

Duke Law Journal

VOLUME 1965

SUMMER

NUMBER 3

PROFESSIONAL RESPONSIBILITIES OF BROKER-DEALERS: THE SUTTA- BILITY DOCTRINE[†]

ROBERT H. MUNDHEIM*

ONE OF the important contributions of the *Special Study of Securities Markets*¹ (Special Study) was the change of emphasis which it effected in the thinking concerning problems related to the sale of securities to the public. Such thinking had been directed primarily to devising ways in which more complete and usable information could be made available to the public investor so that he would have a basis for making informed and reasoned decisions about the investment merits of securities. Although it did not minimize the importance of disclosure, the Special Study turned its attention to the people selling securities because it recognized that often the salesman is the key to the sale of securities. In its study of the qualifications of the persons in the securities industry, the Special Study found large gaps and important deficiencies which created major problems for the protection of the public interest in securities and the securities markets. Accordingly, it recommended that standards encompassing competence, character and integrity, and financial capacity and responsibility be erected for the broker-dealer community.² Congress endorsed the Special Study's conclusions in the Securities Acts Amendments of 1964³ (Amendments Act) by including in that legislation a mandate to the Securities and Exchange Commission (Commission) and the National Association of Securities

[†] This article bears a date of May 20, 1965.

* A.B. 1954, LL.B. 1957, Harvard University. Associate Professor of Law, University of Pennsylvania.

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

² *Special Study*, pt. 1, at 160.

³ 78 Stat. 565 (1964).

Dealers (NASD) to implement these Special Study recommendations. Although the policy of restricting free access into the securities business which was written into the regulatory scheme by the Amendments Act marked a significant departure from the federal government's traditional attitude toward broker-dealer regulation, it inevitably followed from the conclusion that adequate investor protection depends to a great extent on the professional attitude and responsibility of the broker-dealer community.

The decision to encourage the professional aspects of the securities business has not been without critics. The feeling among these critics seems to be that a better (or at least a more realistic) approach would have been to acknowledge that the brokerage business is at bottom a merchandising business and that its success and contributions may be unduly restricted by the inhibitions which the obligations of professionalism inevitably create. These critics would, I suppose, be willing to call salesmen "salesmen" instead of "registered representatives" or "account executives," and customers "customers" instead of "clients." However, the prevailing attitude of the securities industry—particularly as reflected in its advertising campaigns—has been an affirmation of the professional nature of the services rendered by, and the professional quality of, the persons engaged in the securities business. An example of this theme is furnished by a recent full-page advertisement in the *Wall Street Journal* which featured a confidence-inspiring man standing in front of a stock board and contained the following text:

When you buy or sell a security or shares in a mutual fund, you do business with a man like this. In a sense, he is a catalyst, finding places for investors to put their money to work. To some, he's a stock broker; to others, a securities salesman. His official title is Registered Representative, which means he is licensed to represent an investment firm in the buying and selling of securities to the public.

This is a privilege, not a right. To qualify, he must undergo special training, then pass a stiff examination and adhere to stringent rules set up by the Securities and Exchange Commission and other regulatory bodies.

His specialized knowledge, backed by the research and other facilities of his company, is at your disposal. How well he serves you depends largely on how candid you are with him. *Discuss your investment needs with him as frankly as you would discuss your legal problems with your lawyer or health matters with your*

*family doctor. Like them, with true professionalism, he knows that he prospers only as those he serves prosper.*⁴

I do not mean to imply that the segment of the securities industry which is willing to accept an image of professionalism such as that implicit in the advertisement described above is necessarily willing to take on all the obligations of professionalism or eschew the merchandising aspects of the securities business. Indeed, the conflict between the desire for professionalism and the demands of a business the primary purpose of which is the sale of securities provides a dominant theme in securities regulation.⁵ One of the principal areas in which this conflict is taking place concerns the development of standards requiring a broker-dealer, under certain circumstances, to make sure that he recommends and sells to his customers only

⁴ Wall Street Journal, Oct. 20, 1964, p. 15. (Emphasis added.) This advertisement is not alone in analogizing the registered representative to a doctor or lawyer. See ASSOCIATION OF STOCK EXCHANGE FIRMS, MANUAL FOR REGISTERED REPRESENTATIVES: A GUIDE FOR THE OPENING AND CARRYING OF CUSTOMERS' ACCOUNTS 11 (8th rev. 1963). See also United States v. Pandolfo, Crim. Nos. 95, 105, D.N.D., Sept. 28, 1959 (testimony of Harold E. Wood, St. Paul, Minn. investment banker and NASD chairman in 1955-56). Mr. Wood, who appeared as a government witness, was asked: "Is the securities business a specialized business or not, in your opinion?" He answered, "I think it is a profession like medicine or the law," and he went on to say, "I think you have a fiduciary relationship with your customers which is a position of trust with them, and that is where it distinguishes it from any other business." Transcript, p. 16. On cross examination Mr. Wood elaborated:

Some things we won't handle for anybody so we refuse it, and the other is we won't handle it if we don't think the customer should have the same kind of security. It is the same thing as the doctor [who] doesn't give the wrong medicine if a person wants it.

Q. You are not likening the security business to the obligation of a doctor not to give the wrong medicine to a patient?

A. I am making the comparison that an investment banker has the same responsibility to a customer as a doctor does to a patient.

Transcript, p. 58.

The Special Study stated that one of the two major themes typical in broker-dealer advertising is "the theme of reliance and trust in the experience and judgment of the firm, its registered representatives and, often most particularly, its research department." *Special Study*, pt. 1, at 248. It concluded that such advertisements "may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business." *Ibid.*

Any broad characterization of the tone of the advertising of the broker-dealer industry may be inaccurate with respect to the advertising policies of particular firms. Many firms do not emphasize the theme of professionalism in their advertisements and do not try to adorn themselves with the trappings of professionalism. However, an investor's impression of the nature of the broker-dealer and his business often derives from the advertising and attitudes of articulate segments of the industry.

⁵ For an analysis of professionalism in the securities industry, see *Special Study*, pt. 1, at 240-42.

those securities which are suitable for them. This article will analyze the extent to which these standards have been articulated and will suggest the outlines of a fully developed standard of responsibility under such a suitability concept.⁶ The standard which defines the broker-dealer's responsibilities will sometimes be referred to as the suitability doctrine.

The impetus underlying the development of this doctrine is not rooted in a desire to fashion an instrument which can be used to review a broker-dealer's investment judgment⁷ or to make the broker-dealer an insurer of favorable investment performance. Although such a doctrine reflects an attempt to emphasize the demands of professionalism, it does not seek to do so in a way which disregards the importance of the merchandising aspects of the securities business. Further, the imposition of certain broker-dealer responsibilities by a suitability doctrine does not necessarily mean that failure to live up to such responsibilities will impose civil liability on the broker-dealer.⁸

The concept of suitability expresses a homely truth about investing—investment decisions can be made only in light of the goals and needs of the person for whom they are made. Investors vary with respect to the degree of risk which they are able and willing to assume in their investments, and their portfolios should reflect their differing risk thresholds. Consequently, a security which is suitable for one investor may be unsuitable for another. It may be suitable for one investor to have 1,000 shares of XYZ stock, unsuitable for another investor to have more than 100 shares of such stock, and

⁶ The development of broker-dealer responsibilities under the suitability concept is closely related to another development in broker-dealer regulation—the requirement that a broker-dealer not make recommendations to his customers unless he has a reasonable basis for the recommendations and that he disclose known or easily ascertainable facts bearing upon his recommendations. This aspect of broker-dealer regulation, which concerns the broker-dealer's knowledge of his merchandise (rather than his customers), is explored in Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691 (1964) and Comment, *Current Problems in Securities Regulation*, 62 MICH. L. REV. 680 (1964) and will not be discussed in this article. This article also will not discuss the adequacy of various approaches to securities analysis in identifying the risk element in a particular securities purchase.

⁷ There is no attempt to provide a standard for evaluating various systems of analyzing securities or the decisions made as a result of such analyses. The doctrine does not seek to answer a question such as should the broker-dealer have recommended General Motors instead of U.S. Steel.

⁸ See pages 463-71 *infra*.

unsuitable for still another investor to have any such shares. Indeed, it may be unsuitable for some persons to purchase any securities.

A suitability doctrine imposes a responsibility on the broker-dealer to take the risk threshold of his customers into account when he recommends or sells securities to them. This responsibility applies in two basic situations: (1) when a broker-dealer makes a recommendation to a customer, and (2) when he sells a security to a customer without making a recommendation.⁹ In broad outline the suitability doctrine, as it develops, should require that:

1. When a broker-dealer makes a recommendation to a customer, he must recommend only those securities which he reasonably believes are suitable for the customer—or, to put it another way, he may not recommend any securities which he knows or should know would be unsuitable for that customer.

2. Even when the broker-dealer makes no recommendation he still has a responsibility to determine, on the basis of information which he has or should have, that the risk aspects of the contemplated investment are within the risk threshold of the customer who is purchasing the security.

The broker-dealer may discharge his responsibility under the suitability doctrine by informing the customer of the risk aspects of the transaction in a way which will enable the customer, in light of his individual capabilities, to relate these risks to his risk threshold and thus make his own determination of suitability. If under these circumstances the customer wishes to purchase the security, the broker-dealer can sell it to him even though he does not think it is within the customer's risk threshold.¹⁰

Imposition of any suitability doctrine has a revolutionary flavor, because it shifts the responsibility for making inappropriate investment decisions from the customer to the broker-dealer. It does so in what seems to me the correct belief that disclosure requirements

⁹ The idea that the suitability doctrine extends not only to recommendations but also to sales goes beyond what has generally been thought to be the reach of the suitability concept. However, the question what constitutes a recommendation has never been precisely answered. For example, if a broker-dealer sells a security to a customer with whom he has had a long-standing relationship, is there an implied recommendation that the security is not unsuitable for the customer?

¹⁰ If the customer refuses to furnish the broker-dealer with information sufficient to determine the customer's risk threshold, the broker-dealer should not be required to prevent the customer from purchasing securities which are beyond his risk threshold. Broker-dealer responsibility under my concept of suitability is discussed in greater detail on pages 472-77 *infra*.

and practices alone have not been wholly effective in protecting the investor—including protecting him from his own greed.¹¹

The theory on which any doctrine of suitability must rest (and which limits its applicability) is that customers tend to rely on their broker-dealer. As indicated previously, the broker-dealer community has made the investing public aware that it has the special skills needed to deal with such intricate merchandise as securities, and the public has been encouraged to—and has—relied on the superior skill of the broker-dealer community in its securities transactions. Implementation of the Special Study recommendations concerning the qualifications of persons permitted to enter the industry will undoubtedly enhance the professional image of the broker-dealer community and public reliance on it.

In the spectrum of relations which exist between broker-dealers and their customers there are some situations in which reliance is clearly present and some in which it clearly is not. When the broker-dealer recommends securities to an inexperienced customer, reliance is usually present. On the other hand, when the broker-dealer simply serves as an order clerk, there is usually no reliance. There are many situations in between these extremes involving relatively sophisticated persons who rely to some extent on the broker-dealer but who also depend a great deal on their own judgment. The principles of the suitability doctrine, as outlined above, place the burden of guarding against inappropriate investment decisions on the broker-dealer in these intermediate cases, but they permit him to shift that burden to the customer.¹² The net effect of this aspect of the doctrine is to make it unnecessary for the customer to prove that he has relied on the broker-dealer—it raises a presumption that he has done so in all but the order clerk situation. However, the broker-dealer can show that in a particular case the customer did not rely on him and that he was, therefore, relieved of his responsibilities.

Recognition of some broker-dealer responsibility in the suitability area has been included in the NASD Rules of Fair Practice since the

¹¹ Cf. *Philips & Co.*, 37 S.E.C. 66, 68 (1956).

¹² As a practical matter the broker-dealer should endeavor to shift the responsibility for making the investment decision to his customer, but he should act on the assumption that he has not done so. Consequently, when the broker-dealer thinks that his customer is purchasing an unsuitable security, it is good practice in most cases to so inform him. See ASSOCIATION OF STOCK EXCHANGE FIRMS, *op. cit. supra* note 4, at 10.

inception of that organization in 1938. Article III, section 2 of the Rules of Fair Practice provides that:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.¹³

The NASD's suitability rule leaves a number of questions unresolved. It talks about the recommendation of securities but says nothing about the sale of securities. It does not explain under what circumstances the broker-dealer acquires the responsibility which the rule imposes or under what circumstances he may shift that responsibility to his customer. It does not indicate whether the broker-dealer has a duty to obtain information about his customer's existing security holdings and his financial situation and needs, or what his responsibilities are if he is unable to obtain such information.

The easiest case for applying the rule occurs where the customer has told the broker-dealer that the money in his account represents a substantial portion of his life savings, that he is retired, that he wants an account which stresses stability of principal and production of income, that he has had no experience in the market, and that he is placing complete trust and confidence in the broker-dealer (and does so), and where the broker then treats the account as if it were a trading account. The excessive trading cases were among the earliest decided under the NASD's suitability rule.¹⁴ Similarly, if the broker-dealer in this situation recommended and

¹³ NASD Manual D-5. The New York Stock Exchange also has a rule which seems to express a suitability concept. It requires general partners and officers who hold voting stock of member organizations to "use due diligence to learn the essential facts relative to every customer . . ." N.Y. Stock Exch. Rule 405 (1), N.Y. STOCK EXCH. GUIDE ¶ 2405 (1960). This rule, commonly referred to as the "know your customer" rule, appears to be regarded by the Exchange as primarily for the protection of member organizations against customers who will not meet their financial obligations to the member. See *Special Study*, pt. 1, at 239; ASSOCIATION OF STOCK EXCHANGE FIRMS, *op. cit. supra* note 4, at 13. For a discussion of the New York Stock Exchange's views on the suitability doctrine, see note 52 *infra*.

¹⁴ *E.g.*, R. H. Johnson & Co., 33 S.E.C. 180 (1952). The Commission has treated excessive trading cases as involving violations of the anti-fraud provisions of the securities laws. See, *e.g.*, E. H. Rollins & Sons, Inc., 18 S.E.C. 347, 380-82 (1945).

purchased for the account a preponderance of high-risk securities,¹⁵ a violation of the suitability rule would occur. The second case is different from the first—although perhaps theoretically not more difficult—because it requires a judgment about the quality of the security recommended.

In the last few years standards of broker-dealer responsibility under the suitability concept have expanded beyond this simple situation. This expansion has been a concomitant to the growing professional stature of the broker-dealer community.¹⁶ Further, it is in tune with the growing concern of the law with developing techniques for protecting the purchasing public. For example, the suitability doctrine is a first cousin to the implied warranty of fitness for a particular purpose imposed by section 2-315 of the Uniform Commercial Code on the seller of goods where he has reason to know the particular purpose for which the goods are acquired and where the buyer relies on the seller's skill or judgment in selecting or furnishing goods which are suitable for that purpose.¹⁷ A similar warranty is also being implied where the sale consists of services.¹⁸

¹⁵ The purchase of one or two high risk securities for a portfolio the investment objective of which is stability of principal and production of income would not necessarily be improper. Violation of the suitability rule in the purchase of such securities should depend upon the composition of the whole portfolio as it is known or should be known to the broker-dealer.

¹⁶ The same conclusion was reached in a comment on a case involving the sale of insurance in which the court used language which foreshadows expansion of the legal responsibilities of insurance agents: "We do not share the views of those who look upon this decision with dismay. Agents and companies have spent decades in upgrading the stature of those who sell and service life insurance. They are rapidly reaching professional standing, if they have not already done so. The greater the stature, the greater the correlative duty and responsibility. If we want increased stature for agents, all of us will have to pay the price that goes with it." DINEEN, CALLAN & NINNEMAN, REPLACEMENT: CAUSES AND CONTROL 51 (1962). For a discussion of the case referred to, *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962), see text accompanying notes 28-29 *infra*.

¹⁷ The implied warranty imposed by the Uniform Commercial Code probably does not apply to securities transactions because it refers to "goods," and investment securities are specifically excluded from the definition of goods contained in § 2-105 of the code. However, the comment to § 2-105 states that the exclusion of investment securities from the definition of goods is not intended "to prevent the application of a particular section of this Article by analogy to securities . . . when the reason of that section makes such application sensible and the situation is not covered by the Article of this Act dealing specifically with such securities (Article 8)."

The doctrine of suitability as discussed in this article goes further than the implied warranty of fitness for a particular purpose—particularly in the duty it places on the broker-dealer to inquire into the financial needs and resources of his customers.

¹⁸ See *Broyles v. Brown Engineering Co.*, 275 Ala. 35, 151 So. 2d 767 (1963) (engineers held to warrant impliedly that plans and specifications drawn for drainage of proposed subdivision would accomplish proper and adequate drainage).

This expansion has occurred in two kinds of situations. One of these involves circumstances under which no amount of disclosure would permit the particular investor to make a reasoned decision concerning the investment merits of the security. For example, in a recent Commission decision¹⁹ involving a broker-dealer revocation proceeding charging wilful violation of the anti-fraud provisions of the securities laws, the broker-dealer had recommended an investment in the firm itself to one of its customers who, as the broker-dealer knew, was seventy-nine years old, retired, living alone and senile. The firm was at the time in a precarious financial situation, and the investment involved a substantial risk. The Commission found that the broker-dealer failed to make "full and meticulous disclosure of all pertinent information."²⁰ Although the opinion could have stopped there in supporting a finding of wilful violation of the anti-fraud provisions, the Commission went on to say that "in the context of the circumstances here . . . registrant had an obligation not to recommend a course of action clearly contrary to the best interests of the customer, whether or not there was full disclosure."²¹ Even if the broker-dealer had provided his customer with complete information concerning the security, he probably could not (because of the customer's senility) have presented the information in a way which would have enabled the customer to relate the investment risks of the transaction to his risk threshold and thus make the determination of suitability for himself. The implication that a broker-dealer has a responsibility to determine whether his customer can utilize the information disclosed to him in arriving at an investment decision echoes a similar suggestion implicit in an earlier case, *Phillips & Co.*²² In that case, the broker-dealer had encouraged his customers, who he knew were persons of modest means and little experience in the market, to purchase stock involving a high degree of risk. Although the disciplinary action imposed by the NASD could have been upheld by the Commission solely on the basis of misleading statements made by the salesman, the NASD

¹⁹ *Powell & McGowan, Inc.*, SEC Securities Exch. Act Release No. 7302 (Apr. 24, 1964).

²⁰ *Id.* at 2.

²¹ *Ibid.* The opinion in *Powell & McGowan, Inc.* treats the case solely as one involving the responsibilities of a broker-dealer selling securities. It seems to attach no special significance to the fact that the broker-dealer was also the issuer of the security sold.

²² 37 S.E.C. 66 (1956).

and the Commission both found violations of the NASD's suitability rule. This finding was also applied in the case of two of the customers who it was alleged had themselves made a determination that the stock was a suitable investment. The Commission said:

Whether or not customers Z and E considered a purchase of the stock of Quebec's affiliate or of Quebec a suitable investment is not the test for determining the propriety of applicants' conduct in the situation before us. The test is whether Bernheimer fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer's financial situation and needs.²³

The clearest expression of the view that a broker-dealer cannot in every case shift to his customer the responsibility for determining the suitability of an investment appears in Commission rule 15c2-5,²⁴ which governs the sale of equity funding programs.²⁵ These programs involve the purchase of mutual fund shares and the pledging of these shares to secure a loan, the proceeds of which are then used to pay the premiums on an insurance policy purchased at about the same time. Typically, these programs are sold to persons of modest means and little financial experience. The Commission discovered that in many cases they were being offered to persons for whom they were wholly inappropriate. Consequently, it promulgated the present rule which provides that a salesman offering an interest in an equity funding program must disclose certain specified facts about the program (including its risks and disadvantages) which might affect the particular customer, obtain information from the customer concerning his financial situation and needs, and determine, on the basis of this information, whether the transaction as a whole is suitable for the customer. This determination and the basis upon which it is made must be communicated in writing to the customer. Rule 15c2-5 thus goes

²³ *Id.* at 70.

²⁴ SEC Securities Exch. Act Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (1964).

²⁵ Although rule 15c2-5 is sometimes referred to as the equity funding rule, it has a broader impact. It applies to every situation in which a broker or dealer, directly or indirectly, lends money or arranges for a loan to a customer in connection with the sale of a security, unless the credit extended or the loan arranged is by a broker or dealer subject to the provisions of regulation T of the Federal Reserve Board and the transaction complies with the requirements of that regulation. The brokers and dealers not subject to regulation T are those who are not members of a national securities exchange and who do not transact a business in securities through the medium of any such member. Fed. Res. Bd. Reg. T § 1, 12 C.F.R. § 220.1 (1963).

beyond the suitability doctrine as outlined above in that it forbids the sale of the equity funding program unless the broker-dealer reasonably determines that it is suitable for the customer. This prohibition applies even if a customer who is highly sophisticated in financial matters wishes to purchase the program notwithstanding the unfavorable recommendation of the broker-dealer.²⁶ Further, the rule has important implications because it imposes responsibilities on the seller even though there was no prior established relationship between him and the customer. Despite the far reaching nature of this rule, only one letter opposed the suitability aspects of the rule when it was proposed for comment.²⁷

A problem similar to that posed in the equity funding situation has arisen in the insurance industry and was the subject of a 1961 decision of the Ninth Circuit.²⁸ In that case, the defendant insurance agent sold the plaintiff and his wife bank financed life insurance in the face amount of \$150,000. The district court found that the agent had represented to the plaintiff that the plan was suitable for him and his wife, and it further found that the plan was not in fact suitable. In the court of appeals, the defendant argued that he merely presented the program to the plaintiff and his wife, and that the ultimate responsibility for determining whether they wanted the program and whether they could afford to pay for it was theirs. In a lengthy opinion, the court struggled with the question whether the representation by the insurance agent that the plan was suitable constituted a representation of fact or opinion, and whether liability could be predicated on the finding that the plan was in fact not suitable. The court eventually resolved the question in favor of the plaintiff. Toward the end of the discussion, the court intimated—and I think correctly—that even if the agent had not

²⁶ However, if the customer cannot show reliance it is doubtful that he would be able to demand rescission of the transaction even though the broker-dealer's conduct is defined as fraudulent by the rule.

²⁷ The only comment in opposition came from a mutual fund salesman who signed his letter "Ernest F. Boruski, characterized as a 'hostile witness' by the SEC for refusing to go along with their injustice and other nonsense." Mr. Boruski's view was that it made no sense to impose an obligation on one person to make a judgment about the suitability of a particular security for another person, particularly when "most people have no real idea of what is suitable for themselves." Letter from Ernest F. Boruski to the SEC, June 1, 1962. One other letter commenting on the proposed rule stated that the suitability requirement imposed by the rule would not be very effective. Letter from Erich Stock Valicenti, Leighton & Holland, to the SEC, June 15, 1962.

²⁸ *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962).

expressly represented the plan to be suitable for the plaintiff and his wife, he could not have assumed that the responsibility for making the ultimate decision with respect to suitability could be shifted to the customer in this kind of transaction—involving a complicated program, a holding out of the agent as an expert in the creation of such programs, and the relative lack of sophistication of the customer. The court said:

Indeed, the court might well regard seriously the argument that any insurance agent who would sell a man with Knox's limited income and prospects an insurance program that involved saddling him with a bank indebtedness of \$125,000, an essentially term insurance type of protection, and dissipation of the accumulated cash values of his old insurance, must have known that he was not acting honestly in making the sale.²⁹

The other type of situation in which the suitability concept has been stressed involves the sale of securities by boiler-room techniques—high pressure merchandising of low-priced, speculative, obscure securities over the telephone to customers who are unknown to the salesman. In a number of cases dealing with boiler-room sales, the Commission has stressed that aspect in the boiler-room operation which seeks to induce a hasty decision by the customer on the basis of inadequate information and fails to recognize the obligation of the salesman to determine whether the security recommended is suitable for the customer to whom it is recommended.³⁰ In one of

²⁹ *Id.* at 727-28. The district court also thought that the defendant could not shift the responsibility for making the decision to purchase to his customer: "Defendant claims plaintiff was naive or indifferent to the workings of the insurance plan sold. Perhaps he was. However, the doors of this Court are open to the gullible as well as to the alert and sophisticated. It could be said that a more reasonable man under the circumstances might have taken greater care in ascertaining the significance of the tax bracket factor in the context of the bank financed insurance. Yet it was defendant who conscientiously strove to have plaintiff rely on him in this matter. The nature of the reliance which resulted cannot be utilized to mitigate defendant's culpability. The complexity of the insurance plan sold to plaintiff brings us into an area of the law which has long since seen the demise of caveat emptor. 'Buyer beware' lingers now only in the argument of the lawyers." *Knox v. Anderson*, 159 F. Supp. 795, 806 (D. Haw. 1958). See Chittick, *Responsibilities of Professionalism*, 18 J. AM. Soc'y C.L.U. 29 (1964).

³⁰ See *MacRobbins & Co.*, SEC Securities Exch. Act Release No. 6846 (July 11, 1962); *Best Securities, Inc.*, 39 S.E.C. 931 (1960); DUKE UNIVERSITY SCHOOL OF LAW, CONFERENCE ON SECURITIES REGULATION 8, 90 (Mundheim ed. 1965) (comments of Manuel F. Cohen, Chairman of the SEC) [hereinafter cited as CONFERENCE]; Cohen & Rabin, *supra* note 6, at 707.

Commission opinions in boiler-room cases are written either in connection with proceedings to censure, suspend or revoke the registration of a broker-dealer under §

these cases, *Gerald M. Greenberg*,³¹ the defendant objected to a finding of a violation of the NASD's suitability rule on the ground that he did not have any information concerning the financial condition and holdings of his customers and therefore was under no obligation to see that the security recommended was suitable for such customers. The Commission refused to read the words "if any" in the NASD's suitability rule³² as permitting a broker-dealer to avoid making inquiry about the financial situation and needs of his customers. The significance of the use of suitability language in the boiler-room cases is the suggestion, similar to that implicit in rule 15c2-5, that the broker-dealer has a responsibility to his customer in the making of recommendations even though there has been no prior relationship between them. The existence of this responsibility necessitates inquiry concerning his customers' financial situation and needs.

Perhaps the Commission's use of the suitability doctrine in boiler-room cases will be strictly limited to the extreme situation which they present.³³ These cases typically involve the indiscriminate merchandising of high-risk securities which will *in fact* be unsuitable to the needs and resources of many of the investors who are persuaded to purchase them. Since such sales are made under circumstances involving a minimum level of disclosure—indeed false statements, half-truths and optimistic predictions are the hallmarks of the boiler-room—the purchasers will often not be aware of the unsuitability of the security to their needs and resources. However, the NASD apparently began to worry about the implications of the decision in the *Greenberg* case, because shortly thereafter in a case involving disciplinary proceedings against a large, reputable member of the New York Stock Exchange, one of whose branches had been aggressively merchandising a low-priced, speculative, ob-

15 (b) (5) of the Securities Exchange Act, or in connection with review of NASD disciplinary proceedings pursuant to §§ 15A (g) and (h) of the Securities Exchange Act. Section 15 (b) (5) proceedings typically allege wilful violations of § 17 (a) of the Securities Act and §§ 10 (b) and 15 (c) (1) of the Securities Exchange Act and rules 10 (b) (5) and 15c1-2 thereunder—the anti-fraud provisions of the securities laws. In NASD proceedings, violations of §§ 1 and 2 of the Rules of Fair Practice—the obligation to "observe high standards of commercial honor and just and equitable principles of trade" and the suitability rule—are usually alleged.

³¹ 40 S.E.C. 133 (1960).

³² See text accompanying note 13 *supra*.

³³ See CONFERENCE 103-04 (comment of Philip A. Loomis, Jr., General Counsel of the SEC).

scure security, it sought to confine the applicability of the suitability doctrine to those situations in which the broker-dealer has obtained financial information concerning his customer and then disregarded it.³⁴ This interpretation gives effect to the words "if any" in the NASD's suitability rule and does not require the broker-dealer to assume any responsibility until the customer objectively demonstrates his reliance on the superior skill and knowledge of the broker-dealer by supplying him with financial information about himself.³⁵

The Special Study, in its review of NASD controls over selling practices, sharply criticized this retrenchment, stating that:

Under this narrow interpretation of the NASD's own suitability rule, salesmen might be encouraged to learn as little as possible about the customers to whom they recommend securities.³⁶

Indeed, it seemed to desire not only a reaffirmation of the *Greenberg* interpretation, but an expansion of the suitability concept. In its recommendations the Special Study urged that:

Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of 'suitability' of particular securities for particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement. The NYSE, which has less clearly recognized suitability as a standard of conduct, should make greater efforts to define its content and undertake necessary surveillance and enforcement. This area would seem to be a particularly appropriate one to be dealt with through statements of policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. Such statements of policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.³⁷

³⁴ See *Special Study*, pt. 1, at 311-12.

³⁵ This interpretation contrasts sharply with that given the suitability rule by Harold E. Wood, ex-chairman of the NASD. See Transcript, pp. 59-60, *United States v. Pandolfo*, Crim. Nos. 95, 105, D.N.D., Sept. 28, 1959.

³⁶ *Special Study*, pt. 1, at 312.

³⁷ *Id.* at 329.

The first question raised by the Special Study recommendation concerns the desirability of giving greater emphasis to the concept of suitability. The Special Study had its genesis in the excesses of the speculative securities markets of the late 1950's and early 1960's and the disclosures concerning the breakdown in some of the controls over these markets as developed in the investigation of the American Stock Exchange. Further impetus came from the market break in May, 1962. Thus, the Special Study was written at a time when investor confidence had been shaken. One way of sapping investor confidence is by disappointing investor expectations. This is a danger inherent in overselling, and the aggressive merchandising practices of certain segments of the securities industry particularly worried the Special Study. The suitability doctrine is an important counter to such selling practices because of the emphasis which it places on concern for the customer's needs and resources. Moreover, insofar as it encourages the broker-dealer to discuss transactions with his customers—particularly to point out the risks of an investment and relate those risks to the customer's ability to bear them—the suitability doctrine prepares a customer to accept some of the disappointments which inevitably occur in connection with investments in securities.

The second question raised is whether the Special Study intended the suitability concept to be defined as an ethical standard or a legal responsibility. Insofar as the Special Study requested the Commission to emphasize the suitability concept, it seemed to be speaking in terms of a legal responsibility, since the Commission could utilize the suitability concept only in connection with the definition of broker-dealer standards of conduct under the anti-fraud provisions of the securities laws. The recommendation taken as a whole, however, suggests that what the Special Study had in mind was leadership by the self-regulatory bodies—particularly the NASD—in defining the suitability concept as an ethical standard to which broker-dealers would have to adhere in observing rules of fair practice. NASD initiative in this area would be desirable, since the industry itself could then work out the scope of the responsibilities imposed by the concept. Moreover, if the industry defined the concept, standards might be erected without necessarily creating a basis for civil liabil-

ity.³⁸ However, the Special Study also recognized that in the past the NASD had not always exercised sufficient initiative in articulating ethical standards of conduct,³⁹ and it wished to encourage the Commission to fill the regulatory gap which would be created should the NASD fail to act in this area. The Special Study did not discuss the possible role of the courts in defining the concept in the event that the self-regulatory process did not effectively deal with the problem.⁴⁰

The Commission endorsed the Special Study's call for NASD action, and its staff held conferences with representatives of the NASD beginning in early 1964 in an effort to work out a statement which would define the content of the suitability doctrine. The end product of these discussions was a *Guideline on Fair Dealing with Customers* (Guideline), published by the NASD on October 9, 1964.⁴¹ The Guideline begins by stating that all NASD members and registered representatives have a "fundamental responsibility for fair dealing" with customers and other persons, and that sales efforts must be judged "on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers."⁴² The Guideline then sets forth a number of examples of practices which have in the past been found to violate the responsibility for fair dealing. The first example refers to recommending speculative, low-priced securities to a customer without knowledge of or an attempt to obtain information concerning the customer's financial situation and needs. The Guideline states that this violation "has particular application to high pressure telephonic sales campaigns."⁴³ In effect, this example restates the doctrine articulated in the *Greenberg* case. The second example relates to excessive trading in a customer's account (churning), and the third

³⁸ At the time the Special Study was published, only the NASD could develop standards based solely upon a concept of ethical responsibility. Commission action was limited to defining fraud concepts. See text accompanying notes 69-72 *infra*.

³⁹ The Commission has labelled fraudulent certain conduct which the NASD has hesitated to label as violating the ethical standards embodied in its Rules of Fair Practice. The conduct described in rule 15c2-5 and the suitability aspect of the boiler-room cases provide two examples.

⁴⁰ For a discussion of the possibility of court action creating standards of conduct in this area, see text accompanying notes 55-61 *infra*.

⁴¹ NASD Manual G-7 to G-9.

⁴² *Id.* at G-7.

⁴³ *Ibid.*

deals with short-term trading in mutual funds. The fourth example of conduct which violates the responsibility for fair dealing contains five instances of "fraudulent conduct," including transactions in discretionary accounts in excess of or without authorization from customers and the unauthorized use or borrowing of a customer's funds or securities. The fifth example relates to recommending the purchase of securities where the salesman should reasonably expect that the customer does not have the financial ability to pay for them.⁴⁴ The Guideline ends with a statement that a broker-dealer usually fails to live up to the responsibility of fair dealing imposed by the NASD when he violates the obligations of fair dealing as determined by the Commission under the anti-fraud provisions of the securities laws.

Few cheers greeted the Guideline when it was published. Its adoption of the principle of the *Greenberg* case disturbed many of the people who regarded that case as dangerous precedent and who had urged the NASD to retreat from it. Further, it was claimed that certain of the examples in the Guideline seemed to go beyond what had been assumed were the decided cases.⁴⁵

Those persons who wished to see the Special Study recommendation implemented were also disappointed in the Guideline. Not only did it fail to define the concept of suitability, but it very carefully avoided even mentioning the word.⁴⁶ The only guide to broker-dealer conduct in the recommendation of securities which grapples with the problems raised by the suitability doctrine is the example drawn from the *Greenberg* case, and it is confined to speculative, low-priced securities.⁴⁷ Although the next to the last para-

⁴⁴ This example was drafted to cover the situation where shares in a mutual fund are sold under a contractual plan to persons who cannot afford the monthly payments.

⁴⁵ CONFERENCE 98-99 (comment of Thomas A. O'Boyle).

⁴⁶ Marc A. White, vice president and general counsel of the NASD, has stated that consideration was given (prior to publication of the Special Study recommendation) to removing the words "if any" from the NASD suitability rule and imposing on a salesman an affirmative duty to ascertain facts concerning his customer's financial needs and investment objectives. CONFERENCE 105. See *Special Study*, pt. 1, at 311 n.175. However, this was not done.

The NASD membership was informed in a covering letter to the Guideline that the Guideline made no change in the NASD's existing suitability rule.

⁴⁷ The Guideline's emphasis on the low price of the security may be misleading, because the price of a security alone indicates nothing about the risk involved in investing in the security. The same stock may be a high risk purchase at \$12 and a low risk purchase at \$2, and a so-called blue chip security selling at a very high price may be a high risk purchase. See GRAHAM, DODD & COTTLE, *SECURITY ANALYSIS* 48-50 (4th ed. 1962).

graph of the Guideline states that the examples given are not all inclusive, the careful limitations contained in the *Greenberg* example suggest that broker-dealers have no duty to attempt to obtain financial information about their customers as long as they are not recommending the purchase of speculative, low-priced securities.⁴⁸ Such a conclusion is at variance with the underlying thrust of the Special Study recommendation for expansion of the doctrine.

Although the Guideline was disappointing, it may not be fair to blame the NASD too harshly for not publishing a more helpful document. Any regulatory body, particularly a self-regulatory body, is limited in the amount of new ground—especially in controversial areas—that it can break in a short period of time. During the time that discussions were proceeding on the Guideline, the NASD was helping the Commission secure passage of the Amendments Act. More important, the Commission was pressing for NASD action which would satisfy the mandate of new section 15A (b) (12) for NASD rules “governing the form and content of quotations relating to securities sold [in the over-the-counter markets] . . .”⁴⁹ That section requires that such rules “be designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations.”⁵⁰ Specifically, the Commission was urging: (1) a change in the system of quoting prices of over-the-counter securities in the newspapers,⁵¹ (2) improve-

⁴⁸ The NASD, in its 1964 REPORT TO MEMBERS, summed up the impact of the Guideline on the suitability concept as follows: “[The Guideline] calls to the attention of all members various practices in this area and focuses on instances where businessmen believed the practices were improper. But no affirmative obligation to ascertain a customer’s resources and needs was imposed upon a salesman nor was the extremely difficult test of suitability imposed upon the securities business.” NASD, 1964 REPORT TO MEMBERS 8.

⁴⁹ Securities Exchange Act of 1934, § 15A (b) (12), added by 78 Stat. 577 (1964).

⁵⁰ *Ibid.*

⁵¹ The Special Study had criticized the NASD retail quotations as not providing a completely “reliable reflection of the underlying wholesale markets or an accurate indication of actual price range of consummated retail transactions.” *Special Study*, pt. 2, at 644. As printed in the newspapers, retail quotations in over-the-counter securities contained a bid price which was simply the wholesale bid and an asked price derived by taking a wholesale asked price and adding to it an arbitrary mark up—usually 5% for stocks up to \$25. *Id.* at 634. For the Special Study’s recommendation, see *id.* at 677. On February 15, 1965, the NASD instituted a new procedure pursuant to which retail quotations are based on representative inter-dealer prices as of approximately 3 p.m. A group of 19 dealers in Oregon unsuccessfully tried to enjoin the institution of this procedure. *Black & Co., Inc. v. NASD*, CCH FED. SEC. L. REP. ¶ 91,489 (D.C.D.C. Feb. 12, 1965), *aff’d*, CCH FED. SEC. L. REP. ¶ 91,490 (D.C. Cir. Feb. 12, 1965).

ment in disclosures made on confirmation of transactions in over-the-counter securities,⁵² and (3) prohibition of riskless principal transactions.⁵³ Each of these proposals touched on an area very sensitive to the NASD membership, and perhaps these proposals deserved a higher priority than a guideline on suitability. However, I think that the NASD should soon publish a guideline defining broker-dealer responsibility under its suitability rule.⁵⁴

The most serious objection to the promulgation of any such guideline—indeed to any NASD concern with suitability—is that such action might help convert an ethical standard into a rule of law the violation of which would subject a broker-dealer to civil suit.⁵⁵ Such a development, it is urged, would be an invitation for

⁵² The Special Study had recommended that "the confirmation of a customer's purchase (but not sale), whether handled on a principal or agency basis, should provide an indication of the prevailing spread between interdealer bids and offers by showing a representative bid quotation." *Special Study*, pt. 2, at 678. No action has been taken on this recommendation.

⁵³ For the Special Study recommendation, see *id.* at 676. No action has been taken on this recommendation. See CONFERENCE 66-67 (comment of Marc A. White).

⁵⁴ The NASD's 1964 REPORT TO MEMBERS contains little encouragement that such a guideline will be forthcoming. In a paragraph headed "Suitability Rule Change Resisted by NASD," the report states: "While the Association was sympathetic with the idea that all recommendations of purchases or sales to customers be made upon some reasonable basis, the Board believed strongly that to impose such an obligation on the investment banking fraternity would be unwise and impractical, and would interject the possibility of hindsight judgment in determining whether there could conceivably have been any reasonable basis for a sale or purchase." NASD, 1964 REPORT TO MEMBERS 8.

Although as pointed out in note 13 *supra*, the New York Stock Exchange regards its "know your customer rule" as providing protection primarily for its member organizations, it is also clear that the exchange will discipline registered representatives for making "inappropriate recommendations." See *Special Study*, pt. 1, at 239. The Exchange has not published any formal guidelines regarding suitability. However, a training manual for registered representatives warns against the making of wholesale recommendations of a single security to all of a representative's customers "without thought to each individual's overall investment situation." ASSOCIATION OF STOCK EXCHANGE FIRMS, *op. cit. supra* note 4, at 11. It also encourages a registered representative to discover his client's investment objective and, under certain circumstances, to help him define it. *Ibid.* Concern for suitability concepts has also been expressed in discussions on the supervision of registered representatives. In a talk given at a conference on this subject, Clinton P. Stephens, general manager of Alex Brown & Sons, stated: "I have said before that you ought to find out the risk-taking ability of the customer, and this also involves explaining the risks of the securities you recommend, in terms understandable by the customer. I think that many registered representatives make the mistake of trying to explain these risks in sophisticated terms to unsophisticated people." NEW YORK STOCK EXCHANGE, PROCEEDINGS OF CONFERENCE ON SUPERVISION AND MANAGEMENT OF REGISTERED REPRESENTATIVES AND CUSTOMER ACCOUNTS 80 (1963). See also *Special Study*, pt. 1, at 301 (comment of Donald Regan, executive vice president of Merrill, Lynch, Pierce, Fenner & Smith, Inc.).

⁵⁵ For a good illustration of the way in which the existence of ethical standards may be used to help construct a duty the violation of which amounts to fraud, see *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

disappointed customers to blackmail their broker-dealers. These fears are corroborated, it is claimed, by the number of broker-dealers who, after the publication of the Special Study, received letters making claims based on the unsuitability of securities which had been purchased from them. These claims were couched in almost verbatim quotes from the Special Study or newspaper accounts of that document.⁵⁶

A case which seems particularly to frighten the securities industry is the one in which the "greedy old lady" who has lost money speculating in the market comes into court posing as the "sweet trusting widow" who has put her life savings into what is now worthless stock and asks a jury to give her relief against her faithless (and wealthy) broker. Although the suitability doctrine requires that suitability be judged in the light of circumstances as they existed when the recommendation was made, the trier of fact will undoubtedly be influenced by the situation as it exists when the case is heard—and everyone knows that worthless stock is suitable for no one.⁵⁷ The industry fear of court—especially jury—review of such cases seems to be shared by the Commission. Its general counsel recently stated that:

The concept of suitability originated with the NASD as an ethical principle. That's where it basically belongs. . . . What it involves is applying the judgment of the men in the industry to the problem of what is an ethical way to do business and what isn't. There has been some suggestion or some apprehension that the Commission is trying to convert the concept of suitability into a rule of law. I think that apprehension is exaggerated.⁵⁸

Although such assurances undoubtedly have allayed some industry fears,⁵⁹ the apprehension remains that the courts, which have sometimes gone beyond the Commission in articulating broker-dealer

⁵⁶ See CONFERENCE 101 (comment of Thomas A. O'Boyle).

⁵⁷ The time at which review of the broker-dealer's action occurs is only one of the troublesome factors. Another is that the trier of fact will simply see the case as "Smith v. Multi-Million Dollar Firm" and not understand the business context within which the transactions were made.

⁵⁸ CONFERENCE 103 (comment of Philip A. Loomis, Jr.). Mr. Loomis stated that the only instances in which the Commission has converted the suitability concept into a rule of law are in the context of the boiler-room. *Ibid.*

⁵⁹ The industry has been under the impression that the Commission staff desires extension of the suitability rule as a legal responsibility. See CONFERENCE 105 (comments of Thomas A. O'Boyle and Philip A. Loomis, Jr.).

responsibilities under the anti-fraud sections of the securities laws, will not exhibit the Commission's restraint.⁶⁰

As yet there appears to have been no lawsuit in which a plaintiff has recovered damages on the ground that unsuitable securities were recommended and sold to him. Moreover, it has been held that violation of New York Stock Exchange or NASD rules does not give rise to a private cause of action—at least under federal law.⁶¹ Even though such holdings have occurred recently, there are a number of suits now pending which seek relief for, among other things, violation of a responsibility to recommend and sell only suitable securities. A number of suits involving claims of similar violations have been settled—in part perhaps because of the fear that a court will impose civil liability in a case involving an appealing fact situation.

Some persons in the securities industry seem to take the position that if no one says anything about suitability, the problem will disappear as soon as the suits "instigated" by the Special Study are disposed of. Under this approach promulgation of a guideline grappling with the problems presented by the suitability doctrine and defining its scope would be sheer folly. I disagree with that conclusion. Indeed, I think that refusal of the NASD to explain and enforce its suitability rule would increase the likelihood that a court would grant recovery in a case alleging a violation of the responsibility to make only suitable recommendations.

Consider the case described above from the judge's point of view. The pleadings show that a widow has lost money, which she now needs in order to live, by investing in stocks which appear not to have been of the highest quality. The broker on whom she claims to have relied failed to warn her to refrain from making such purchases. Indeed, he may have encouraged her. Further, he has

⁶⁰ One example of judicial willingness to go beyond Commission concepts appears in the concurring opinion of Judge Clark in *Kahn v. SEC*, 297 F.2d 112, 114 (2d Cir. 1961), in which he explained his understanding of the Commission's shingle theory: "The essence of this theory is that in certain circumstances one who sells securities to the public—who hangs out his shingle—implicitly warrants the soundness of statements of stock value, estimates of a firm's earnings potential, and the like..." *Id.* at 115. The suggestion that a broker-dealer implicitly warrants the soundness of statements of stock value goes beyond any language in Commission opinions. See JENNINGS & MARSH, *SECURITIES REGULATION* 693-94 (1963). See also CONFERENCE 10 (comment of Manuel F. Cohen).

⁶¹ *O'Neill v. Maytag*, CCH FED. SEC. L. REP. ¶ 91,466 (2d Cir. 1964); *Colonial Realty Corp. v. Bache & Co.*, CCH FED. SEC. L. REP. ¶ 91,351 (S.D.N.Y. 1964). For a discussion of the possibility of alleging a violation of state law for failure to live up to the responsibilities created by the suitability concept, see note 75 *infra*.

earned a substantial amount in commissions for his services in these transactions. The defense is that the broker-dealer's only duty was not to lie or tell any half-truths about the stocks (which he did not do), and that the decision to buy was the customer's. Perhaps some broker-dealers would think it incumbent upon them, as an ethical matter, to warn the customer against making such purchases, but that is a business judgment for each broker-dealer to make. It would not be surprising to find a court confronted with this situation looking for some way in which this widow and others like her could be protected. In the light of existing law—the development of the implied warranty of fitness for a special purpose, the implications of some of the language in *Anderson v. Knox*,⁶² and (perhaps most helpful) the articulation of suitability standards by the Commission under the anti-fraud provisions of sections 10 and 15 of the Securities Exchange Act—a court might experience little difficulty in holding that the widow had a cause of action against the broker-dealer. The Guideline itself may be helpful in supporting such an action, because the responsibility for fair dealing about which it talks sounds very similar to the Commission's shingle theory,⁶³ violations of which may give rise to private causes of action. The Guideline says nothing which would support a dichotomy between ethical and legal responsibility in this area.

Assuming—and I do so assume—that it is more desirable for the standards of conduct under the suitability doctrine to be developed within the framework of the self-regulatory process than through action by the courts, it would seem to be essential that the courts be persuaded that self-regulation is capable of—and is—dealing with the problem of providing protection for the investing public. The Maloney Act⁶⁴ under which the NASD was created sought to encourage “obedience to ethical standards beyond those any law can establish.”⁶⁵ It recognizes that the legal process as it functions in the

⁶² 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962). See text accompanying notes 28-29 *supra*.

⁶³ For an analysis of the shingle theory, see Cohen & Rabin, *supra* note 6, at 702-07.

⁶⁴ 52 Stat. 1070 (1938), 15 U.S.C. § 780-3 (1958).

⁶⁵ Address by William O. Douglas to the Bond Club of Hartford, Conn., Jan. 7, 1938. Both the Senate and House reports on the Maloney Act pointed out that one aspect of the problem of regulating the over-the-counter markets was “to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market . . .” S. REP. NO. 1455, 75th Cong., 3d Sess. 3 (1938); H.R. REP. NO. 2307, 75th Cong., 3d Sess. 4 (1938).

courts may be a clumsy instrument for constructing and enforcing business ethics. The framers of the act wanted to give the more subtle instrument of self-regulation the first opportunity to resolve some of the delicate questions involved in developing standards of broker-dealer conduct.⁶⁶ However, self-regulation was conceived as only one aspect of a process of cooperative regulation.⁶⁷ The essence of cooperative regulation is that where the self-regulatory process fails to meet a regulatory need, direct regulation must fill the gap. Commission articulation of suitability standards under the anti-fraud provisions of the securities laws is one example of how this process has worked. Judicial articulation of a standard under which customers may recover damages from broker-dealers who have sold them unsuitable securities may prove to be an additional example of how the process works.

One difficulty in persuading a court that the self-regulatory process can effectively cope with the problems raised by the suitability cases may be the inability of the NASD to make a plaintiff, such as the widow in the hypothetical case described above, whole by ordering restitution. Although neither the board of governors nor the district committees have power to order restitution in connection with disciplinary proceedings, it is generally recognized that if a member makes restitution he may be less severely penalized than he would otherwise have been. This practice seems to be proper and desirable, and it should be embodied in a formal interpretation. Indeed, the NASD might go further and adopt a rule under article VII, section 3 of its by-laws permitting the imposition of a penalty in an amount sufficient to make whole customers who have been damaged by the improper acts of the member being disciplined.⁶⁸ The NASD would then pay the customer that part of the fine necessary to effect restitution.⁶⁹ One advantage in the NASD assuming the power to, in effect, order restitution is that it, unlike a court, need not order full restitution. It can take into

⁶⁶ See *Special Study*, pt. 4, at 716-17.

⁶⁷ See *id.* at 692-728.

⁶⁸ Under present rules no member or registered representative may be fined in excess of \$1,000. NASD Rules of Fair Practice, art. V, § 1, NASD Manual D-23.

⁶⁹ If the fine imposed is beyond the ability or desire of the member to pay, the NASD has no sanction, other than suspending the member until he does pay. See NASD Manual H-7. Consequently, in cases involving broker-dealers who would rather be suspended from the association than pay a huge fine, the NASD would have no power to assure that the customer would be made whole.

account the degree to which the customer took reasonable steps to protect himself and the extent to which the broker-dealer sought to put the customer in a position so that he could protect himself.⁷⁰

If the NASD decides to face the problems presented by the suitability doctrine squarely, it should be able to look to the Commission for substantial help and encouragement, since the Amendments Act thrusts upon the Commission a type of regulatory responsibility akin to the self-regulatory responsibility of the NASD. The original draft of the Amendments Act required all registered brokers and dealers to join a registered securities association,⁷¹ but objections from certain elements in the securities industry—particularly certain mutual fund underwriters⁷²—resulted in a compromise. Under the new act no registered broker or dealer is required to join a registered securities association, but every broker or dealer who is not a member of such an association is subject to direct regulation by the Commission.⁷³ The act places a responsibility on the Commission, identical to that imposed on the NASD, of promulgating rules and regulations “designed to promote just and equitable principles of trade.”⁷⁴ Thus, for the first time the Commission is faced with the problem of articulating ethical standards—standards that go beyond fraud concepts. In practical terms this means that the Commission must determine whether it will continue to support the Special Study recommendation for definition of the suitability doctrine and whether violations of the standards articulated should give rise to civil liability.

Assuming that the standards which the Commission enunciates under the mandate of the new act are (at least insofar as they establish responsibilities under the suitability concept) ethical standards,

⁷⁰ The suggestion that the NASD assume the power to order restitution would make it the arbitrator of disputes between customers and member firms, a role which it has never assumed and for which its present procedures for handling disciplinary proceedings may not be adequate. The NASD role under this suggestion would differ from that of the New York Stock Exchange in making available facilities for arbitrating disputes arising out of the business of member organizations. See New York Stock Exchange Constitution art. VIII, N.Y. STOCK EXCH. GUIDE ¶¶ 1351-57 (1960); New York Stock Exchange Rules 481-91, N.Y. STOCK EXCH. GUIDE ¶¶ 2481-91 (1963).

⁷¹ S. 1642, H.R. 6789, H.R. 6793, 88th Cong., 1st Sess. § 6 (a) (1963).

⁷² See *Hearings on H.R. 6789, H.R. 6793, S. 1642 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 88th Cong., 1st & 2d Sess., pt. 2, at 836-40, 843-45 (statement of Arthur V. Toupin, General Counsel, Insurance Securities, Inc.). See also *id.* at 775-77, 781-83.

⁷³ Securities Exchange Act of 1934, §§ 15 (b) (8)-(10), added by 78 Stat. 572-73 (1964).

⁷⁴ Securities Exchange Act of 1934, § 15 (b) (10), added by 78 Stat. 573 (1964).

the violation of which should not give rise to civil liability, it would be desirable for the Commission to announce its position to that effect in the release accompanying the promulgation of the rules. Indeed, it would be helpful and proper for this determination to be included among the rules themselves.⁷⁵ Once the Commission determines that it can best accomplish its responsibility for promoting high standards of conduct among non-member broker-dealers by insulating such broker-dealers from civil liability in the suitability area, authority for promulgating a rule to that end seems to exist in the broad wording of section 23 (a) of the Securities Exchange Act which states that the Commission shall have the power "to make such rules and regulations as may be necessary for the execution of the functions vested in them by this title."⁷⁶

Commission action along these lines might be helpful in supporting the claim that a violation of the NASD's suitability rule should not give rise to civil liability.⁷⁷ Moreover, it is arguable that the Commission could adopt a rule under section 23 (a) insulating NASD members from civil liability in such cases. Since the Com-

⁷⁵ Action by rule is desirable because a court may be more reluctant to substitute its own judgment for that of the Commission in reviewing a rule than it would be in reviewing the effect of a statement in a release.

⁷⁶ A case against the authority of the Commission to promulgate such a rule might be posited on the language in § 27 of the Securities Exchange Act which grants U.S. district courts exclusive jurisdiction of all suits "brought to enforce any liability or duty created by this title or the rules and regulations thereunder." Since the Supreme Court has held that this section creates private rights of action, *J. I. Case Co. v. Borak*, 377 U.S. 426 (1964), it may be argued that the Commission has no power to destroy any right of action created by § 27 for violation of a rule promulgated under § 15 (b) (10). Although such an argument may be persuasive in connection with the promulgation of rules defining broker-dealer standards of conduct under fraud concepts, it would not be persuasive in connection with the Commission's new obligation to look beyond fraud concepts in defining broker-dealer standards of conduct under § 15 (b) (10).

The Commission might be reluctant to include an exculpatory rule for broker-dealers who are not members of the NASD, because, unlike the NASD, the Commission has no power to levy fines. See Phillips & Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706, 826.

⁷⁷ Imposition of civil liability on the broker-dealer may be based not only on violations of fraud concepts in the securities laws, but also on the theory that a broker-dealer's failure to live up to what are thought to be generally accepted standards of responsibility under the suitability concept constitutes a violation of state tort law principles. See Morris, *Custom and Negligence*, 42 COLUM. L. REV. 1147 (1942). Articulation of standards governing the conduct of broker-dealers gives rise to certain expectations on the part of the broker-dealer's customers. When these expectations are disappointed and as a result the customer is harmed, he is entitled to damages. The crux of this theory is that the customer has justifiably relied upon the broker-dealer to his detriment. Liability need not arise under this theory, however, if the standard of conduct is clearly labelled as exclusively ethical in nature.

mission has no specific power to alter or supplement the NASD's Rules of Fair Practice,⁷⁸ the authority for adoption of such a rule would have to derive from the Commission's general responsibility for regulation of the securities markets and the Commission's belief—shared by Congress and the Special Study—that a key to such regulation is the creation of a broker-dealer community which is willing to assume many of the responsibilities of professionalism. If the promulgation of such a rule would encourage the NASD to take a stance which would support the assumption of desirable professional responsibilities by its members, then the rule could be supported by the broad language of section 23 (a).

The major problem in attempting to provide insulation from civil liability in the suitability area by means of a rule is the difficulty in articulating a meaningful line of demarcation between failure to meet responsibilities imposed by the suitability doctrine and violations of fraud concepts. In every case in which suitability concepts have been articulated there have also been fraud grounds for disposing of the case. In those cases there have been lies, half-truths and failures to disclose with respect to the security involved. Insofar as the suitability doctrine reflects an attempt to provide a substitute for disclosure concerning the security there is a tendency for the fraud and suitability doctrines to merge. The point of merger is in the area concerning the failure to disclose. Fraud has been implied where the special relationship between two parties raises a duty to disclose facts and the disclosure is not made.⁷⁹ It may be argued that

⁷⁸ The Commission's power to alter or supplement NASD rules under § 15A (k) (2) of the Securities Exchange Act is confined to organizational aspects of the NASD. *Special Study*, pt. 4, at 705-06. However, the Commission has used its power to review NASD disciplinary proceedings to help define concepts of "high standards of commercial honor" and "just and equitable principles of trade." See Cohen & Rabin, *supra* note 6, at 707-08.

⁷⁹ See *Strong v. Repide*, 213 U.S. 419 (1909). In its only consideration to date of the anti-fraud provisions of the federal securities laws, the Supreme Court took the view that when Congress attempted to codify the common law of fraud in the Investment Advisers Act of 1940, it did so "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). The *Capital Gains* case involved scalping by an investment adviser—that is the practice of buying shares of a stock shortly before subscribers to the advisory service sold by the investment adviser are urged to buy the stock for long term investment, and sale of the stock by the adviser shortly after the recommendation is made so that advantage can be taken of the temporary market effect of the buy recommendation. The Commission argued that the fiduciary relationship between the adviser and the subscribers to his service required him to disclose his

the suitability doctrine presupposes such a relationship between the broker-dealer and his customer.

The problem can be illustrated in terms of the "trust and confidence" cases in which the broker-dealer has churned his customer's account or otherwise abused the relationship.⁸⁰ These cases have been decided under suitability rules and under the anti-fraud provisions of the securities laws. To the extent that they are properly treated under the latter, these cases give rise to civil liability. The finding of trust and confidence in these cases rests either on the fact that the broker-dealer has expressly been given control over his customer's account or on the fact that the relationship between the customer and the broker-dealer developed in a manner which resulted in the broker-dealer having de facto control over the account. These cases (which are properly treated as fraud cases) are different from those at which the suitability doctrine is directed, because here the broker-dealer consciously engages in a course of conduct which is designed to create an expectation in the customer that he may rely on him to a far greater extent than would be expected in the normal broker-dealer-customer relationship. Accordingly, in a case where the broker-dealer has had a long-standing relationship with a customer and the customer has come to rely on him, it may be that a court would hold the broker-dealer civilly liable for failure to make a suitable recommendation or—less likely—for failing to prevent the customer from making an unsuitable purchase. Such a case is easily distinguished, however, from the case in which the broker-dealer has had only minimal contacts with the customer. For example, although the aspect of the boiler-room cases which involves wholesale recommendation of a security to unknown customers violates broker-dealer responsibilities in the suitability area (ethical), it does not, in my view, constitute the kind of conduct which should give rise to civil liability (fraud).

Even if a distinction along these lines is too subtle (or perhaps ephemeral) to support an exculpatory rule,⁸¹ there is still merit in

scalping activities. The lower courts had held that failure to make such disclosure did not violate the anti-fraud provisions of the Investment Advisers Act of 1940, *SEC v. Capital Gains Research Bureau, Inc.*, 191 F. Supp. 897 (S.D.N.Y. 1961), *aff'd*, 300 F.2d 745 (2d Cir. 1961), *affirmance upheld on rehearing*, 306 F.2d 606 (2d Cir. 1962), *rev'd*, 375 U.S. 180 (1963), a conclusion with which the Supreme Court disagreed.

⁸⁰ See cases cited note 14 *supra*.

⁸¹ If the suitability doctrine does represent only an ethical standard, the Commission should logically refrain from using suitability concepts in the prosecution of boiler-

promulgation of an NASD guideline on suitability. The existence of such a guideline (and NASD enforcement of the responsibilities outlined in it) may, as indicated previously, be effective in persuading a court that its intervention is necessary only in a very narrow class of cases in the suitability area. More important, it would provide the broker-dealer community with some meaningful help in understanding and meeting its responsibilities under this evolving doctrine.

Outline of a Proposed Guideline

Such a guideline should begin by pointing out that individual investors have different risk thresholds and that different securities or combinations of securities are suitable for these varying thresholds. It should go on to state that when a broker-dealer recommends a security to a customer he has a responsibility to determine that the security recommended is within the particular customer's risk threshold. The guideline must make clear the unacceptability of the attitude manifested by one salesman who told the Special Study that the basis on which he selected securities for recommendation to customers was: "Whatever they come in, like a grocery store. Now we got beans and now we got bread."⁸² The only time when the broker-dealer should be relieved of this responsibility is when his only rela-

room cases. The Commission may be unwilling to exercise such restraint, however, in view of the fact that use of suitability concepts minimizes the Commission's burden of proof. This point is illustrated in a recent case involving a review of NASD disciplinary proceedings. *C. Gilman Johnston, SEC Securities Exch. Act Release No. 7390 (Aug. 14, 1964)*. In that case the defendant aggressively merchandised its own stock and convertible debentures (both described in the opinion as involving an "extraordinarily high degree of risk") to a large number of small investors. The salesmen were, as defendant knew, "inexperienced and unfamiliar with the risks involved in the securities." No evidence was presented concerning the identity or investment needs of any of the customers. The NASD's finding of a violation of its suitability rule was sustained on the theory that neither the salesmen nor the firm had any reasonable basis for believing that the securities were suitable. Absent the ability to rely on violation of the suitability rule, it would have been necessary to prove what was communicated, tie the communications made orally over the telephone to the broker-dealer and assemble evidence about the issuer to show that the representations made were false and misleading. See Note, *A Symptomatic Approach to Securities Fraud: The SEC's Proposed Rule 15c2-6 and the Boiler Room*, 72 *YALE L.J.* 1411 (1963).

Rule 15c2-5 (a) (2), which requires a salesman to obtain information about his customer and determine the suitability for the customer of the transactions to which the rule applies, also seems to constitute an undesirable utilization of the fraud concept if the NASD itself sets forth and enforces an adequate suitability doctrine.

⁸² *Special Study*, pt. 1, at 264. The proprietor of the firm in which that salesman was employed explained to the Special Study: "I think that any underwriting is a suitable investment, however speculative it might be." *Ibid.*

tionship with the customer is that of an order clerk. If a customer calls a broker-dealer and tells him to buy 100 shares of XYZ stock, the broker-dealer should be able to do so without attempting to determine whether that security is suitable for the customer. However, if the broker-dealer has had a prior relationship with the customer going beyond that of serving as an order clerk, and if on the basis of information which he knows or should know about the customer's risk threshold he determines or should determine that the security is unsuitable, he should be required to inform his customer that he thinks the security is unsuitable. Once he has informed the customers of his determination, he should be free to sell him the security.⁸³

Since the suitability doctrine requires the broker-dealer to relate the risk aspects of the security to his customer's risk threshold, it necessarily implies that the broker-dealer must make a reasonable effort to obtain information concerning the customer's risk threshold.⁸⁴ The guideline should clearly indicate that the words "if any" in the NASD's suitability rule serve only to reflect an awareness that in some situations a broker-dealer may not be able to secure all the information that may be helpful concerning his customer's willingness and ability to take risks, and that he may have to proceed on the basis of the information that he does receive.⁸⁵ Under no circumstances should the broker be permitted to evade his obligations by attempting to learn as little as possible about the risk thresholds of his customers. On the contrary, the guideline should encourage broker-dealers to establish procedures under which new customers

⁸³ When practical, it is desirable to inform the customer in writing (or have the customer sign a statement) that he is purchasing the security despite an adverse recommendation by his broker-dealer.

⁸⁴ Determining what constitutes a reasonable effort to obtain information under particular circumstances may be difficult. A busy customer who transacts all his business with the broker-dealer over the telephone presents a different situation from the customer who comes into the broker-dealer's office and appears willing to spend a considerable amount of time chatting. The development of guidelines which suggest how much of an effort a broker-dealer must make to discharge his responsibility is precisely the kind of problem to which it is desirable that, at least initially, the industry (rather than a court, regulator or professor) address itself.

⁸⁵ If the broker-dealer has no information about his customer's investment objectives or financial needs and resources it is impossible for him to recommend a security to the customer. See pages 475-76 *infra*. That is the precise problem in the boiler-room cases. If such information is not forthcoming after a reasonable effort, however, the broker-dealer may sell securities to the customer if it is clear to the customer—as it usually will be—that he may not rely on the broker-dealer to prevent him from purchasing unsuitable securities.

will, as a matter of routine, be asked for information about their financial situation, and under which such information will be kept up-to-date.⁸⁶ The principal aim of these procedures should be a definition of each customer's risk threshold. The risk threshold concept is broader than the concept of investment objective. Investment objective expresses what the customer wishes to achieve from his investment in relation to his willingness to bear risk. Risk threshold refers to the customer's willingness and ability to bear risk. Choice of an investment objective is personal and must be made by the customer, but the broker-dealer should make sure that the customer fully understands the meaning—including particularly the risk elements—of an objective selected. This would make it unlikely that the customer would choose an investment objective exceeding his ability to bear risk.⁸⁷ The process by which the broker-dealer gets to know his customer and by which the customer learns something about the activity in which he is risking his money is the essence of the suitability doctrine.

Although the guideline should stress the affirmative aspects of the broker-dealer's responsibilities under the suitability doctrine, it should also recognize that the recommendation of a particular security to a particular customer involves an exercise of judgment by the selling broker-dealer at the time of the sale. The guideline should make it clear that if the selling broker-dealer's judgment is subsequently questioned in a proceeding before the NASD's district committee or board of governors, he will only be found to have violated his responsibility if no reasoning broker would have recommended the particular security to the particular customer in

⁸⁶ One large brokerage firm seeks to obtain the following specific information: Dollar Value of Portfolio \$_____ Annual Income \$_____ Own Home \$_____ Additional Cash Available for Investment \$_____ Approx. Tax Bracket_____ Age_____ Years To Retirement_____ No. of Dependents_____ Annual Savings \$_____ Ages of Dependent Children_____ Amount of Life Insurance \$_____ Amount Needed for Children's Education \$_____ When?_____ Other Comments:_____ It also seeks to determine the customer's investment objective using the following broad categories: conservation of capital with stable income, long term growth of capital—income secondary, moderate capital appreciation with reasonable income, short term trading profits, speculative capital gains. See NASD, A GUIDE TO SUPERVISION PROCEDURES 57 (1964). See also Transcript, pp. 58-60, *United States v. Pandolfo*, Crim. Nos. 95, 105, D.N.D., Sept., 28, 1959 (testimony of Harold E. Wood).

⁸⁷ The broker-dealer's responsibility in the case where a security meets the customer's investment objective but exceeds his risk threshold is discussed on pages 475-76 *infra*.

light of information about the customer which the broker-dealer knew or should have known. This review must be made in the light of the circumstances which existed at the time the recommendation was made. Price performance of the security after it was purchased—whether favorable or unfavorable—should be irrelevant in determining whether the recommendation was suitable when made.

The guideline should also suggest ways in which some of the common but troublesome cases should be handled. One situation with which the guideline should deal is the case mentioned earlier involving the "sweet trusting widow" who turns out to be a "greedy old lady." Typically, the "sweet trusting widow" has opened an account with an investment objective stressing conservation of capital and stability of income. At some point—and for various reasons—she asks for recommendations of a speculative nature which will permit her to become rich quickly. At first glance, it may seem that no suitability problem arises if the securities recommended meet the new investment objective. However, the literal wording of the NASD's suitability rule suggests, as does the concept of risk threshold, that the broker-dealer cannot, without more, act on her announced change in investment objective. The problem is similar to that which occurs when a customer opens an account and the broker-dealer helps him to decide on the proper investment objective. Here the broker-dealer's responsibility to help the widow is even stronger because of the established relationship between them. Thus, the guideline should state that the broker-dealer must assume the responsibility for ascertaining that the widow understands the investment risks involved in her changed objective. These risks should be explained by the broker-dealer in the light of her financial situation as known to him. The conversation between the broker-dealer and the widow may result in: (1) The widow's return to her old investment objectives. In this case she would not purchase any of the speculative securities she initially demanded. (2) The widow's adherence to her changed investment objective with the broker-dealer persuaded that she is able to bear the risks inherent in the new investment objective. In this case he should be permitted to recommend those speculative securities which he thinks are appropriate. (3) The widow's adherence to her changed investment objective without, however, the broker-dealer being persuaded that she is able

to bear the risks inherent in the new investment objective. In this case the broker-dealer should be required to inform the customer that no speculative securities are suitable for her. If, nevertheless, she insists on purchasing such securities, the broker-dealer should be allowed to advise her about various speculative securities and purchase for her the ones which she selects. However, he should not, as long as he thinks that the securities are beyond her risk threshold, be permitted to solicit her purchase of any such speculative securities.

Acceptance of such responsibility by broker-dealers would make good business sense. If the "greedy old lady" becomes the "poor old lady" because her stocks decline in value, she may turn to a regulatory agency or the courts as the "sweet trusting widow" who has been bilked by an unscrupulous broker-dealer. The time spent discussing any customer's financial situation and needs whenever a switch in usual investment patterns occurs may prove valuable, in the event that an action is brought, in showing that the banker-dealer has discharged any responsibility which he may have incurred. Further—and more important—such discussions may preclude the bringing of any action by either discouraging the customer from making an unsuitable purchase or preparing him for the disappointment which may result from the purchase.

The primary purpose of the suggested guideline should be to make the broker-dealer community aware of its obligations under the suitability concept. An important first step in raising standards of conduct is the definition of those standards. Failure to provide such a definition is the major deficiency of the NASD's existing Guideline. A second objective of the guideline should be to demonstrate that adherence to the principles set forth in the guideline is—at least in the long run—good business. The communication between broker-dealer and customer fostered by the guideline can be a solid foundation on which to build investor confidence.⁸⁸ The third

⁸⁸ An interesting parallel in this respect appears in the doctrine of informed consent which has recently been developing in the medical malpractice field. See Oppenheim, *Informed Consent to Medical Treatment*, 11 CLEV.-MAR. L. REV. 249 (1962); 75 HARV. L. REV. 1445 (1962). Essentially this doctrine requires a doctor to inform a patient of the nature of the risks which a particular treatment entails so that the patient can intelligently decide whether or not to consent to such treatment. Although the development of this doctrine was viewed with some alarm, the conclusion seems to be that the full discussion contemplated by the doctrine "will probably eliminate many of the disappointments and misunderstandings by patients (out of which lawsuits grow)." Oppenheim, *supra* at 264.

function of the guideline would be to suggest procedures to broker-dealers which will help them fulfill their responsibilities under the suitability doctrine. In this connection the drafters of the guideline should be able to draw upon the procedures already adopted by a number of firms to meet self-imposed suitability doctrines.

A number of objections may be raised to promulgation of the suggested guideline. A principal fear is that fulfilling the responsibilities imposed by such a guideline would result in decreased sales. Aggressive merchandising practices would be severely inhibited; the broker-dealer and his customers would become more risk conscious; some customers would be frightened away by the requirement that they undress themselves financially before the broker-dealer. It may well be that the restrictions on selling activity implicit in the proposed guideline would make it very difficult to sell securities to a customer who, immediately prior to the sale, is unknown to the salesman. The over-all impact on sales which would result from imposing upon the broker-dealer the responsibilities outlined in the proposed guideline cannot accurately be predicted.⁸⁹ The only basis for forming any sort of judgment in this respect is the experience of those firms which have voluntarily adopted programs designed to implement the assumption of some or all of the responsibilities referred to in the suggested guideline. There appears to be no feeling that the adoption of such programs has resulted in a net loss of sales. Indeed, as suggested previously the opposite result may be anticipated. If the suitability doctrine can foster a feeling of confidence by the public investor in his broker-dealer—because the broker-dealer is required to look out for his customer—the long-run impact on sales should be favorable.

Related to the objection that the proposed guideline would have an adverse impact on sales is the objection that it would force broker-dealers to recommend only the more conservative securities, thus drying up a source of financing for venture capital enterprises. A number of the large New York Stock Exchange member firms already have a policy of restricting or prohibiting the sale of low-priced securities by their salesmen. Although it may be true that imposition of the responsibilities of the suitability doctrine would result in a

⁸⁹ Regulation of mutual funds at least has been credited with having a favorable long-run effect on sales. WIESENBERGER, *INVESTMENT COMPANIES* 17, 38 (1964). See also CONFERENCE 12 (comments of Manuel F. Cohen).

decrease in the sale of securities in venture capital enterprises to the investing public, it does not necessarily follow that a shortage in the supply of risk capital would therefore occur. Studies made by the Securities Research Unit of the Wharton School of Finance and Commerce indicate that at present there is no such shortage,⁹⁰ and it is doubtful that to the extent there is a shortage it should be met by investment from the broad range of public investors.

It may also be urged that the larger firms, more easily than the smaller ones, can devise programs which will permit adherence to the responsibilities imposed by the suggested guideline.⁹¹ Thus, the guideline would contribute to the existing trend toward dominance of the securities industry by large retail firms which can afford a centralized research operation and thorough-going supervisory procedures. The importance of such firms will continue to grow regardless of whether the guideline is promulgated. Although increased regulation probably contributes to the growth of these firms, such growth is primarily attributable to factors rooted in the economics of doing business in the securities industry.⁹² To the extent that the objection implies that the smaller firms can compete only if they merchandise more obscure, speculative securities and, therefore, are more prone to violating the suitability doctrine, the objection can legitimately be disregarded. The larger the element of risk in a security the smaller the circle of people for whom it is suitable and the greater the disclosure concerning it required. The key is the type of security dealt in, not the size of the firm involved. The primary focus of securities regulation must be upon protection of investors. If they require greater protection when obscure, speculative securities are offered to them, such protection should be afforded

⁹⁰ SECURITIES RESEARCH UNIT OF WHARTON SCHOOL OF FINANCE AND COMMERCE, STUDY OF INVESTMENT BANKING AND THE NEW ISSUES MARKET: SELECTED HIGHLIGHTS. This study, which will contain 8 monographs, including one on Price Experience and Return on New Stock Issues, will be published in 1965. The NASD has recently commenced its own study to determine the validity of the fears expressed by some of its members that the newly instituted program of publishing inter-dealer quotations and implementation of the other Commission recommendations described on pages 462-63 *supra* would seriously impair the ability of small enterprises in regions remote from the major capital centers in the United States to raise capital.

⁹¹ On the other hand, smaller firms may find it easier to discharge their responsibilities under a suitability doctrine, because often they have a small clientele who are well known by the management. The problems which large firms may have in controlling their salesmen are discussed in *Special Study*, pt. 1, at 268-90.

⁹² CONFERENCE 17-18 (comment of Charles E. Rickershauser, Jr., California Commissioner of Corporations).

even if an incidental effect is to make it more difficult for firms selling such securities to do business.

Another objection to promulgation of the proposed guideline may be that the concept of suitability is too vague to be meaningful. Although it is true that broker-dealers may disagree with respect to the particular security which they would recommend to a particular customer at a particular time, it is also true that they can agree that the recommendation of certain securities to that customer at that time would be unsuitable. The standard of review set forth in the guideline specifically recognizes the wide latitude to be given the selling broker-dealer's judgment. The principal thrust of the guideline would not be to provide a vehicle for second-guessing the judgments of broker-dealers. Rather, it would endeavor to create a more professional attitude on the part of the broker-dealer—a primary concern with the welfare of his customer—and to encourage more meaningful communication between him and his customer.

CONCLUSION

The Special Study, the Amendments Act, and Commission and court decisions defining the standards of conduct to which broker-dealers must adhere all point to the conclusion that the broker-dealer community will be forced to live up to the professional image which it has tried to create.⁹³ It has traditionally been hoped that the self-regulatory bodies will provide the leadership in creating these standards of professionalism. Although that hope has often been disappointed in the past, it has been reaffirmed in the many recent expressions of faith in "cooperative regulation."⁹⁴ Another test of the efficacy of this philosophy seems to be present in the suitability area. Developments in the law generally and in the broker-dealer area particularly suggest a broad consensus that broker-dealers are expected to live up to at least some of the responsibilities inherent in the suitability doctrine. Many of the most influential firms in the securities industry think that it is desirable and feasible for members of the industry to adhere to some degree to such standards, and they have adopted programs designed to assure that their employees will do so. Nevertheless, the NASD, the industry representative, has been

⁹³ CONFERENCE 1-2 (comment of Robert H. Mundheim).

⁹⁴ CONFERENCE 23-34 (comment of Marc A. White); *id.* at 41 (comment of Richard W. Jennings, Coffroth Professor of Law at the University of California, Berkeley).

unwilling to define and enforce acceptable standards under such a doctrine. As has been the case in the past, the unwillingness of the securities industry to take the initiative in regulation will encourage other forces of regulation—in this case the courts responding to the pleas of private litigants—to fill the regulatory gap. The problem is that if the regulatory gap is filled by the courts, it may be done in a manner which may prove much more costly to the industry—and therefore ultimately to the investing public—than if the industry itself acts.

The invitation for self-regulatory initiative does not exclude the Commission. Under the Amendments Act it has, for the first time, functions akin to those of a self-regulatory body and an opportunity to participate directly in the formulation of ethical standards for the broker-dealer community. It should capitalize on the opportunity to provide effective leadership by cooperating with the NASD in promulgating a meaningful guideline on suitability.