

TRANSFORMING RHETORIC INTO REALITY:

A FEDERAL REMEDY FOR NEGLIGENT BROKERAGE ADVICE

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INTRODUCTION

Nearly everyone wishing to invest in the securities markets must use the services of brokerage firms out of necessity. Even investors who select their own investments require brokerage services to execute their transactions. Other investors place greater reliance on their brokers and look to them to provide investment advice. Many brokerage houses, particularly large full-service firms, distinguish their services from discount brokers by encouraging customers to rely on their advice. Such companies advertise heavily to promote both their investment acumen and their attention to customers' needs.¹ Because incompetent or careless brokers can cause tremendous harm to their customers' financial well-being, often with grave implications for their retirement security, customers who are encouraged to rely on information provided by their brokers are entitled to expect that brokers will perform these services competently and carefully.

The principal participants in the regulation of the brokerage industry agree that broker competence and care are central to the federal regulatory system. When Congress enacted the Securities Exchange Act of 1934 ("SEA"), it recognized² that public confidence in the U.S. capital markets depends on competent and careful

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¹ See Barbara Black, *Brokers and Advisers – What's in a Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 32 (2005); PACE INVESTOR RIGHTS PROJECT, ADVERTISING STUDY (2004) (unpublished, on file with author).

² As expressed by a Commissioner of the Securities and Exchange Commission ("SEC") who was a staff attorney in its Enforcement Division for many years, "[I]t is clear that, in enacting the securities laws, Congress intended to raise the standards of conduct of those playing important roles in the securities markets . . ." Manuel F. Cohen & Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROBS. 691, 694 (1964).

securities salespersons.³ Moreover, the need for professionalism in the selling of securities is a consistent theme in subsequent amendments to the SEA: in 1964,⁴ Congress strengthened qualification standards for broker-dealers;⁵ in 1975, it adopted major reforms to the self-regulatory system to better “police the conduct and strengthen the professional standards of professional participants in [the United States] securities markets;”⁶ in 1990, it added provisions to curb brokers’ sales practices in penny stocks, a segment of the market particularly rife with abuses.⁷ The U.S. Supreme Court has frequently stated that one of the purposes of the federal securities laws is achieving “a high standard of business ethics in the securities

³ The brokerage firm’s salespersons are technically “associated persons” as defined in Securities Exchange Act of 1934 § 3(a)(18), 15 U.S.C. § 78c(a)(18) (2006). However, they are more colloquially referred to as brokers.

⁴ In 1961, Congress directed the SEC to conduct a study and report on the adequacy of the rules of the Self-Regulatory Organizations (“SROs”) for the protection of investors, including disciplinary rules for conduct inconsistent with just and equitable principles of trade. *See* Securities Exchange Act of 1934 § 19(d), 15 U.S.C. § 78s(d) (2006). The SEC’s final product, the Special Study of the Securities Markets, led to the 1964 amendments to the SEA that subjected non-exchange broker-dealers to additional regulation: all broker-dealers in the over-the-counter markets (“OTC”) would be subject to standards of “training, experience, competence, and such other qualifications as the Commission finds necessary.” Securities Exchange Act of 1934 § 15(b)(7), 15 U.S.C. § 78o(b)(7) (2006). Broker-dealers that were regulated only by the SEC (“SECO”) would be subject to SEC rules designed “to promote just and equitable principles of trade.” Securities Exchange Act of 1934 § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (2006). In 1983, Congress required all OTC broker-dealers to belong to a national securities association, thus eliminating SECO broker-dealers. Securities Exchange Act of 1934 § 15(b)(10), 15 U.S.C. § 78o(b)(8) (2006).

⁵ The House of Representatives observed “a dramatic increase in public participation in the securities markets, particularly among persons having but slight acquaintance with the intricacies of corporate finance and stock market operations. This development demands that the selling of securities be conducted in a more professional manner” H.R. REP. NO. 1778, at 3 (1962), *reprinted in* 2 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 1759, 1761 (1983).

⁶ H. R. REP. NO. 94-123, at 44 (1975), *reprinted in* 3 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 2471, 2514 (1983). Specifically, the rules of national securities exchanges, the SEC (with respect to SECO broker-dealers), and national securities associations were required to promote “just and equitable principles of trade,” Securities Exchange Act of 1934 § 6(b)(5), 15 U.S.C. § 78f(b)(5) (2006); Securities Exchange Act of 1934 § 15A(b)(6), 15 U.S.C. § 78o-3(b)(6) (2006); *see* Securities Exchange Act of 1934 § 15(b)(9), and standards with respect to “training, experience, and competence.” Securities Exchange Act of 1934 § 6(c)(3)(A), 15 U.S.C. § 78f(c)(3)(A) (2006); Securities Exchange Act of 1934 § 15(b)(7), 15 U.S.C. § 78o(b)(7) (2006); Securities Exchange Act of 1934 § 15A(g)(3)(A) & (B), 15 U.S.C. § 78o-3(g)(3)(A) & (B) (2006).

⁷ *See generally* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990) (regulating the penny stock market).

industry.”⁸ The Securities and Exchange Commission (“SEC”), in turn, identified competence and care as important components of ethical conduct through its development of the “shingle theory,” which holds brokerage firms to an implied representation that they will deal fairly and competently with their customers.⁹ The principal Self-Regulatory Organizations (“SROs”)¹⁰ charged with the front-line responsibility of regulating the brokerage industry, the National Association of Securities Dealers (“NASD”) and the New York Stock Exchange (“NYSE”), have enacted rules that include standards of competence and emphasize “commercial honor” and “just and equitable principles of trade”¹¹ for the protection of investors. In short, they all would agree with the statement, made over forty years ago, that “[n]o amount of disclosure . . . can be effective to protect investors unless the securities are sold by a salesman who understands and appreciates both the nature of the securities he sells and his responsibilities to the investor to whom he sells.”¹²

Unfortunately, these views are largely rhetoric. In reality, many customers are victims of negligent treatment by their brokers. The SEC reports that it receives more complaints about broker-dealers than any other type of entity,¹³ and customers who file arbitration claims against their brokers¹⁴ classify a significant number of

⁸ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)); see *SEC v. Zandford*, 535 U.S. 813, 819 (2002); *United States v. Naftalin*, 441 U.S. 768, 775 (1979).

⁹ See, e.g., *Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969); *Kahn v. SEC*, 297 F.2d 112 (2d Cir. 1961).

¹⁰ “Self-regulatory organization” is defined at Securities Exchange Act of 1934 § 3(a)(26), 15 U.S.C. § 78c(a)(26) (2006).

¹¹ NYSE CONST. art. I, § 2(a) (2003); NASD BY-LAWS art. XI, § 1 (2006), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000026.

¹² See H.R. Doc. No. 95, pt. 1, at 588 (1963). The omitted language refers to a prospectus, but the point is the same with respect to trading transactions.

¹³ Cynthia A. Glassman, Comm’r, U.S. Sec. & Exch. Comm’n, A View from Inside the SEC: Remarks at the Financial Service Institute’s 2006 Broker-Dealer Conference (Jan. 25, 2006), available at <http://www.sec.gov/news/speech/spch012506cag.htm> [hereinafter Glassman].

¹⁴ In *Shearson/Am. Express, Inc. v. McMabon*, 482 U.S. 220 (1987), the Supreme Court permitted arbitration of SEA claims pursuant to arbitration clauses in customers’ agreements with their brokers. *Id.* at 238. Since this holding, virtually all disputes between individual investors and their brokers go to arbitration before NASD or NYSE arbitration forums.

these claims as negligence.¹⁵ As just one example of widespread negligence resulting in customers' losses, in 2004, fifteen firms settled with the SEC and NASD for their salespersons' failure to obtain discounts on mutual fund fees that customers were entitled to because of the amount of their purchases.¹⁶

A fundamental deficiency in the current federal regulatory system, as interpreted by the federal courts, is that customers have no federal remedy for injuries caused by the investment advice of incompetent and careless salespersons. The lofty language of Congress and the Supreme Court¹⁷ masks the reality that, since 1933, Congress has been stingy in creating private remedies for investors¹⁸ and that in recent years, the Supreme Court has taken a narrow view of investors' remedies, doubting their deterrence value and expressing concern about their costs.¹⁹ Section 12(a)(2) of the Securities Act of 1933 ("SA")²⁰ is the only express private damages remedy for negligent advice; however, in *Gustafson v. Alloyd Co.*,²¹ the Supreme Court held that this provision did not apply to trading transactions.²² In *Ernst & Ernst v.*

¹⁵ These statistics are available at <http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/statistics/index.htm>.

¹⁶ Glassman, *supra* note 13.

¹⁷ The Supreme Court uses the aspirational language set forth *supra* in the text accompanying note 8 only when the government is enforcing the federal securities laws, not when private parties seek to enforce them.

¹⁸ Congress has added only one explicit remedy since the original enactments of the SA and SEA, in the Insider Trading Sanctions Act of 1988. See Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, EXPRESSO PREPRINT SERIES, Working Paper 941, Feb. 8, 2006, available at <http://law.bepress.com/expresso/eps/941> (analyzing why Congress devoted so much attention to increasing the penalties for insider trading). In 1990, Congress amended Securities Exchange Act of 1934 § 29(b), 15 U.S.C. § 78cc(b) to allow purchasers of penny stocks to rescind purchases made in violation of the cold-calling rules. See *infra* note 114 and accompanying text. In 2002, as part of the Sarbanes-Oxley Act, Congress extended the statute of limitations for Rule 10b-5 claims. See 28 U.S.C. § 1658(b) (2006).

¹⁹ The best example is *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1977), where the Court asserted that Rule 10b-5 litigation poses a greater danger of vexatiousness than other types of litigation. *Id.* at 741.

²⁰ 15 U.S.C. § 771(a)(2) (2006).

²¹ 513 U.S. 561 (1995).

²² *Id.* at 582.

Hochfelder,²³ the Court limited the implied remedy under SEA section 10(b)²⁴ and Rule 10b-5²⁵ to exclude negligence actions.²⁶ While the Supreme Court held that SA sections 17(a)(2) and 17(a)(3)²⁷ apply to negligent advice in trading transactions,²⁸ the federal courts of appeal currently assume that the Court would not recognize an implied cause of action under this provision.²⁹ Similarly, federal courts do not recognize the SEC's shingle theory outside of SEC enforcement actions³⁰ and have refused to imply private causes of action for breach of NYSE and NASD rules.³¹

²³ 425 U.S. 185 (1976).

²⁴ 15 U.S.C. § 78j(b) (2006).

²⁵ 17 C.F.R. § 240.10b-5 (2006).

²⁶ *Hochfelder*, 425 U.S. at 214.

²⁷ 15 U.S.C. § 77q(a)(2) & (3) (2006).

²⁸ In *Aaron v. SEC*, 446 U.S. 680 (1980), the Supreme Court held that SA sections 17(a)(2) and 17(a)(3) do not require scienter. *Id.* at 702. In *United States v. Naftalin*, 441 U.S. 768 (1979), the Supreme Court held that SA section 17(a) applies to "ordinary market trading." *Id.* at 778.

²⁹ *See, e.g.*, *Maldonado v. Dominguez*, 137 F.3d 1 (1st Cir. 1998), discussed *infra* notes 105-108 and accompanying text. *But see* *AFA Private Equity Fund 1 v. Miresco Inv. Servs.*, No. 02-74650, 2005 U.S. Dist. LEXIS 22071, at *14-15 (E.D. Mich. Sept. 30, 2005) (following Sixth Circuit precedent to the contrary).

³⁰ *See* *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *Roebuck v. Guttman*, 678 F. Supp. 68, 69 (S.D.N.Y. 1988); *Vernon J. Rockler & Co. v. Graphic Enters., Inc.*, 52 F.R.D. 335, 342 n. 12 (D. Minn. 1971); *see also* *Roberta S. Karmel, Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1296-97 (1995) (concluding that private plaintiffs cannot recover damages under the shingle theory).

³¹ Since the Supreme Court's retrenchment from implying causes of action, appellate courts are instead focusing on legislative intent and finding it lacking. *See, e.g.*, *Spicer v. Chicago Bd. of Options Exchs.*, 977 F.2d 255, 266 (7th Cir. 1992) (declining to announce a categorical rule, but looking to legislative intent to find no implied cause of action under the CBOE trading rules); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679-81 (9th Cir. 1980). Previously, courts had been more favorably disposed to imply a cause of action in some circumstances, although they expressed reluctance to impose liability for negligence. *See, e.g.*, *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 143 (7th Cir. 1969) (noting that plaintiffs alleged fraud); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir. 1966). In contrast, commentators at that time generally supported imposing liability on brokers for negligent violations of those SRO rules intended to protect investors (as opposed to "housekeeping rules"). *See, e.g.*, *Lewis D. Lowenfels, Implied Liabilities Based upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 30 (1966); *Lewis D. Lowenfels, Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L. Q. 633, 643 (1966); *Nicholas Wolfson & Thomas A. Russo, The Stock Exchange Member: Liability for Violation of Stock*

Some federal courts have even said that brokers owe no duty of care to their customers.³²

What accounts for this discrepancy between rhetoric and reality? The late Professor Louis Loss, who was present at the creation of the federal securities laws, thought it “almost inconceivable” that Congress failed to provide a remedy for the vast majority of investors who purchase securities in trading transactions.³³ Many commentators agree with Professor Loss and cogently argue that the Supreme Court simply got it wrong in *Gustafson*.³⁴ An equally plausible explanation, however, is that Congress made a deliberate policy decision that SEC and SRO regulation would adequately protect investors from incompetent and careless brokers; this viewpoint is supported by consistent Congressional action to strengthen the responsibilities and authority of the SROs³⁵ and to add private remedies only for more egregious forms of broker misconduct.³⁶ More cynically, Congressional failure to provide investors with a private damages remedy for negligent advice may reflect the securities industry’s extensive lobbying efforts and political clout.³⁷

Whatever the explanation, the reality for many customers who are victims of their broker’s negligence is that their losses may go uncompensated. In the absence of a federal remedy, customers are forced to fashion a remedy from state law

Exchange Rules, 58 CAL. L. REV. 1120, 1141-42 (1970). *But see* Philip J. Hoblin, Jr., *A Stock Broker’s Implied Liability to its Customer for Violation of a Rule of a Registered Stock Exchange*, 39 FORDHAM L. REV. 253, 272 (1970) (arguing that “protection of investors” means protection of the general public and not the individual investor, “who very often profits from and participates in the rule violation”).

³² *See, e.g.*, *Richardson Greenshields Secs., Inc. v. Lau*, 693 F. Supp. 1445, 1457 (S.D.N.Y. 1988) (stating that since there is no duty of care for securities brokers, there certainly is not one for commodities brokers).

³³ Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 916 (1992).

³⁴ *See, e.g.*, Stephen M. Bainbridge, *Securities Act Section 12(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1251 (1995); Ted J. Fiflis, *Gustafson v. Alloyd Co., Inc.: Judicial vs. Legislative Power*, 23 SEC. REG. L. J. 423 (1996); Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 EMORY L.J. 95 (1996).

³⁵ *See supra* notes 4-7 and accompanying text.

³⁶ *See supra* note 18.

³⁷ For a former SEC Chairman’s description of the powerful interest groups in the securities industry, see ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON’T WANT YOU TO KNOW, WHAT YOU CAN DO TO FIGHT BACK 236-239 (2002).

principles cobbled together primarily from tort and agency law. State law, however, provides inadequate protection for customers for two reasons. First, the choice of state law can result in significantly different treatment of substantially similar conduct.³⁸ Second, as explained in Part I of this Article, while tort and agency law provide a sound basis for imposing liability on negligent brokers, state courts generally have been reluctant to do so and instead take a narrow view of the duty the broker owes to his customer.³⁹ Thus, reliance on state law is anomalous with the important federal principle of the centrality of broker competence and care to well operating national capital markets.

This Article argues that Congress should amend the SEA to establish federal standards of care and competence and to allow customers to sue for damages when these standards are violated. Part I explains why state law remedies provide inadequate protection for investors. Part II sets forth the proposed federal standards. Part III considers, as an alternative to congressional enactment, promulgation of these standards by the SEC and explores possible ways that investors could use them as a basis for damages claims. Part IV assesses the policy objections made by the Supreme Court and other federal courts to expanding private damages remedies for investors. This Article argues that such objections are inapplicable or unconvincing in the customer-broker setting, particularly since virtually all of these claims will be resolved through SRO arbitration. Part V explains why adoption of these legal standards is important as SRO arbitration moves away from its origins as an equitable forum toward a quasi-judicial system where investors' claims may need to be more firmly grounded in legal principles. For these reasons, this Article concludes that Congress should adopt federal standards of competence and care and provide an express remedy for broker negligence.

I. THE NECESSITY FOR A FEDERAL REMEDY: THE INADEQUACY OF STATE LAW PROTECTION

This Section discusses some common forms of broker negligence that harm investors. Although broker negligence theories may overlap, for the sake of convenience, Section A divides them into three categories: negligent misstatements, negligent conduct, and negligent failure to speak. Section B sets forth basic tort and

³⁸ *See, e.g.*, *Williams v. Deutsche Bank Secs., Inc.*, No. 04 Civ. 7588, 2005 U.S. Dist. LEXIS 12121, at *18-19 (S.D.N.Y. June 13, 2005) (noting that California law offers greater protection to customers than New York law).

³⁹ *See, e.g.*, *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1307-08 (2d Cir. 2002) (discussing the limited scope of the broker's legal duties to customers).

agency law principles, as well as established industry standards, and demonstrates that together these principles support imposing liability on brokers in all three situations. Despite this, state courts have been reluctant to impose negligence-based liability on brokers. Although this judicial reluctance is unwarranted, it is pervasive and longstanding, as is illustrated in Section C. Thus, the best solution is to amend the SEA to establish federal standards of competence and care and to provide an express federal remedy.

A. Broker Negligence

To some degree, all investors are vulnerable to harm from their brokers' negligence. Even investors who make their own investment decisions rely on their brokers to execute orders in accordance with their instructions, to obtain the best available prices and not to enter into unauthorized transactions. Investors expect their brokers to perform these services competently and can suffer financial harm if the brokers' conduct is negligent.

Many investors expect more from their brokers and rely on them to provide sound investment advice. In turn, many brokers are eager to provide advice and solicit customers by promoting the quality of their advice. Accordingly, this Article focuses in particular on the harm brokers can cause through negligent advice. The degree of customers' reliance can vary. Customers may seek occasional advice about which securities to purchase and expect that their brokers will be diligent in obtaining the information, will have the requisite expertise to assess the information, and will exercise care in communicating the information to them.⁴⁰ Instead, brokers may communicate inaccurate or incomplete information about an investment product or strategy to customers because they were careless in obtaining the correct information, they lacked sufficient expertise to understand the information, or they were careless in communicating the information accurately. As a result, customers may make investment choices they otherwise would not have made and may suffer financial harm because of their brokers' negligent misrepresentation.

Other customers' reliance on their brokers' advice may be a longstanding and integral aspect of their relationship; the customer may never make an investment decision without consulting with, and indeed without the recommendation of, the broker. In these relationships, the customer expects that the broker will only recommend investment products or strategies that are suitable for the customer's financial needs. In egregious cases, the unsuitable recommendation is the result of the broker's fraud. More frequently, however, it is the product of the broker's lack

⁴⁰ See RESTATEMENT (SECOND) OF TORTS § 552 cmt. e (1977).

of diligence resulting from failure to ascertain and understand the customer's financial situation and objectives, failure to research and comprehend the recommended investment product or strategy, or failure to communicate the recommendation to the customer with sufficient care so that the customer understands the potential benefits and risks of the investment. If the broker's recommendations are unsuitable, the customer may experience serious financial harm. Although unsuitable recommendations may also be considered a type of misrepresentation, this Article treats them as a form of conduct because of the specialized nature of the claim, the importance of the broker's actions in investigating the recommendation, and the frequency of these claims.

Finally, other investors seek greater assistance from their brokers; they expect their brokers to construct and manage suitable investment portfolios for them, including recommending alterations to their portfolios based on changing conditions. Customers who look to brokers to serve as their financial advisers may expect their brokers to provide them with information, and, if brokers fail to do so, they may suffer financial loss. Customers have frequently made two complaints. First, after the broker persuades the customer to buy an investment product (typically, stock in a start-up company with growth potential), the broker does not provide the customer with any updated information about the investment, so that the customer is caught unawares when its market price drops. Second, if the customer instructs the broker to purchase an investment product or pursue an investment strategy that involves greater risk than is suitable for the customer, the broker does not warn the customer that, in the broker's professional opinion, the investment is too risky for the customer. Customers may expect that, because of the nature of that relationship, brokers have a duty to provide their customers with information in these two instances.

B. Basic Tort and Agency Law Principles

Negligent Misrepresentations. Leading torts commentators state that common law liability for negligent misrepresentations exists in commercial relationships where the resulting injury is pecuniary.⁴¹ According to the Restatement (Second) of Torts,

[o]ne who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business

⁴¹ Judicial concerns about the potentially broad scope of liability, as expressed in *Ultramares Corp. v. Touche*, 255 N.Y. 170 (1931), are not present in the customer-broker situation.

transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.⁴²

In the words of one leading treatise, “there would seem to be very little justification for not extending liability to all parties and agents to a bargaining transaction for making misrepresentations negligently.”⁴³

Negligent Conduct. Common law agency and tort principles hold agents responsible for harm caused to their principals by their failure to live up to industry standards of care and competence. Under the Restatement (Second) of Agency, an agent owes a duty to the principal to act with the standard of care recognized within the industry, unless the agreement provides otherwise.⁴⁴ Similarly, the Restatement (Second) of Torts requires individuals to exercise the degree of care and skill “normally possessed by members of that profession or trade in good standing in similar communities.”⁴⁵ Failure to live up to industry standards is a basis for liability, unless the parties agreed that the standards were not part of their contract. In addition, under the Restatement (Second) of Agency, the agent has a duty “to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to

⁴² RESTATEMENT (SECOND) OF TORTS § 552(1) (1971); *see, e.g.*, *Maliner v. Wachovia Bank, N.A.*, No. 04-60237-CIV-ALTONAGA/Bandstra, 2005 U.S. Dist. LEXIS 5985, at *26 (S.D. Fla. Mar. 1, 2005) (allowing plaintiff’s negligent misrepresentation claim against portfolio manager). Professor Dobbs’ criticism that section 552 is over-inclusive does not apply to broker-customer relationships, since he is concerned about imposing liability on adversary bargainers who do not undertake to exercise reasonable care. *See* 2 DAN B. DOBBS, *THE LAW OF TORTS* § 472 at 1352-53 (2001) [hereinafter 2 DOBBS].

⁴³ W. PAGE KEETON ET AL., *PROSSER AND KEETON ON THE LAW OF TORTS* 745 (5th ed. 1984).

⁴⁴ RESTATEMENT (SECOND) OF AGENCY § 379(1) (1958); *see* *Index Futures Group, Inc. v. Ross*, 557 N.E.2d 344, 347 (Ill. Ct. App. 1990) (explaining that negligence claims can be based on breach of industry regulations).

⁴⁵ RESTATEMENT (SECOND) OF TORTS § 299A (1965).

have.”⁴⁶ Courts, for example, consistently impose liability on real estate brokers in negligence for failure to live up to industry standards.⁴⁷

Industry Standards of Care and Competence. SRO rules and other recognized industry standards set forth standards of care and competence applicable to brokers. With respect to negligent misrepresentations, SRO rules generally require that when communicating information about an investment product or strategy to a customer, the broker must exercise care to ensure that the information is correct and that the broker conveys it accurately to the customer.⁴⁸ When the broker recommends an investment product or strategy to the customer, the broker’s responsibilities, and what constitutes reasonable care, are spelled out in more detail.⁴⁹ SRO rules make clear that brokers must have sufficient information about their customers’ financial situation, including their current holdings and investment objectives,⁵⁰ as well as sufficient information about the recommended investment product or strategy,⁵¹ so that their recommendations are suitable for their customers (the “suitability obligation”).⁵²

Although there are no specific SRO rules addressing the broker’s duty to update and duty to warn, industry standards recognize both duties. The Content Outline for the General Securities Registered Representative Examination (Test Series 7),⁵³ the qualification examination for general securities registered

⁴⁶ RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

⁴⁷ *See, e.g.,* Saiz v. Horn, 668 N.W.2d 332, 337 (S.D. 2003); Menzel v. Morse, 362 N.W.2d 465, 471 (Iowa 1985).

⁴⁸ *See* NYSE Rules and Constitution, Rule 472(i) (2006); NASD Manual Conduct Rules, Rule 2110 (2006); NASD Manual Conduct Rules, Rule IM-2310.2 (2006).

⁴⁹ NASD Manual Conduct Rules, Rule 2310 (2006); NYSE Rules and Constitution, Rule 405 (2006).

⁵⁰ NASD Manual Conduct Rules, Rule 2310 (2006).

⁵¹ Churning (excessive trading done for the purpose of generating commission income) is an example of an unsuitable trading strategy. *See* Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, 767 F.2d 1498, 1502 (11th Cir. 1985) (recognizing churning as a Rule 10b-5 violation where there is scienter).

⁵² *See* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 601 (2d Cir. 1978) (recognizing unsuitability claim as a Rule 10b-5 violation where there is scienter).

⁵³ The Content Outline is *available at* <http://www.nyse.com/pdfs/series7.pdf> (last visited Oct. 23, 2006) [hereinafter Content Outline].

representatives,⁵⁴ identifies monitoring the customer's account and making ongoing recommendations as one of the broker's "critical functions and tasks."⁵⁵ In addition, industry standards recognize that a broker has a duty to warn if a customer is about to engage in investment activity that the broker deems excessively risky. While the Content Outline does not specifically use the verb "warn," several general descriptions fairly encompass this duty: "[a]ssist[ing] the customer in determining investment needs and objectives"⁵⁶ and "[e]xplain[ing] how the risks and rewards of a particular investment or investment strategy relate to the customer's financial needs and investment objectives."⁵⁷ Brokerage firms' compliance manuals frequently state

⁵⁴ The Series 7 examination is the entry-level examination for registered representatives. It is developed, maintained and owned by the NYSE and is administered and scored by NASD. It is intended "to safeguard the investing public by helping to ensure that registered representatives are competent to perform their jobs" and "seeks to measure accurately and reliably the degree to which each candidate possesses the knowledge, skills and abilities needed to perform the critical functions of a registered representative." Self-Regulatory Organizations; New York Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change and Amendment No. 1 Thereto Relating to Increasing Certain Fees Charged by the Exchange to its Members and Member Organizations, Rel. No. 34-53235, 2006 WL 1595655, at *2 (Feb. 6, 2006). For background on the development of the Series 7 examination, see Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Relating to Amendments to the Examination Specifications and Content Outline for the General Securities Registered Representative (Series 7) Examination, Rel. 34-35401, 60 F.R. 10886 (Feb. 28, 1995).

⁵⁵ This is one of seven identified "critical functions." See Content Outline, *supra* note 53, at 3-4. Specifically, registered representatives must

- [1] Routinely review[] the customer's account to ensure that investments continue to be suitable.
- [2] Suggest[] to the customer which securities to acquire, liquidate, hold, or hedge.
- [3] Explain[] how news about an issuer's financial outlook may affect the performance of that issuer's securities.
- [4] Determine[] which sources would best answer a customer's questions concerning investments and use[] information from appropriate sources to provide the customer with relevant information.
- [5] Keep[] the customer informed about the customer's investments.

Id. at 3.

⁵⁶ This is an aspect of the critical function of "[e]valuates customers in terms of financial needs, current holdings, and available investment capital, and helps them identify their investment objectives." *Id.*

⁵⁷ This is an aspect of the critical function of "[p]rovides customers and prospective customers with information on investments and makes suitable recommendations." *Id.* The language quoted in the text is not limited to investments or strategies recommended by the broker. *Id.*

that warning customers of risks they may not adequately understand is part of brokers' responsibilities to their customers.⁵⁸ A well-known study guide for the Series 7 examination states that "[o]ccasionally, a customer asks a registered rep to enter a trade that the rep believes is unsuitable. It is the rep's responsibility to explain why the trade might not be appropriate for the customer."⁵⁹

To recap: (1) Tort and agency principles establish that agents can be held liable for failure to live up to established industry standards of care and competence; and (2) SRO rules and other industry standards relating to advice-giving are well-established. Thus, it would seem a foregone conclusion that courts would impose negligence-based liability on brokers when their failure to adhere to these standards results in financial harm to their customers. As this Article will demonstrate, however, courts have been reluctant to impose negligence-based liability on brokers.

C. Judicial Decisions

Courts generally recognize that customers may sue their brokers for negligent misrepresentations,⁶⁰ although some courts have cabined the theory with limiting doctrines. Courts have not allowed negligent misrepresentations claims against brokers where "sophisticated equals" negotiated at arms-length⁶¹ or where the broker was acting as the agent for the seller of the investment product.⁶² These limitations illustrate a general disinclination to impose liability for negligent misrepresentations unless the court believes that the defendant owed a special responsibility to the

⁵⁸ See Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 501-02 (2003) [hereinafter Black & Gross].

⁵⁹ *Id.* (quoting PASSTRACK SERIES 7: GENERAL SECURITIES REPRESENTATIVES 670 (11th ed. 2000)).

⁶⁰ See, e.g., *Zurad v. Lehman Bros.*, 757 F.2d 129, 134 (7th Cir. 1985) (holding that broker violated duty of reasonable care in obtaining and relaying information when he advised customer to purchase securities without supplying information about the stock's volatility); *Cont'l Leavitt Commc'ns, Ltd. v. PaineWebber, Inc.*, 857 F. Supp. 1266, 1270 (N.D. Ill. 1994) (noting that defendant held itself out as providing information and advice to customers); *Ebrahimi v. E.F. Hutton & Co.*, 794 P.2d 1015, 1016-17 (Colo. Ct. App. 1989) (discussing the statute of limitations for negligent misrepresentation claims).

⁶¹ See *Stephenson v. Deutsche Bank*, 282 F. Supp. 2d 1032, 1061 (D. Minn. 2003); see also *Crigger v. Fahnestock & Co.*, 443 F.3d 230, 233 (2d Cir. 2006) (finding no fraud liability where the customers were sophisticated).

⁶² See *Zahorik v. Smith Barney, Harris Upham & Co., Inc.*, 664 F. Supp. 309, 314 (N.D. Ill. 1987).

person to whom he was communicating the information.⁶³ New York courts, for example, require this “special relationship” because otherwise liability would attach to “casual response[s] given informally” in commercial relationships that do not warrant justifiable reliance.⁶⁴ Thus, liability will be imposed only on those persons who possess unique or specialized expertise or who are in a special position of confidence or trust with the injured party.⁶⁵

Even under the restrictive view, the customer-broker relationship establishes the requisite “special relationship” since the broker solicits the customer’s business on the basis of the broker’s expertise and the customer seeks the broker’s advice for precisely that reason.⁶⁶ Indeed, in providing advice and information, the broker fosters a non-adversarial relationship with his customers for the very purpose of encouraging the customer’s reliance on his expertise and use of his services. Thus, the broker should not be encouraged to make the kind of casual uninformed responses that may be countenanced from used car salesmen. There is some case support for this view; for example, New York, a state that is not generally receptive to customers’ claims, has recognized that a special relationship is present when a broker-dealer provides information about securities to its customers when soliciting their business.⁶⁷

In contrast to real estate brokers,⁶⁸ courts are reluctant to impose negligence liability on securities brokers for failure to adhere to industry standards. The Minnesota Supreme Court, for example, held that state regulations requiring brokers to have reasonable grounds for making recommendations to customers did not

⁶³ See 2 DOBBS, *supra* note 42, § 472, at 1349; 2 FOWLER V. HARPER, FLEMING JAMES, JR. & OSCAR S. GRAY, HARPER, JAMES, AND GRAY ON TORTS § 7.6 at 476-77 (2006).

⁶⁴ See *Kimmell v. Schaefer*, 675 N.E.2d 450, 454 (N.Y. 1996) (quoting *Heard v. City of New York*, 623 N.E.2d 541, 546 (N.Y. Ct. App. 1993)).

⁶⁵ *Id.* Expertise alone, however, may not be enough. See *Mechigian v. Art Capital Corp.*, 612 F. Supp. 1421, 1431 (S.D.N.Y. 1985) (expressing unwillingness to hold that “in every case wherein someone with expertise is hired a fiduciary relationship is created”).

⁶⁶ See 2 DOBBS, *supra* note 42, § 469, at 1350.

⁶⁷ See *In re Sterling Foster & Co., Inc.*, 222 F. Supp. 2d 216, 284-85 (E.D.N.Y. 2002).

⁶⁸ See *supra* note 47 and accompanying text.

provide a basis for a customer's negligence claim.⁶⁹ Similarly, courts have refused to hold a broker liable for failing to monitor the account unless the broker has discretion or otherwise controls the customer's account.⁷⁰ There is, however, some case law support for recognition of a duty to warn. *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁷¹ frequently cited for the proposition that the broker owes the customer only a limited duty, acknowledges that a broker could have a "duty to inform the customer of the risks involved in purchasing or selling a particular security,"⁷² the extent of this duty depending on the customer's experience and intelligence. A few other cases extend this duty to warning about investment strategies, where there is a relationship between the broker and the unsophisticated customer that justifies the customer's reliance on the broker's supposed expertise.⁷³

Courts do not provide extensive analysis or compelling justifications for their reluctance to hold brokers responsible for their failure to meet industry standards. Courts frequently assert a narrow view of the duties that brokers owe their customers and, in particular, assert that brokers owe their customers no ongoing duty of care.⁷⁴ Rather, courts view the broker's duty as transaction-specific, limited to the execution of the customer's orders in accordance with his instructions and completed upon execution.⁷⁵ The only exceptions the courts recognize involve

⁶⁹ *Minneapolis Employees Ret. Fund v. Allison-Williams Co.*, 519 N.W.2d 176, 182 (Minn. 1994); *see also* *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1291 (S.D. Ohio 1996) (declining to apply section 299A to a broker-dealer).

⁷⁰ *See, e.g.*, *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1302 (2d Cir. 2002); *Cooperativa de Ahorro y Credito Aguada v. Kidder, Peabody & Co.*, 777 F. Supp. 153, 159 (D. P.R. 1991), *rev'd on other grounds*, 993 F.2d 269 (1st Cir. 1993); *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 567 (9th Cir. 1985). For further discussion of the cases, *see* Black & Gross, *supra* note 58, at 504-05.

⁷¹ 461 F. Supp. 951 (E.D. Mich. 1978).

⁷² *Id.* at 953.

⁷³ *See, e.g.*, *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049-50 (11th Cir. 1987); *Beckstrom v. Parnell*, 730 So.2d 942, 948-52 (La. Ct. App. 1998).

⁷⁴ *See, e.g.*, *De Kwiatkowski*, 306 F.3d at 1306. In contrast, investment advisers are treated as having a fiduciary relationship with the investor. *See, e.g.*, *Capital Dist. Physician's Health Plan v. O'Higgins*, 939 F. Supp. 992, 1001-1003 (N.D.N.Y. 1996).

⁷⁵ *See Leib*, 461 F. Supp. at 952-53.

situations where the broker has control over the account.⁷⁶ Under this narrow view, even when the broker recommends the purchase of a particular security and the customer acts on the recommendation, the broker has no duty to advise the customer about developments that make it inadvisable for the customer to continue to hold the security. The Minnesota Supreme Court's opinion is a typical example, reciting this narrow view of the broker's duty and then stating that brokers are not "guarantor[s] or insurer[s]" against customers' losses.⁷⁷ The latter statement is a *non sequitur*, since the customer is not asserting that the broker made any guarantee of results nor is he seeking recovery for unanticipated losses. Rather, the customer seeks recovery for losses attributable to the broker's negligence. Some courts state that, to impose liability on the broker, there must be evidence that the broker made a commitment to observe the standards and that the customer relied on this commitment.⁷⁸ This approach is exactly the opposite of the Restatement (Second) of Tort's approach, which holds the broker to the industry standard unless the parties contract otherwise.⁷⁹ Other courts have stated that internal firm rules are for the benefit of the firm;⁸⁰ others are disinclined to impose liability on firms that have adopted higher standards.⁸¹ These courts apparently believe that when the broker fails to live up to these standards, the disappointed customer should take those losses as a learning experience and find a better broker.

Judicial reluctance to hold brokers to well-established industry standards is inexplicable: since these standards are for the protection of investors, customers can reasonably expect their brokers to live up to them. This judicial reluctance, however, is pervasive and longstanding; thus, the best solution is to amend the SEA to establish federal standards of competence and care and to provide expressly for a federal remedy. Legislative consideration of this proposal would at least engender a

⁷⁶ Most instances of control are created by contract, where the customer gives his broker discretionary power over the account, although courts sometimes recognize *de facto* control, as where the broker dominates a particularly vulnerable customer. See Black & Gross, *supra* note 58, at 488.

⁷⁷ Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 182 (Minn. 1994).

⁷⁸ See, e.g., Hotmar v. Lowell H. Listrom & Co., Inc., 808 F.2d 1384, 1387 n.3 (10th Cir. 1987).

⁷⁹ See *supra* notes 44-45 and accompanying text.

⁸⁰ See, e.g., J.E. Hoetger & Co. v. Ascencio, 572 F. Supp. 814, 822 (E.D. Mich. 1983).

⁸¹ See, e.g., De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293, 1311 (2d Cir. 2002); J.E. Hoetger, 572 F. Supp. at 822.

robust public debate over what customers can reasonably expect from their brokers. Part II sets forth proposed federal standards.

II. AMENDING THE SEA TO ESTABLISH FEDERAL STANDARDS OF COMPETENCE AND CARE AND A FEDERAL REMEDY

This Article proposes that federal standards include four minimum standards of care that brokers owe to all their customers. These proposed standards are based on SRO rules, industry standards, and common law tort and agency principles. They may be stated as follows: (1) the broker must obey the customer's instructions and must not make decisions pertaining to the account unless authorized by the customer to do so;⁸² (2) when executing transactions on behalf of a customer, the broker must obtain the best available price (the "duty of best execution");⁸³ (3) when communicating information about an investment product or strategy to a customer, the broker must exercise care to ensure that the information is correct and that the broker conveys it accurately;⁸⁴ and (4) when making recommendations (or purchases in a discretionary account), the broker must have sufficient information about both the customer's financial situation, including current holdings and investment objectives, and the recommended (or purchased) investment product, to ensure that the recommendations (or purchases) are suitable for the customer (the "suitability obligation"). This suitability obligation also extends to trading strategies.⁸⁵ Because these four standards are minimum standards that apply to all customer-broker relationships, the broker should not be able to disclaim his responsibility to adhere to these standards.

Two additional standards should be applicable when the customer relies on the broker to provide financial advice. These duties, based on well-recognized industry standards, may be stated as follows: (5) the broker has a duty to monitor the customer's account and to make ongoing recommendations about the customer's portfolio based on changes in the portfolio, the market, or the customer's financial situation;⁸⁶ and (6) the broker owes a duty to warn the customer when securities or

⁸² Brokers, as agents, must obey the customer's instructions. *See* RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

⁸³ *See* *Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 269-70 (3d Cir. 1998).

⁸⁴ *See supra* notes 41-43, 48 and accompanying text.

⁸⁵ *See supra* notes 49-52 and accompanying text.

⁸⁶ *See supra* notes 53-55 and accompanying text.

strategies the customer decides on his own to pursue entail greater risks than he should assume.⁸⁷ Many customers make their own investment decisions and select their brokers for reasons unrelated to the quality of the investment advice; thus, brokers and customers should have the freedom to agree that these two standards do not apply to their relationship. Accordingly, the broker's contract with the customer may explicitly state that the broker does not undertake any responsibilities to oversee the customer's account. Because it is important for customers to understand that they cannot expect such services from their brokers, this provision should be written in plain English, in bold-face type, and require a separate acknowledgement from the customer, such as initialing.

Finally, customers of those securities firms that hold themselves out as financial advisors and heavily advertise their stock-picking prowess may reasonably expect their brokers to meet industry performance standards. Brokers could be rated, just as mutual funds are, according to their performance relative to market benchmarks. Under this view, selecting suitable investments is a minimum requirement; among a choice of suitable investments, some will outperform others. The brokerage firm or individual broker that promotes superior stock-picking abilities could be held to (7) a duty of professional competence, just as investment advisers are.⁸⁸ Reluctance to propose this as a legally enforceable standard, however, stems from the lack of well-developed legal standards for determining professional competence for stockbrokers. Moreover, there is a reasonable argument that the broker should not be liable to the customer so long as the recommended investments are suitable. Whether the broker has constructed the optimal investment portfolio for the customer involves financial planning considerations that well may be inappropriate for determination by a judge or arbitration panel. If the customer is dissatisfied with the performance of his portfolio, the best solution may be to find another broker. Therefore, adoption of this standard may not be advisable. However, in instances where brokers advertise their stock-picking prowess, judges and arbitrators may reasonably take this into consideration in determining the broker's liability to the customer.

⁸⁷ See *supra* notes 56-59 and accompanying text.

⁸⁸ See *Erich v. First Nat'l Bank of Princeton*, 505 A.2d 220, 234-35 (N.J. Super. 1984) (holding that a bank offering professional investment advisory services should be held to the standard of care for professional investment advisers); *Alton v. Wyland*, 595 N.E.2d 993, 996 (Ohio Ct. App. 1991) (stating that one who holds himself out as an investment advisor is liable as such). Some states, however, do not allow professional malpractice claims against financial advisers because they are not "professionals" under state licensing requirements. See, e.g., *Maliner v. Wachovia Bank, N.A.*, No. 04-60237-CIV-ALTONAGA/Bandstra, 2005 U.S. Dist. LEXIS 5985, at *24 (S.D. Fla. Mar. 1, 2005).

III. A SECOND-BEST APPROACH

While the best solution is amending the SEA as described above, it is unlikely that Congress would adopt such legislation. The securities industry is sure to oppose it and to finance lobbying efforts against it. Moreover, history shows that amendments to provide investors with additional remedies are rare.⁸⁹ Accordingly, this Part argues that the SEC should promulgate rules establishing the previously described federal standards of competence and care for brokers. Since there also needs to be a remedy for customers who suffer losses because of their brokers' negligent violation of these standards, this article explores ways to accomplish this.

A. SEC's vs. SROs' Authority

The SEC has the authority to adopt federal standards of competence and care. SEA section 15(b)(7) authorizes the SEC to establish standards of "training, experience, competence, and such other qualifications" as the SEC finds necessary or appropriate in the public interest or for the protection of investors.⁹⁰ In addition, the SEC has the authority, under SEA section 15(c)(2)(D), to regulate negligent conduct by brokers in the OTC market that harms investors.⁹¹ Under the latter authority, the SEC has defined fraud broadly⁹² to include misrepresentations made with reasonable grounds to believe they are untrue.⁹³

The SEC has generally preferred, however, to delegate the responsibility for establishing standards and regulating sales practices,⁹⁴ including the creation and the administration of the qualifying examinations, to the SROs.⁹⁵ Similarly, the SEC has

⁸⁹ See *supra* note 18 and accompanying text.

⁹⁰ 15 U.S.C. § 78o(b)(7) (2006).

⁹¹ The provision gives the SEC the authority to adopt rules that "prescribe means reasonably designed to prevent" fraudulent, deceptive or manipulative acts. 15 U.S.C. § 78o(c)(2)(D) (2006).

⁹² Fraud includes "any act, practice or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. § 240.15c1-2(a) (2006).

⁹³ 17 C.F.R. § 240.15c1-2(b) (2006).

⁹⁴ See 17 C.F.R. § 240.15b7-1 (2006).

⁹⁵ See *supra* note 54.

adopted only a few rules regulating sales practices, and those it has adopted relate to abusive, not negligent, conduct⁹⁶

Due to the national importance of industry standards, the SEC should no longer delegate the responsibility of promulgating these standards to the SROs or the industry. Instead, as the agency entrusted with investor protection, the SEC should assume responsibility for establishing the proposed federal standards of competence and care. Elevation of these principles to SEC rules should send a signal to the industry that the SEC treats brokers' duties of competence and care seriously. In addition, a SEC rule-making proposal would provide a salutary opportunity for debate about what customers can reasonably expect from their brokers and would reaffirm the importance of competent and careful brokers. The SEC rules should explicitly state that investors are the intended beneficiaries of these standards.

B. Enforcement of these Standards

If the SEC promulgates these standards and states that investors are the intended beneficiaries, the next issue is how customers injured by their brokers' failure to adhere to these standards could obtain redress.

Virtually all customers' claims against their brokers are arbitrated in SRO-sponsored arbitration forums. There is a debate about whether arbitrators must apply the law in deciding these claims.⁹⁷ Traditionally, arbitration has been viewed as an equitable forum where arbitrators are not bound by strictures of legal doctrine;⁹⁸

⁹⁶ Rule 15c1-7 prohibits churning in discretionary accounts. 17 C.F.R. § 240.15c1-7 (2006). Rules 15g-1 through 15g-9 regulate sales practices for penny stocks. 17 C.F.R. §§ 240.15g-1 to g-9 (2006).

⁹⁷ See Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 995-98 (2002).

⁹⁸ The following frequently quoted language, attributed to Domke on Aristotle, captures the concept: "Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail." SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, THE ARBITRATOR'S MANUAL unnumbered preface page (May 2005), *available at* http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_009668.pdf [hereinafter ARBITRATOR'S MANUAL].

however, this view may be changing as, increasingly, the SRO arbitration process is becoming a more formal and quasi-judicial process.⁹⁹

Currently, both NASD and the courts take a middle-of-the-road approach. Thus, NASD provides arbitrators the following guidance:

Arbitrators are not strictly bound by case precedent or statutory law. Rather, they are guided in their analysis by the underlying policies of the law and are given wide latitude in their interpretation of legal concepts. *On the other hand, if an arbitrator manifestly disregards the law, an award may be vacated.*¹⁰⁰

The Supreme Court announced the “manifest disregard” standard in *Wilko v. Swan*,¹⁰¹ but has never explained when arbitrators’ deviation from the law becomes so great as to constitute “manifest disregard.” Due to this lack of clarity, the federal appellate courts have adopted different versions of the standard.¹⁰² For purposes of this Article, it is sufficient to note that courts recognize limitations on the arbitrators’ powers to award damages to customers in the absence of a legal basis for the award. If Congress provided an explicit remedy, as proposed in Part II, arbitrators unquestionably would have the power to award damages to customers. Under the second-best approach, there must be a source of law that arbitrators can look to in providing a remedy to customers for breach of the standards. The following sections, therefore, address the likelihood that courts would recognize remedies, but it is important to keep in mind that these issues are likely to be resolved in arbitration. Thus, investors’ attorneys must be able to marshal sufficient legal

⁹⁹ The best example of this is a pending rule change by NASD Dispute Resolution to require arbitrators to provide reasons for awards upon the customers’ request. Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 Thereto, to Provide Written Explanations in Arbitration Awards Upon the Request of Customers, or of Associated Persons in Industry Controversies, SEC Rel. 34-52009 (July 11, 2005), *available at* <http://www.sec.gov/rules/sro/nasd/34-52009.pdf> [hereinafter The Reasoned Awards Proposed Rule Change].

¹⁰⁰ ARBITRATOR’S MANUAL, *supra* note 98, at 29 (emphasis added).

¹⁰¹ 346 U.S. 427 (1953). *Wilko*’s holding that arbitration agreements were unenforceable with respect to SA claims was overruled in *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), but the manifest disregard standard for vacatur survived. Barbara Black, *The Irony of Securities Arbitration Today: Why do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 434 (2003).

¹⁰² *See id.* at 434-38.

precedent to ensure that an award of damages based on breach of the standards would not be susceptible to vacatur on the ground it is in manifest disregard of either federal or state law. There are three possible sources of law: SA section 17(a), SEA section 29(b), and state law.

SA Section 17(a).¹⁰³ As noted above,¹⁰⁴ the current assumption among the federal appellate courts is that the Supreme Court would not imply a private cause of action under SA section 17(a). Is there any possibility of revisiting this issue? *Maldonado v. Dominguez*¹⁰⁵ illustrates the judicial reasoning. The court began its analysis with *Hochfelder*¹⁰⁶ and the Supreme Court's concern that without a requirement of scienter, plaintiffs could use the implied Rule 10b-5 remedy to bypass the procedural obstacles of an express negligence remedy.¹⁰⁷ It then generalized *Hochfelder's* holding to require scienter for any implied cause of action under the securities laws if there is already an express remedy addressing much of the same conduct and benefiting the same parties.¹⁰⁸ The court apparently did not attach any significance to the fact that, after *Gustafson*,¹⁰⁹ there is no explicit remedy for negligent trading advice by brokers.

Victims of negligent trading advice, therefore, can argue that the specific concern addressed in *Hochfelder* is not present. Additionally, given the strong federal interest in protecting investors from incompetent and careless brokers, as expressed by the SEC in adopting these standards, the Court would imply a private cause of action under SA section 17(a). Unfortunately, however, this argument distinguishing *Hochfelder* ultimately may not be convincing, since the absence of an express cause of action for negligent advice in trading transactions may be seen as strong evidence that Congress did not intend to provide a remedy for this type of broker misconduct. In this view, Congress, in 1933 and 1934, was primarily concerned about grosser

¹⁰³ 15 U.S.C. § 77q (2000).

¹⁰⁴ See *supra* note 29 and accompanying text.

¹⁰⁵ 137 F.3d 1 (1st Cir. 1998).

¹⁰⁶ See *supra* notes 23-26 and accompanying text.

¹⁰⁷ *Maldonado*, 137 F.3d at 7.

¹⁰⁸ *Id.*

¹⁰⁹ See *supra* notes 21-22 and accompanying text.

forms of broker misconduct, such as fraud and manipulation,¹¹⁰ and, in subsequent amendments, it remained focused on conduct that was bad, not just careless.¹¹¹ Unless the Supreme Court does an about-face and either determines that *Gustafson* was wrongly decided or moves away from its almost exclusive focus on legislative intent, it is unlikely to accept policy arguments for implying a cause of action under SA section 17(a).

SEA Section 29(b). The most overlooked explicit remedy in federal securities laws is SEA section 29(b).¹¹² It invalidates “every contract” made in violation of any SEA provision or any of its rules and regulations, and “every contract,” “the performance of which involves the violation of, or the continuation of any relationship or practice in violation of,” any SEA provision or any of its rules and regulations.¹¹³ In 1990, Congress expanded the section’s coverage to ensure that customers could void transactions if brokers solicited purchases of penny stocks in violation of the SEC’s penny stock cold calling rules, as well as other SEC rules.¹¹⁴ If the SEC adopted federal standards of competence and care, could a customer assert a claim for rescission and restitution¹¹⁵ under SEA section 29(b) if the broker, in the course of performing his contract with the customer, violates any of these provisions?

¹¹⁰ For a thorough examination of the Supreme Court’s view toward implying causes of action in 1934, see Margaret V. Sachs, *Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes*, 49 OHIO STATE L.J. 559, 571-76 (1988). She concludes that particularly where the statute was viewed as comprehensive, courts viewed the express causes of action as exclusive. *Id.*

¹¹¹ See *supra* note 18 and accompanying text.

¹¹² The first, and still the most comprehensive, scholarly examination of this provision is Samuel H. Gruenbaum & Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1 (1979) [hereinafter Gruenbaum & Steinberg].

¹¹³ 15 U.S.C. § 78cc(b) (2000).

¹¹⁴ The amendment “amends Section 29(b) . . . to make voidable securities contracts made in violation of the Commission’s penny stock cold calling rule and all other rules adopted pursuant to Section 15(c)(2)” H.R. REP. NO. 101-617, at 7 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1408, 1435. Section 29(b) “gives customers the ability to protect themselves from abusive conduct in the securities markets by voiding trades that violate the securities laws and rules thereunder.” H.R. REP. NO. 101-617, at 33 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1408, 1409.

¹¹⁵ The remedy does not allow for consequential damages. See Gruenbaum & Steinberg, *supra* note 112, at 24-27.

There is a paucity of case law interpreting SEA section 29(b), much of it applying the provision narrowly because of a judicial belief that the remedy is draconian.¹¹⁶ Some courts hold that only unlawful contracts may be rescinded, not lawful contracts whose performance involves illegal conduct.¹¹⁷ Other courts draw a distinction between violations that are inseparable from contract performance and violations involving conduct that is collateral or tangential to the contract.¹¹⁸ These narrow interpretations, however, are contrary to the plain meaning of the statute, particularly after the 1990 amendments,¹¹⁹ and Congress's precision in carving out explicit exceptions to its applicability.¹²⁰ The Supreme Court has consistently stated that the plain meaning of the statute, as supplemented by the legislative history, should control in interpreting securities laws;¹²¹ policy considerations are relevant only in fleshing out the contours of the implied remedies.¹²² Accordingly, if the SEC adopts these federal standards, customers should be able to avail themselves of SEA section 29(b) and rescind trades with brokers for violations of these standards.

¹¹⁶ See, e.g., *Occidental Life Ins. Co. of North Carolina v. Pat Ryan & Assocs.*, 496 F.2d 1255, 1263 (4th Cir. 1974).

¹¹⁷ See *Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 855 (S.D.N.Y. 1995) (refusing to allow rescission of trades made to churn the account); *Zerman v. Jacobs*, 510 F. Supp. 132, 135 (S.D.N.Y. 1981), *aff'd*, 672 F.2d 901 (2d Cir. 1981).

¹¹⁸ See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189, 213-14 (3d Cir. 2001) (holding that borrower could not rescind a lending agreement on the ground that the lender violated rule 10b-5 by its short sales of the borrower's stock). This distinction was followed in *In re Mutual Funds Inv. Litig.*, 384 F. Supp. 2d 873 (D. Md. 2005), where late trading and market-timing activities were not a basis to rescind investment advisory agreements under § 47(b) of the Investment Company Act, which is similar to § 29(b). *Id.* at 882-83. *But see* *Beres v. Thomson McKinnon Sec., Inc.*, No. 85 CIV 6674, 1989 WL 105967, at *10-12, *16 (S.D.N.Y. Sept. 1, 1989) (refusing to dismiss the section 29(b) claim where Rule 10b-5 violations were alleged).

¹¹⁹ See *supra* notes 113-114 and accompanying text.

¹²⁰ Thus, Congress provided that a rescission claim could not be brought because of an alleged violation of any rule prescribed under section 15(c)(3) and gave the SEC the authority to designate rules adopted under section 15(c)(2) as not triggering rescission under this section.

¹²¹ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (stating that "[t]he starting point in every case involving construction of a statute is the language itself" (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring))).

¹²² "It is . . . proper that we consider . . . what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance." *Blue Chip Stamps*, 421 U.S. at 737.

Furthermore, an arbitration award providing this remedy should not be subject to vacatur for manifest disregard.

State Law Claims. As discussed above,¹²³ although common law tort and agency principles support imposing liability on brokers for violations of industry standards, courts have been reluctant to recognize remedies for negligent brokerage conduct.¹²⁴ After establishment of these proposed federal standards and the SEC's clear statement that customers are the intended beneficiaries of these standards, arbitration panels should not be reluctant to impose liability on brokers for violations of these standards under common law tort and agency principles.

Some may question whether this proposal is necessary since, whether or not there is judicial authority for it, arbitrators may, in fact, be awarding damages to customers even in the absence of fraud; further, at least to date, unsuccessful parties do not routinely attempt to vacate awards under the "manifest disregard" standard.¹²⁵ Thus, arbitrators may be arriving at the right results, even if not strictly countenanced by the law. However, currently there is a movement to make the SRO arbitration forums more like courts. NASD is rewriting its arbitration code for customers' claims¹²⁶ and is proposing new rules that transform securities arbitration into a more judicial process.¹²⁷ The most significant step in this direction, if adopted, is the requirement that arbitrators give reasons for their award if the customer requests them. If arbitrators provide reasons, the award is more susceptible to judicial scrutiny, since it is virtually impossible to demonstrate that there is manifest disregard of the law in the absence of an explanation.¹²⁸ Indeed, while NASD stated

¹²³ See *supra* notes 41-59 and accompanying text.

¹²⁴ See *supra* notes 60-81 and accompanying text.

¹²⁵ See *supra* notes 100-102 and accompanying text.

¹²⁶ Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendments Nos. 1, 2, 3, and 4 Thereto to Amend NASD Arbitration Rules for Customer Disputes, SEC Rel. 34-51856 (June 15, 2005), *available at* <http://www.sec.gov/rules/sro/nasd/34-51855.pdf>.

¹²⁷ See, e.g., Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change to Provide for a 10-Day Notice Requirement Before a Party Issues a Subpoena to a Non-Party for Pre-Hearing Discovery; SEC Rel. 34-51981 (Oct. 25, 2006), *available at* <http://www.sec.gov/rules/sro/nasd/34-51981.pdf>; The Reasoned Awards Proposed Rule Change, *supra* note 99.

¹²⁸ See *Dawahare v. Spencer*, 210 F.3d 666, 669 (6th Cir. 2000).

that the purpose of the amendment was to increase investors' confidence in the process, it noted that the presence of a reasoned award increased the likelihood that a reviewing court might find grounds to vacate the award.¹²⁹ In addition, brokerage firms increasingly are moving to dismiss investors' claims and moving for summary judgment on the ground that there is no legal basis for the claim, and courts have upheld awards that dismiss customers' claims on such legal grounds.¹³⁰ If the SRO arbitration forums are taking on more aspects of a judicial proceeding, it will become increasingly important that investors have an unassailable legal basis for their negligence claims.

IV. POLICY CONCERNS

This Part examines whether there are policy concerns unique to federal securities laws that might explain judicial reluctance, even prior to *Hochfelder* and *Gustafson*, to impose liability on brokers for negligent conduct. If there are valid concerns, Congress or the SEC should be wary of providing customers with a new federal remedy. First, this Part will examine the Supreme Court opinions to determine the relevance of their articulated policy grounds in the customer-broker context. Next, this Part will look at lower federal court opinions to assess other reasons given for the disinclination to hold brokers accountable for their negligence.

The Supreme Court precedent provides limited guidance (1) because it focuses primarily on the plain meaning of the statute, as supplemented by legislative intent,¹³¹ and, (2) because only two of the Supreme Court's federal securities opinions involve suits by a customer against his broker.¹³² Nevertheless, even though *Gustafson*¹³³ did not involve a customer-broker relationship, the majority opinion did

¹²⁹ The Reasoned Award Proposed Rule Change, *supra* note 99, at 4.

¹³⁰ See, e.g., *Sheldon v. Vermonty*, 269 F.3d 1202, 1206 (10th Cir. 2001) (holding that arbitrators can dispose of legal issues on dispositive motions); *Reinglass v. Morgan Stanley Dean Witter, Inc.*, No. 86407, 2006 WL 802751, at *4 (Ohio Ct. App. Mar. 30, 2006) (upholding arbitrators' dismissal of arbitration claim because the investor failed to plead fraud with the specificity required by Federal Rules of Civil Procedure).

¹³¹ See *supra* notes 121-122 and accompanying text.

¹³² Both these opinions relate to tangential issues. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985), deals with the *in pari delicto* defense. *Id.* at 306. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006) deals with preclusion under the Securities Litigation Uniform Standards Act. *Id.* at 1514. The paucity of case law is attributable, in large part, to *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). See *supra* note 14.

¹³³ *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).

address policy reasons for restricting the applicability of private remedies that relate directly to customer-broker suits. First, the Court alluded to the dangers of “extensive liability for every casual communication between buyer and seller in the secondary market. It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that would, if included, qualify the accuracy of a statement.”¹³⁴ This concern echoes that of state courts that impose liability for negligent misrepresentations only if a “special relationship” exists; such a relationship is present when a customer has a relationship of trust and confidence with his broker so that reliance on his statements is warranted.¹³⁵ More fundamentally, however, the reason to impose liability on brokers for negligent misrepresentations is to *curb* any tendency brokers may have to treat their responsibilities to convey information and recommendations casually. If this results in brokers providing less casual advice to their customers, such an effect could be positive and may lead investors to seek better, more informed advice. Second, in interpreting SA section 12(a)(2), the *Gustafson* majority found it worrisome that liability could be imposed without a showing that plaintiff relied on the negligent misstatement.¹³⁶ To establish liability under the proposed standards, however, the customer would have the traditional burden of establishing reasonable reliance. A related concern expressed by the Court in both *Blue Chip Stamps* and *Hochfelder*—the dangers of expanding the class of plaintiffs to include those who were not in privity with the maker of the statements¹³⁷—is also not present in customer-broker cases.

Customer-broker relationships are agency relationships, and, in another line of cases, the Supreme Court has expressed a desire to limit the scope of Rule 10b-5 claims so that they do not intrude into areas more appropriately regulated under state law. In the Court’s view, some purported Rule 10b-5 claims, properly viewed, do not raise federal securities disclosure issues. Rather, these claims are transparent attempts to convert state law mismanagement or breach of fiduciary duty claims into

¹³⁴ *Id.* at 578. Indeed, this concern relates more directly to the customer-broker situation than it does to the facts in *Gustafson*, which involved alleged misrepresentations contained in the contract negotiated between the controlling shareholder and the purchaser of its shares. *Id.* at 564.

¹³⁵ See *supra* notes 63-66 and accompanying text.

¹³⁶ *Gustafson*, 513 U.S. at 578.

¹³⁷ The following language is found in both opinions: “[W]e are not the first court to express concern that the inexorable broadening of the class of plaintiff who may sue in this area of law will ultimately result in more harm than good.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 747-48 (1975).

federal claims that are “‘at best a subsidiary purpose’ of the federal legislation.”¹³⁸ Amending the SEA to create a federal remedy for negligent broker conduct, however, is consistent with an important purpose of the federal securities laws from their inception—to improve professional standards of broker-dealers.¹³⁹ While creation of this federal remedy would, to some extent, overlap with state law, it would not interfere with state regulation. In light of increased investor participation in the securities markets and greater recognition of the importance of individuals investing for their retirement, the participation of the federal courts in interpreting and applying federal standards of competence and care would serve a vital national interest.

Another concern expressed by the Supreme Court is the increased cost of doing business resulting from vexatious litigation. More specifically, the Court is concerned about the effects of class action suits where the plaintiffs have purchased or sold securities during a period when material misrepresentations allegedly distorted the stock price.¹⁴⁰ In class actions, the stakes of individual plaintiffs are small, and the driving force may be the lure of lucrative fees for plaintiffs’ attorneys; hence, there is some reason for the Court to be skeptical of both the compensatory benefit to investors and the deterrence value of the litigation.¹⁴¹ However, the Court’s general fear of strike suits has no relevance when the real party in interest is the customer who is seeking compensation for losses suffered through the broker’s negligence. In addition, the Court’s concern for protecting professionals who have a peripheral role in the plaintiffs’ loss¹⁴² is not relevant here.

It is true, more generally, that imposing liability on brokers for negligence will increase the costs of doing business on an already highly regulated industry. Since the large publicly-traded brokerage firms consistently report large profits,¹⁴³

¹³⁸ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977).

¹³⁹ *See supra* notes 2-7 and accompanying text.

¹⁴⁰ *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188-89 (1994); *Blue Chip Stamps*, 421 U.S. at 740.

¹⁴¹ The latter was the principal reason the Supreme Court initially implied causes of action in federal securities laws. *See J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

¹⁴² *Cent. Bank of Denver*, 511 U.S. at 188-189.

¹⁴³ *See* Susanne Craig, *Bear Stearns Profit Surges 81%, Driven by Bond and Stock Trading*, WALL ST. J., June 16, 2006, at C3; Randall Smith, *Morgan Stanley, Mack See Net Soar*, WALL ST. J., June 22, 2006, at C4; Press Release, Merrill Lynch & Co., Inc., Merrill Lynch Reports Highest-Ever Net Revenues of \$8.0

requiring them to invest more money in better training and supervision of their brokers would not be an excessive hardship, especially given the anticipated benefits to investors. To the extent that federal standards may drive out of the industry firms with fewer resources to devote to training and supervision, this is not an undesirable result. Moreover, there is reason to doubt that self-regulation gives investors adequate protection. Unfortunately, recent history provides numerous instances of both the SEC and the SROs' inability to protect investors even from outright fraud and other serious abuses of investor confidence.¹⁴⁴ In addition, self-regulation is certain to change as a result of both the NYSE and NASD becoming publicly owned, for-profit corporations. Thoughtful commentators have expressed concerns about whether enforcement of the SRO rules will be a priority in this environment.¹⁴⁵

Furthermore, the valid concern expressed about non-frivolous Rule 10b-5 litigation—that former shareholders of the issuer will recover at the expense of current shareholders¹⁴⁶—is not present in customer/broker cases, unless we extend the “robbing Peter to pay Paul” concern to apply to shareholders of a brokerage firm, who presumably understand the risks of the company's business when they make their investment.¹⁴⁷ To the extent factoring in the financial impact on firms' accounting for their investors' losses is a valid concern, it may be alleviated if

Billion for First Quarter 2006, Up 28 Percent (Apr. 18, 2006), *available at* http://www.ml.com/index.asp?id=7695_7696_8149_63464_65577_65830.

¹⁴⁴ See generally *One Broker Gone Bad: Punishing the Criminal, Making Victims Whole: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 107th Cong. (2002) (chronicling the massive fraud conducted by Frank Gruttaduria, a broker employed by three securities firms over the course of 15 years, during which he stole at least \$40 million of customers' funds before turning himself in), *available at* <http://financialservices.house.gov/media/pdf/107-71.pdf>.

¹⁴⁵ See, e.g., Roberta S. Karmel, *Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 424 (2002); Edmund W. Kitch, *Hard Thinking About Inevitable Developments?*, 2000 COLUM. BUS. L. REV. 37, 44 (2000).

¹⁴⁶ See *Basic Inc. v. Levinson*, 485 U.S. 224, 262-63 (1988) (White, J., dissenting). There has been much scholarly commentary on the problem of damages in securities class actions. See, e.g., JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, *SECURITIES REGULATION CASES AND MATERIALS* 727-28 (5th ed. 2006).

¹⁴⁷ The SEC recently formulated a policy on corporate penalties in response to similar concerns. See Press Release, U.S. Secs. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* <http://www.sec.gov/news/press/2006-4.htm>.

Congress enacts federal standards in the current climate, when the nation is now sufficiently far removed from the recent market debacle that constructive and dispassionate debate can result in a consensus regarding appropriate standards.

Lower federal courts have expressed other policy reasons against customers' suits against negligent brokers. Even prior to the Supreme Court era that cut back on federal jurisdiction, the Second Circuit expressed hostility toward "saddl[ing]" the federal courts with "garden-variety customer-broker suits."¹⁴⁸ It is unclear whether this statement reflects merely a concern for docket control or whether it signifies a more substantive view that these issues are better left to state law. The nearly universal presence of arbitration agreements in broker-customer contracts today cures the first objection, and the importance of individual investors in today's society makes the customer-broker relationship a federal concern.

Other courts believed that it would be unfair to subject a broker who acted in good faith to judicial review of his market judgment.¹⁴⁹ However, in determining whether the broker satisfied his duty under the first six standards set forth above, the issue is whether he lived up to his duty of care, a familiar judicial inquiry under tort law. A broker's market judgment would be an issue for judicial review under the seventh standard, and because of the paucity of judicial precedents on this issue, this Article does not advocate for its adoption. However, it should be noted that assessing the soundness of market judgment is a question that securities arbitration is uniquely qualified to perform. In arbitration, there is no jury that might be prone toward undue sympathy for the customer or hostility toward the brokerage firm. and, on a typical three-person arbitration panel, one of the arbitrators is an industry arbitrator for the purpose of bringing industry expertise to bear on appropriate professional standards.

Finally, another category of objections focuses on the plaintiff-customer and finds him insufficiently worthy. Concern is expressed that greedy customers who were willing to gamble may now be trying to blackmail the firm into paying for losses the customers willingly incurred.¹⁵⁰ These are valid concerns, but they are not unique

¹⁴⁸ Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 183 (2d Cir. 1966).

¹⁴⁹ See e.g., Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 431 (N.D. Cal. 1968), *rev'd on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

¹⁵⁰ This sentiment is not new. In the debate on the SEA, one Congressman stated: "I also recognize another man who is very largely responsible for the misfortunes of the country and the excessive stock speculation and debacle. That is Mr. American Citizen who wants to get something for nothing." 78 CONG. REC. 7861, 7862 (1934) (statement of Rep. Lea), *reprinted in* 1 FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 853 (1983); *see also* Robert H. Mundheim,

to these tort claims. Contributory negligence, justifiable reliance and similar defenses are available to minimize or, in appropriate cases, eliminate recovery altogether. Arbitration, with its emphasis on the facts of each particular case, is an especially good forum to resolve these disputes. While arbitration is sometimes derided for its “splitting the baby” approach, such a compromise is appropriate when contributory negligence issues are significant.

CONCLUSION

Since 1934, Congress has amended the SEA on several occasions to improve professionalism in the selling of securities. What is missing, however, is a federal remedy for investors to hold their brokers accountable for negligent conduct in trading transactions, particularly negligent advice-giving. It is now time that Congress adopts federal standards of competence and care and provides customers with a remedy that will allow recovery for the financial harm caused by incompetent or careless brokers. Toward that end, this Article proposes a number of federal standards of care and competence for consideration. Legislative consideration of this proposal should, at the least, engender a robust public debate over what customers can reasonably expect from their brokers that hopefully will lead to a remedy to vindicate their rights.

Professional Responsibilities of Broker-Dealers: The Suitability Doctrine, 1965 DUKE L.J. 445, 463-64 (1965) (discussing concerns that imposing civil liability for violations of industry standards “would be an invitation for disappointed customers to blackmail their broker-dealers”).