup>231</sup>

This award does not represent a departure from well-established legal principles. First, almost all of the options trades in Mr. Aaron's account were solicited by the broker, and thus carried with them a suitability obligation.<sup>232</sup> Second, as stated above, trading in options mandates that the broker make specific disclosures about the risks involved,<sup>233</sup> and the firm at issue had its own internal policies requiring a heightened level of care in this type of options account.<sup>234</sup> Thus, the firm breached an industry standard of care, hardly a violation breaking hallowed legal ground.<sup>235</sup>

#### 4. Awards Based on the Duty to "Know Your Customer"

Several panels awarded damages to a customer based on the broker's and/or firm's violation of the duty to "know your customer," set forth in NYSE Rule 405. These panels invoked this duty as a "standard of care in measuring negligence claims."<sup>236</sup> For example, in *Whittman v. Merrill Lynch*,

230. *Id.*

231. *Id.* However, because the Panel ruled that Aaron had some responsibility for his losses, the Panel assessed damages to compensate Claimant only for a portion of his losses. *Id.* at 3.

232. See R. Leavitt, *Securities Arbitration Practice and Procedures* (The Securities Arbitration Institute and the *Securities Arbitration Commentator*, Los Angeles, CA), Nov. 17, 1989 at 14. See also *Johnson v. Quick & Reilly, Inc.*, No. 91-03881 (N.A.S.D. July 27, 1992) (Richberg, Arb.) (awarding \$174,224 to a millionaire real estate investor and developer who claimed his discount broker made unsuitable recommendations of index options trades and rejecting firm's defense that, as a discount broker, it made no recommendations and provided no investment advice); see also Michael Siconolfi, *Bad Advice Costs Discount Broker \$212,100 Judgment*, WALL ST. J., July 31, 1992, at B8A (reporting that this award "effectively expands the types of cases that investors can win against discount brokerage firms").

233. See *supra* note 87 and accompanying text.

234. See *supra* notes 118-29 and accompanying text.

235. See also *Cooper v. Janney Montgomery Scott, Inc.*, No. 95-03075 (N.A.S.D. May 13, 1997) (Wiest, Arb.) (awarding damages for losses stemming from broker's recommendation of entry and exit points in options trades even though customer initiated overall trading strategy); see also *de Kuyper v. A.G. Edwards & Sons, Inc.*, No. 86-00985 (N.A.S.D. Apr. 26, 1991) (Prifti, Arb.) (awarding \$228,000 to 48-year-old waitress who alleged the firm recommended unsuitable options transactions).

236. *McCotter v. Shearson*, No. 13-136-00408-90 (A.A.A. May 12, 1992) (Carmody, Arb.) (holding that firm violated Rule 405 where account of 64 year old widow heavily traded in naked options). Notably, the Panel's opinion stated that "Rule 405 is a Rule adopted to protect investors and thus can serve as a basis for civil liability by itself." (Carmody, Arb., concurring, at 2). This statement contradicts the view that the

*Pierce, Fenner & Smith, Inc.*,<sup>237</sup> the Panel awarded compensatory damages to a customer who claimed that the broker and firm churned his account and made unsuitable recommendations. The Panel explicitly rejected these two claims, but instead based the award against the broker on the broker's failure to "take steps to adequately know his customer."<sup>238</sup> Thus, even though the Panel concluded that any recommendations were suitable, the broker still violated an independent duty to know his customer and prevent the losses. In their invocation of Rule 405 as a basis for creating a broker's duty to prevent the customer's economic suicide, these Panels have extended the law.<sup>239</sup> On the other hand, the use of an industry standard as a basis for a negligence claim against a broker is not unprecedented.<sup>240</sup>

### 5. Arbitration Awards Involving Margin Liquidations

Several awards which at first glance seem to be economic suicide cases may be explained just as credibly as margin liquidation claims, where the Panel concluded that the firm violated its own prior course of conduct in liquidating a customer's account with a debit balance without giving the customer an opportunity to pay a margin call.<sup>241</sup> While this holding differs from most case law governing margin liquidation claims, it is not entirely without precedent.<sup>242</sup>

In one arbitration in Indiana, a Panel awarded damages to a customer of the discount brokerage firm Ameritrade.<sup>243</sup> Mr. Desmond was an Indiana University medical student who used his tuition money to purchase on margin a number of technology stocks.<sup>244</sup> After Ameritrade issued margin calls on his account following a sudden decline in their value, which Claimant was unable

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NYSE adopted Rule 405 originally to protect the firm, not the customer. *See supra* note 62 and accompanying text.

237. *Whitman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 92-03840 (N.A.S.D. Feb. 7, 1994) (Laden, Arb.).

238. *Id.* at 3. The firm was liable due to its failure to supervise the broker. *Id.*

239. *See supra* notes 62-64 and accompanying text.

240. *See supra* notes 118-29 and accompanying text; *see also* *Investors Equity Life Ins. Co. of Hawaii v. ADM Investor Serv., Inc.*, 1997 WL 33100645 (D. Haw. Dec. 1997) (confirming award finding commodities broker negligent in allowing insurance company to use hedge account for speculation, in violation of Chicago Board of Trade rule and state insurance law).

241. *E.g.*, *Edward C. Wang Revocable Living Trust v. Charles Schwab & Co., Inc.*, No. 99-00560, 2000 WL 572796 (N.A.S.D. Apr. 20, 2000) (Reilly, Arb.).

242. *See, e.g.*, *Conway v. Icahn & Co.*, 16 F.3d 504 (2d Cir. 1994).

243. *Desmond v. Ameritrade, Inc.*, No. 98-04397 (N.A.S.D. Jan. 14, 2000) (Medow, Arb.).

244. *Id.* at 1.



to meet in time, Ameritrade liquidated his account to pay the debit balance. Desmond even had to borrow additional monies on four credit cards to pay back the remaining margin debt.<sup>245</sup>

In the arbitration, Claimant alleged, *inter alia*, that Ameritrade failed to allow him sufficient time to meet the margin calls and failed to disclose to him the risks of margin trading.<sup>246</sup> While he acknowledged signing a margin agreement when he opened the account, he claimed he did not read the form that disclosed the risks of trading on margin.<sup>247</sup> He also alleged that Ameritrade breached its suitability obligations “by allowing him to continue investing on margin when he was financially unable to meet the commitment of the margin investment.”<sup>248</sup> Without explanation, the Panel awarded him \$40,000 in compensatory damages.<sup>249</sup>

Following the extensive media coverage, Ameritrade attempted to limit the significance of the award by claiming it was based on an improper margin liquidation claim, rather than an economic suicide claim that could supply precedent for any expanded duties on the broker.<sup>250</sup> This explanation is credible in light of supporting precedent.

## 6. Anomalous Awards

Finally, after eliminating those awards that can be explained by reference to existing law, we are left with only one example of an arbitration award that is clearly based on the imposition on the brokerage firm of a duty to prevent the customer from financial suicide.<sup>251</sup> In *Nulph v. First Security Investor Services, Inc.*,<sup>252</sup> Claimant was an unsophisticated divorcee investing her

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245. R. Buckman, *Student Awarded \$40,000 from Firm in Internet Trading Case*, WALL ST. J., Jan. 17, 2000.

246. *Id.* Desmond sought total damages of \$225,000. *Id.*

247. *Id.*

248. See, e.g., Danielle Fugazy, *Brokerage: Ameritrade Loses Arbitration Case*, WEB FINANCE, Feb. 14, 2000.

249. *Desmond*, No. 98-04397, at 2. Specifically, the Panel denied Claimant's claim for punitive damages but awarded him \$20,609 in compensatory damages, \$2,061 in interest on the compensatory damages, and \$17,844 in attorneys' fees and costs pursuant to Indiana Securities Act 23-2-1-19(a) and other applicable state and federal securities laws. *Id.*

250. See Fugazy, *supra* note 248.

251. A few other awards, such as *Mirabile*, *supra* note 225, and *Sturman*, *supra* note 162, suggest the Panel imposed such a duty, but also can be explained by reference to existing law. As a result, we did not include them in this section.

252. *Nulph v. First Sec. Investor Servs., Inc.*, No. 97-05371, 1998 WL 1179858 (N.A.S.D. Nov. 19, 1998) (Owen, Arb.).

divorce settlement money with the objective of using the money to pay for the long-term educational needs of her children. She opened an account with a discount brokerage firm, gathered information about investments in an internet chat room, and then placed trades on the telephone with no recommendations. She lost over \$150,000 based on her unsuccessful trades.

She filed an arbitration claim, seeking over \$500,000 in damages, including statutory treble damages under Utah securities laws plus punitive damages.<sup>253</sup> The evidence at the hearing showed that the telephone brokers who executed her trades knew that she often was distraught—because she cried or spoke in a broken voice—and that she placed numerous irrational trades. After a hearing, the Panel awarded her \$70,000 in compensatory damages, and no additional statutory or punitive damages, and assessed costs against Respondents.<sup>254</sup> This award represents one of the few occasions we found where there appears to be no legal basis for the award of damages.

### III. CONCLUSION

In conclusion, we have found no judicial or regulatory precedent and scant arbitral awards supporting a broker's duty to prevent the customer from economic suicide. Although there is sufficient elasticity in the concept of a recommendation to support an expansion of the broker's duty to determine suitability,<sup>255</sup> our research does not show that arbitrators are explicitly adopting this approach.<sup>256</sup> In the absence of a recommendation or control over the account, case law supports imposing only a duty to warn a customer about the risks of a specific investment. While possessing the unique opportunity to impose a greater duty on brokers to prevent their self-directed customer's financial ruin, arbitrators generally have not endorsed that view. Despite some assertions to the contrary, our study shows that arbitrators are following the law.

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253. *Id.* at 1.

254. *Id.* at 2.

255. *See supra* notes 45-50 and accompanying text.

256. *The GMS Group, LLC v. Benderson*, 191 F. Supp. 2d 318 (W.D.N.Y. 2001), *aff'd*, 326 F.3d 75 (2d Cir. 2003), suggests that some arbitrators may implicitly find a recommendation. In that case the firm sought to vacate an award on the ground that the arbitrators had manifestly disregarded the law, because the evidence did not support finding a recommendation to trigger liability under NASD suitability rules. In denying the motion, the court noted that the transcript of the hearing showed that the arbitrators were aware of the legal requirement of a recommendation and had focused their attention on the relevant evidence; this was sufficient to show that they had not manifestly disregarded the law.

But should either the courts in a forum of law or arbitrators in a forum of equity transform into legal duties the ethical obligations of brokers to warn, monitor and even stop their irrational customers, allowing customers to recover damages for breach? Some scholars have argued that the stock market is akin to a casino and should be regulated like one.<sup>257</sup> Another has proposed that investors should not be allowed to invest in the stock market without a license certifying their competence to do so.<sup>258</sup> While these proposals may seem extreme, the regulatory focus on full disclosure of material information as a panacea may not be enough in light of recent market failures. This is especially so because securities industry regulators assumed that disclosure obligations could dependably rely on the professionalism of the broker for effective policing. However, recent scandals in the corporate and investment communities in this country have diminished the credibility of those professionals who assist investors in their trading decisions.

An expanded duty of brokers to warn their self-directed customers of the dangers of risky trading strategies should be a welcome development. Even under the limited view of brokers' duties set forth in *Leib*, a broker owes a duty at least to **warn** a customer about the risk of a *specific security* even if the customer controls the account. It would be a modest expansion of this duty to extend it to providing a warning about the risks of *particular trading strategies*. We have found some support for a more expanded duty to warn at the outset of implementing a risky trading strategy.<sup>259</sup> Additionally, such an expanded duty is consistent with the regulatory focus on full disclosure as well as with the industry's expectations that a broker should warn his customers of unsuitable transactions. Moreover, a duty to warn is neither novel nor burdensome. As noted above, brokers are already obligated to provide risk disclosure statements in instances of penny stocks, day trading, margin trading, commodities futures and options, and stock options.<sup>260</sup> Finally, the content of the warning and how it is made—whether written or oral, whether made by the account executive or by the compliance officer—may appropriately vary according to the circumstances.<sup>261</sup>

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257. Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 J. CORP. LAW 225 (2001); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611 (1995).

258. See Choi, *supra* note 15.

259. See *supra* notes 111-12 and accompanying text.

260. See *supra* notes 84-87, 93-95 and accompanying text.

261. The risk disclosure statements that brokers send out to customers routinely may not be sufficient.

We also recognize, however, that a warning about a specific transaction or even a warning about an investment strategy may not be meaningful unless made in the context of the customer's entire investment portfolio.<sup>262</sup> For example, the portfolios of many investors in the late 1990s were over concentrated in technology equities. Technology stocks are a suitable component of an investment portfolio for a customer whose objectives are long-term growth and who is comfortable with the risks of volatility. What percentage of a customer's portfolio can suitably be invested in high-tech stocks will vary considerably depending on many factors, including the investor's investment horizon. There may be no reason for concern if the customer has, for example, 25% of his portfolio in high-tech equities, but 100% investment in high tech stocks may be unsuitable. Furthermore, particularly in times of market volatility, an investment or strategy that was suitable at the outset may become unsuitable because of changes in the investment, market conditions, or the customer's financial circumstances and objectives.

Significantly, investors who successfully pursued an investment strategy concentrating in high-tech stocks in the 1990s are now bringing claims against their brokers for failing to advise them to reduce their holdings when the market turned downward. If the customer had a close personal relationship with his broker on which the customer relied, then that relationship might generate arbitration awards for customers who claim wrongful holding: failure to monitor the downward slide of the portfolio and to recommend a reduction in speculative investments.<sup>263</sup> If the broker had an ethical obligation to monitor the customer's trading based on the relationship, then as a matter of equity it is easy to see how an arbitration panel could award damages to a customer for a breach of that ethical obligation (especially in the case of options trading), even in the absence of clear-cut legal support.

Yet, the lack of ample support for a duty of the broker in an ongoing relationship with a customer to **monitor** the customer's trading activities seems logical.<sup>264</sup> Imposing a duty to monitor the customer who might become

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262. If the broker recommended an unsuitable investment, the broker cannot raise the defense that the investment was only one component of the customer's portfolio, when the investment did not meet the customer's objectives. See *In re Klein*, Exch. Act Release No. 34-37835, 63 SEC Docket (CCH) 52 (Oct. 17, 1996).

263. One court recently endorsed an investor's common law claim against an issuer based on a theory of wrongful holding. *Small v. Fritz Cos., Inc.*, 132 Cal. Rptr. 2d 490 (2003).

264. Some of the judicial concern is based on a fear that juries' sympathies would result in excessive verdicts against brokerage firms. See *Hill v. Bache Halsey Stuart Shields Inc.*, 790 F.2d 817, 825 (10th Cir. 1986). This concern is not present in arbitration, where one of the three arbitrators is affiliated with the

over-concentrated in one type of investment, or to warn of escalating risks in a volatile market, would transform the broker into an investment adviser responsible for managing the entire portfolio of the customer. Once the broker assumes the role of an investment adviser, he also assumes a fiduciary duty to the customer and then certainly has the duty to monitor the performance of the portfolio.<sup>265</sup> Courts have expressed concern that treating the broker like a de facto investment adviser would increase the costs of doing business on an already highly-regulated industry and would be particularly unfair in instances where both the customer's and broker's expectations are that the customer is making the investment decisions.<sup>266</sup> Thus, absent a relinquishment of management control by the customer to the broker such that the broker has complete discretion and is responsible for the performance of the account overall, the law should not impose a duty to monitor on the broker who periodically makes recommendations to the customer and even has an ongoing personal relationship with the customer, but does not control the account.

Finally, the absence of support—either in the case law or in arbitration awards—for the notion that the broker has a duty to **stop** the customer from making unsound or unwise investment decisions if the customer selected the transaction and did not relinquish control to the broker is both rational and equitable. Brokers are not insurers; to the contrary, implicit in every investment choice is the concept of risk, and any investment in isolation or as part of a strategy entails an acceptance and assumption of that risk. Investors have the minimal duty to understand that investing in securities markets is inherently more risky than placing money under a mattress or in a savings account, and even investments labeled as conservative entail some degree of risk.<sup>267</sup> It follows then that if an investor knowingly chooses a risky investment or risky trading strategy, that investor must retain responsibility for the risk of loss and should pay for his mistakes.

Brokers should be more professional, competent and ethical. They are not strictly liable, however, for an investor's "fiscal hari-kari."<sup>268</sup> It would indeed be "outrageous" to impose a duty to rescue and "save"<sup>269</sup> a self-directed

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securities industry.

265. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 182-83 (1963) (recognizing that investment advisers have a statutory fiduciary duty to their customers under the Investment Advisers Act).

266. *See Chee v. Marine Midland Bank*, No. 88 CIV. 0557, 1991 WL 15301, at \*4 (E.D.N.Y. Jan. 29, 1991); *Puckett v. Rutenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 280 (Miss. 1991).

267. *See Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 351-52 (2d Cir. 1993).

268. *Puckett*, 587 So. 2d at 278.

269. *Weinstein v. Brokers Exch., Inc.*, No. 93-04713 (N.A.S.D. Dec. 7, 1994) (Cohn, Arb.).

trader—even a compulsive gambler—from himself. Ultimately, brokers' ethical responsibilities to aid their customers in making sound investment decisions should not transcend the law and transform into a legal duty to stop the customer from engaging in economic suicide.

