

2002

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Recommended Citation

Ramirez, Steven, The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles? 70 U. Cin. L. Rev. 527 (2002)

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THE PROFESSIONAL OBLIGATIONS OF SECURITIES BROKERS UNDER FEDERAL LAW: AN ANTIDOTE FOR BUBBLES?

Steven A. Ramirez*

I. INTRODUCTION

In the wake of the stock market crash of 1929 and the ensuing Great Depression, President Franklin D. Roosevelt proposed legislation specifically designed to extend greater protection to the investing public and to elevate business practices within the securities brokerage industry.¹ This legislative initiative ultimately gave birth to the Securities Exchange Act of 1934 (the '34 Act).² The '34 Act represented the first large scale regulation of the nation's public securities markets.³ Up until that time, the securities brokerage industry⁴ had been left to regulate itself (through various private stock exchanges). This system of

* Professor of Law, Washburn University School of Law. Professor William Rich caused me to write this Article by arranging a Faculty Scholarship Forum at Washburn University in the Spring of 2001 and asking me to participate. He has been a constant positive influence in my efforts to improve as a scholar. My excellent former secretary Mary Beth Bero has also been a consistently positive factor in helping me be a productive scholar.

1. The background of the President's [initiative] is only too familiar to everyone. During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or \$25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.

H.R. REP. NO. 73-85, at 2 (1933).

2. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2000)).

3. HOWELL E. JACKSON & EDWARD L. SYMONS, JR., REGULATION OF FINANCIAL INSTITUTIONS 653 (1999). Some state regulation of the securities markets and the securities brokerage industry was in place in 1934, but for a variety of reasons it was of limited effectiveness. *Id.* at 656. For example, states had inadequate resources for expert regulatory staff, and a lack of uniformity created opportunities for regulatory competition and avoidance whereby business could gravitate towards lax jurisdictions. *Id.*

4. The '34 Act regulates both "brokers" and "dealers." A broker is defined as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4) (2000). A dealer is defined as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." 15 U.S.C. § 78c(a)(5) (2000). This paper refers to both of these types of entities under the terms "broker-dealer" or "securities brokerage industry."

self-regulation had the benefit of being expertly promulgated, administered, and enforced, but it lacked government sanctioning power. In addition, because the professional standards were set by the profession itself, the regulations were susceptible to dilution.⁵ Because the industry's unassisted efforts at self-regulation had failed so spectacularly,⁶ the '34 Act was aimed at preserving self-regulation within a legal framework that assured the enforcement of higher industry standards.⁷ The '34 Act, therefore, empowers self-regulatory organizations (SROs) to wield initial regulatory authority, subject to the federal oversight of the Securities and Exchange Commission (SEC).⁸ The '34 Act thus effectively preserved self-regulation while at the same time mandating "just and equitable principles of trade" in the securities brokerage industry with the specific intent of raising industry standards for the protection of investors.⁹ This was a key element of the New Deal effort to reconstruct investor confidence and restore macroeconomic stability and growth.¹⁰

5. See JACKSON & SYMONS, *supra* note 3, at 659 (discussing how the New Deal transformed private regulation to "quasi-public" self-regulation). See also U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 7 (1996) (discussing the benefits of self-regulation and the risk that self-regulation may favor industry interests over those of investors) [hereinafter SEC REPORT].

6. "One would have to turn the pages of history back to the days of the South Sea bubble to find an equivalent fantasy of security selling." H.R. REP. NO. 73-85, at 3.

7. See SEC v. Zandford, 122 S. Ct. 1899, 1903 (2002) ("Among Congress' objectives in passing the Act was 'to insure honest securities markets and thereby promote investor confidence' after the market crash of 1929."); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 315 (1985) (stating that the "primary objective of the federal securities laws" is investor protection through promotion of a "high standard of business ethics" in "every facet of the securities industry") (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963)); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (noting that the intent of the '34 Act was to "achieve a high standard of business ethics in the securities industry" and that the Act must consequently "be construed . . . flexibly to effectuate its remedial purposes") (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186, 195 (1963)); Silver v. N.Y. Stock Exch., 373 U.S. 341, 366 (1963) ("It requires but little appreciation of . . . what happened in . . . the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail as to every aspect of the [securities business].").

8. Compare 15 U.S.C. § 78f (2000) (delineating powers of exchanges) and 15 U.S.C. § 78o-3 (2000) (delineating powers of National Association of Securities Dealers, the only registered securities association), with 15 U.S.C. § 78s (2000) (specifying oversight powers of the SEC). See also WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 64-65, 82 (1940) (stating that stock exchanges are the "scales upon which that great national resource, invested capital, is weighed"; therefore, they may not be allowed to be run as "private club[s]" and instead government must exercise a "residual role" and "keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned and ready for use"). Justice Douglas served as Chairman of the SEC during the 1930s. *Id.* at viii.

9. See 15 U.S.C. § 78f(b)(5) (2000) (requiring rules of SROs to "protect investors and the public interest").

10. "This proposal . . . puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." H.R. REP. NO. 73-85, at 2 (quoting letter from President Franklin D. Roosevelt). The Great Depression demolished investor confidence so thoroughly that investors had "grown timid to the point of hoarding" cash. This breakdown in free,

Since 1934, however, the courts have largely ignored the logical implications of this New Deal initiative to elevate standards of conduct within the securities industry and insure investor protection when assessing the duties of broker-dealers to customers. Instead, the courts essentially allow federal law to define federal securities fraud claims and look exclusively to state law for non-fraud claims. This result is in large part the responsibility of counsel who have represented investors against securities professionals. For the most part, the theories advanced to invoke federal protections have been stilted and have allowed courts to fail to fully appreciate the policy foundations of the '34 Act and the nature of the professional obligations imposed under the Act, particularly as amended in 1938, 1964, and 1975. Rather, courts have blithely assumed, on a vast majority of occasions, that except in cases of fraud, state law principles of fiduciary duties are the exclusive source of broker-dealer obligations in a private suit to recover monetary damages. Moreover, academic commentators have failed to devote much thought to how the federal oversight of self-regulation fits with remedies for broker-dealer misconduct.¹¹ Fundamentally, the '34 Act embodied a legislative compromise whereby federal law would elevate industry standards while preserving self-regulation so long as that compromise would secure the transcendent goal of investor protection.¹² This Article consequently posits that the '34 Act (particularly as amended in subsequent years) effectively mandates minimum standards of professional conduct (giving rise to state law remedies) without interfering with state fiduciary duty law and without creating an entire new class of federal

unregulated securities markets posed a historic threat to "honest enterprise" and capitalism generally. S. REP. 73-47, at 1 (1933).

11. See Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 119 (1997) (stating that "key issue" to fiduciary obligation is "control"); Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1272-73 (1995) (contending that the shingle theory, discussed *infra* note 105, is no longer a sound basis for civil liability under the antifraud provisions of the federal securities laws); Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties—Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DEPAUL L. REV. 709, 713 (1990) (arguing that fiduciary duty concepts may saddle market professionals with "extravagant" duties that have "unpersuasive" foundations that are untethered to industry understandings and practices); Carol R. Goforth, *Stockbrokers' Duties to their Customers*, 33 ST. LOUIS U. L.J. 407 (1989) (reviewing common law of broker liability with little analysis of role of SRO rules in supporting professional liability); Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445 (1965) (discussing industry professional obligations but failing to assess the extent to which such standards support professional liability).

12. "The bill proceeds on the theory that the exchanges are public institutions . . . and are not private clubs to be conducted only in accordance with the interests of their members." H.R. REP. NO. 73-1383, at 15 (1934).

remedies, claims, and law. In essence, federal law supports state law claims for broker malpractice or professional liability.¹³

In the decades following the '34 Act, the fact that the courts failed to fully appreciate the significance of the Act mattered little; state law fiduciary principles generally supported broker liability on a basis similar to the industry standards required under the '34 Act. In addition, Rule 10b-5¹⁴ was broadly interpreted to extend remedies to investors harmed by misconduct. However, a growing body of state-based case law has narrowed broker-dealer fiduciary obligations. Thus, in the wake of the fading memory of the Great Depression, state law has developed unevenly, with a number of courts wandering into a decisively *caveat emptor* mode, as if the Great Depression and the '34 Act had never occurred.¹⁵ Meanwhile, in the federal courts, the New Deal remedies

13. Of the scores of reported broker liability cases, few even discuss broker liability in terms of malpractice or professional liability. See *Ferritto v. Olde & Co.*, 577 N.E.2d 101, 104 (Ohio App. 1989) (affirming jury verdict for broker's negligent violation of the New York Stock Exchange's (NYSE) Business Conduct Rule 405, which requires brokers to "learn the essential facts relative to every customer" and "every order"); *Twomey v. Mitchum Jones & Templeton*, 69 Cal. Rptr. 222, 244 (1968) (stating that "ethical standards" can form the basis for civil liability for negligence even if such violations are unsupported by an express or implied right of action under federal law); *McCollum v. Billings*, 279 N.Y.S.2d 609, 616-617 (1967) (finding the claim that the broker "failed to exercise their special skill and competence" invoked jurisdiction of state court for redress under state law).

The *Twomey* court did not address explicitly whether its substantive basis for liability rested upon fiduciary duty concepts or professional malpractice. See *id.* at 227-28. The opinion is premised on the term "misfeasance," which is consistent with professional malpractice as well as breach of fiduciary duty. See *id.* at 227. Similarly, the *Ferritto* court applied concepts of professional negligence in the context of a claim for breach of fiduciary duty. 577 N.E.2d at 585.

14. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5 (2001). As such, Rule 10b-5 is the general anti-fraud provision of the federal securities laws.

15. Ferdinand Pecora served for seventeen months, from January 1933 to July 1934, as counsel to the Senate Committee on Banking and Currency during the time of hearings on the Securities Act and the Exchange Act. See FERDINAND PECORA, *WALL STREET UNDER OATH: THE STORY OF OUR MODERN MONEY CHANGERS* 3 (Augustus M. Kelley ed., 1973) (1939). Pecora published a summary of those congressional hearings because "[a]fter five short years, we may now need to be reminded what Wall Street was like before Uncle Sam stationed a policeman at its corner." *Id.* at xi.

Pecora was prescient in predicting a failure of public memory:

Under the surface of the governmental regulation of the securities market, the same forces that produced the riotous speculative excesses of the "wild bull market" of 1929 still give evidences of their existence and influence. Though repressed for the present, it cannot be

in favor of investors have generally been reversed so that federal law now provides remedies that are more restrictive than those available under state law.¹⁶ For the first few decades after the New Deal, then, it mattered little whether the professional liability of brokers was given effect, as other equally generous means of recovery were available.¹⁷ Today, however, fiduciary concepts and private securities litigation have contracted to such a point that broker liability is now best based upon federally mandated industry standards and traditional state claims of professional liability, such as malpractice. Most important, there are compelling policy reasons for courts to give effect to these standards: the economic imperatives of stemming speculative bubbles and an erosion in professional conduct. Recognition of professional standards can thereby avoid another meltdown in investor confidence like that which occurred in 1929 and which seems to be recurring in 2002 in the wake of relaxed standards of conduct for securities brokers.

This Article does not posit that the '34 Act provided for federal fiduciary standards preemptive of state fiduciary duties, or even for federal private rights of action against broker-dealers for violation of industry standards.¹⁸ Rather, the Act preserved industry self-regulation

doubted that, given a suitable opportunity, they would spring back into pernicious activity. Frequently we are told that this regulation has been throttling the country's prosperity. Bitterly hostile was Wall Street to the enactment of the regulatory legislation. It now looks forward to the day when it shall, as it hopes, reassume the reins of its former power. . . . The public, however, is sometimes forgetful. As its memory of the unhappy market collapse of 1929 becomes blurred, it may lend at least one ear to the persuasive voices of The Street subtly pleading for a return to the "good old times." Forgotten, perhaps, by some are the shattering revelations of the Senate Committee's investigation

Id. at ix-x.

16. See, e.g., Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1059 (1999) (noting that Congressional "reforms" in private securities litigation during the 1990s had the perverse effect of using federal law to narrow investor rights).

17. The '34 Act regulates both broker-dealers as well as individuals working for broker-dealers, under the term "person[s] associated with a broker or dealer."

The term "person associated with a broker or dealer" or "associated person of a broker or dealer" means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term

15 U.S.C. § 78c(a)(18) (2000). Thus, for purposes of this article the term "brokers" or "broker-dealers" refers to individuals as well as firms.

18. Given the breadth of the '34 Act, which regulates everything from insider trading to public company disclosure obligations, and the reach of the New Deal generally, which regulates everything from deposit insurance to monetary policy, such far-reaching and intrusive regulation would have been politically problematic.

while mandating high industry standards of professional conduct with powerful enforcement mechanisms. Congress and President Roosevelt specifically intended these mandated self-regulatory standards to operate to protect investors, but to do so outside of an express federal remedial scheme. The most logical result is the imposition of federally mandated industry standards that operate to give investors contract and professional negligence remedies in accordance with state law.

This Article shows that under the '34 Act, federal law imposes minimum professional obligations upon securities broker-dealers that should operate to benefit and protect investors by, among other things, providing monetary damages to investors harmed by professional misconduct. Part II of the Article reviews in detail the content, scope, and source of these federally mandated standards of professional conduct. Integral to this review is an analysis of the history of the federal regulatory regime of the securities brokerage industry. Part III of this Article attempts to account for more than sixty-five years of common law development of the professional obligations of securities professionals. For the most part, these common law obligations have diverged from the federally imposed regime, especially as the lessons of the Great Depression have faded. Part IV assesses the risks of allowing professional standards to meander lower, as has been the trend in the courts. The Article concludes that the recent dilution of investor remedies originally contemplated by the drafters of the '34 Act risks excessive speculation, reduced investor confidence, and the continued erosion of the market niche of professional broker-dealers. In the end, this Article seeks to demonstrate that high standards of professional conduct, enforceable by aggrieved investors, will stabilize financial markets as well as the business of providing professional broker-dealer services.

II. FEDERAL PROFESSIONAL OBLIGATIONS FOR SECURITIES PROFESSIONALS

A paramount goal of the Securities Exchange Act of 1934, as embodied in the legislation's conference committee report, was to "prevent inequitable and unfair practices" on securities exchanges.¹⁹ This Part will show that this fundamental goal has given rise to a persistent effort to professionalize the securities brokerage industry. This effort has led to standards of conduct that should operate to benefit

19. *E.g.*, S. REP. NO. 73-185, at 1 (1934) (conference report on final bill).

and protect investors harmed by brokers' misconduct, including supporting state law claims for traditional professional negligence.²⁰

A. The Legislative and Political History of the '34 Act

The ultimate political source of the New Deal regulatory initiatives—including the regulation of securities—was President Franklin D. Roosevelt.²¹ President Roosevelt was quite clear about the purposes of the Securities Act of 1933²² and the Securities Exchange Act of 1934.²³ He viewed these legislative initiatives as a seamless effort²⁴ to raise the standards of conduct across the entire securities business and to replace

20. Neither by the Securities Act of 1933 nor by the Securities Exchange Act of 1934 does the Federal Government undertake to approve or guarantee the present soundness or the future value of any security. The investor must still, in the final analysis, select the security which he deems appropriate for investment. The purposes of the Securities Act of 1933 are to make available to him complete and truthful information from which he may intelligently appraise the value of a security, and to safeguard against the negligent and fraudulent practices perpetrated upon him in the past by incompetent and unscrupulous bankers, underwriters, dealers and issuers.

S. REP. NO. 73-1455, at 153 (1934).

21. For example, in addition to the usual legislative process, President Roosevelt directed the Secretary of Commerce to form a committee to study the problems inherent in federal regulation of the securities markets. The result of this study was transmitted by the President to Congress and became the basis of the '34 Act. See REPORT TO THE SEC'Y OF COMMERCE BY THE COMM. ON STOCK EXCH. REGULATION, reprinted in SENATE COMM. ON BANKING AND CURRENCY, 73D CONG., 2D SESS., LETTER FROM THE PRESIDENT OF THE UNITED STATES TO THE CHAIRMAN OF THE COMM. ON BANKING AND CURRENCY WITH AN ACCOMPANYING REPORT RELATIVE TO STOCK EXCH. REGULATION, reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Item 16, at III (Comm. Print 1934) (J.S. Ellenberger & Ellen P. Mahar eds., 1973) [hereinafter STOCK EXCHANGE REGULATION STUDY].

22. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)).

23. *Supra* note 2.

24. S. REP. NO. 73-792, at 1 (1934) (stating that the '33 Act was "one step" in our "broad purpose of protecting investors") (quoting letter from President Franklin D. Roosevelt). Congress also viewed the various New Deal initiatives aimed at restructuring our system of financial regulation as an integrated effort to address the same complex of problems:

In the course of the investigation thus far conducted by the subcommittee a record of more than 12,000 printed pages has been compiled and more than 1,000 exhibits received in evidence. The subcommittee has endeavored to investigate thoroughly and impartially some of the complex and manifold ramifications of the business of issuing, offering, and selling securities and the business of banking and extending credit. It has endeavored to expose banking operations and practices deemed detrimental to the public welfare; to reveal unsavory and unethical methods employed in the flotation and sale of securities; and to disclose devices whereby income-tax liability is avoided or evaded. Its purpose throughout has been to lay the foundation for remedial legislation in the fields explored and in some measure that purpose has already been achieved. During the progress of this investigation, Congress enacted the Banking Act of 1933, the Securities Act of 1933, the Securities Exchange Act of 1934, and several amendments to the revenue act calculated to eliminate methods of tax avoidance described before the subcommittee.

S. REP. NO. 73-1455, at 3-4 (1934).

the principle of *caveat emptor*²⁵ with a “clearer understanding of the ancient truth” that those managing “other people’s money” should be subject to trustee duties.²⁶ Focusing specifically upon the regulation of the securities broker-dealer profession, Roosevelt stated that his legislative proposal was animated by a “broad purpose of protecting investors” and to provide for “better supervision” of securities exchanges.²⁷ The goal of the Act was therefore to establish “a minimum standard of fair dealing” on securities exchanges.²⁸ The ’34 Act was essentially an attempt to make capitalism more durable by making “intelligent adjustments,” rather than an attempt to “destroy” the market mechanism for allocation of capital.²⁹ Thus, for example, the ’34 Act focuses upon disclosure obligations rather than having the government approve securities for sale to the public.³⁰

The legislative history of the securities acts evinces an intent that is entirely consistent with President Roosevelt’s goal of elevating standards within the securities profession.³¹ The House Report accompanying the

25. “This proposal adds to the ancient rule *caveat emptor*, the further doctrine ‘let the seller also beware.’ It puts the burden of telling the whole truth on the seller.” H.R. REP. NO. 73-85, at 2 (quoting letter from President Franklin D. Roosevelt).

26. H.R. REP. NO. 73-85, at 1-2 (1933). See also JACKSON & SYMONS, *supra* note 3, at 659 (“While it had a profound effect on capital formation, the 1933 Act was recognized from the start as simply the first phase of federal regulation over the securities industry.”).

27. H.R. REP. NO. 73-1383, at 1 (1934) (quoting letter from President Franklin D. Roosevelt).

28. STOCK EXCHANGE REGULATION STUDY, *supra* note 21, at v. Roosevelt was modeling his securities initiatives on Louis Brandeis’s landmark work, *Other People’s Money*, which posited that investment professionals should be subject to duties akin to a “trustee.” See LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 199-200 (1911). See also generally SHELDON M. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* § 1.03 (1977).

29. The bill is conceived in a spirit of the truest conservatism. It attempts to change the practices of exchanges and the relationships between listed corporations and the investing public to fit modern conditions, for the very purpose that they may endure as essential elements of our economic system. The lesson of 1921-29 is that without changes they cannot endure.

The bill is not a moral pose or a vengeful striking back at brokers for the losses which nearly the entire Nation has suffered in the last 5 years. Nor is its purpose or effect to regiment business in any way. It is simply an earnest attempt to make belated intelligent adjustments, long required by changing conditions, in a faulty system . . . which from the coldly objective viewpoint of the welfare of a conservative public simply has not worked.

H.R. REP. NO. 73-1383, at 3.

30. See S. REP. NO. 73-792, at 13 (1934).

31. Indeed, section 2 of the ’34 Act articulates many broad and important policy reasons for regulation, all of which militate for the abolition of *caveat emptor* and the creation of “fair and honest” markets:

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for

'34 Act plainly states that "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'" is required to "support[] the constant extension of . . . confidence which is the foundation of a maturing and complicated economic system."³² The '34 Act therefore "proceeds on the theory that the exchanges are public institutions" and "not private clubs to be conducted only in accordance with the interests of their members."³³ Consequently, the Securities and Exchange Commission was "empowered" to impose appropriate rules for "the protection of investors" and "to insure fair dealing."³⁴ Still, Congress hoped that the bill would give exchanges the power to reform themselves and that Commission action would not be needed.³⁵ These precepts form the foundation upon which the modern mandatory self-regulatory regime is built.

This self-regulatory regime came about because the securities industry was able to launch a substantial attack upon any effort to displace industry self-regulation with a federalized, transcendent fiduciary principle or an effort for detailed statutory standards of conduct.³⁶ The "central compromise" of the '34 Act was to implement a scheme of "cooperative regulation" instead of fully federalized regulation.³⁷ This

the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.

15 U.S.C. § 78b (2000).

32. H.R. REP. NO. 73-1383, at 5.

Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

Id.

33. *Id.* at 15.

34. *Id.*

35. *See id.*

36. The original bill submitted to the Committee dealt very specifically and definitely with a number of admitted abuses. In many cases, however, the argument was made that while the solutions offered might be correct, their effects were so far-reaching as to make it inadvisable to put these solutions in the form of statutory enactments that could not be changed in case of need without Congressional action. Representatives of the stock exchanges constantly urged a greater degree of flexibility in the statute and insisted that the complicated nature of the problems justified leaving much greater latitude of discretion with the administrative agencies than would otherwise be the case.

Id. at 6.

37. JACKSON & SYMONS, *supra* note 3, at 659-62; JAFFE, *supra* note 28, § 1.04.

compromise had a sound basis in policy. First, the compromise gave recognition to the fact that the brokerage industry is complex and often in need of flexible and swift regulatory action.³⁸ Second, the exchanges had a history of some level of self-regulation.³⁹ Third, the use of self-regulation lowers the expenses of regulation and dispenses with the need for vast bureaucracies.⁴⁰ Finally, self-regulation can impose ethical standards beyond minimum legal requirements.⁴¹ The mandatory self-regulation compromise thus reflected the hope that "well-managed exchanges" would have the power under the '34 Act to raise industry standards.⁴²

In 1938, Congress took another step in professionalizing the securities brokerage industry when it passed the Maloney Act,⁴³ which expanded the SEC's authority into the over-the-counter securities market by expanding the concept of self-regulation beyond just broker-dealers that were exchange members. Congress intended the Maloney Act to stem unethical conduct (and insist upon "professional conduct") that, "while technically outside of the area of definite illegality," would nevertheless prove harmful to "customer and to decent competitor" alike.⁴⁴ This

38. Stock exchanges raise essentially new problems in Federal regulation. They do not present a static situation susceptible to fixed standards. On the contrary, it is a highly dynamic, ever-changing picture, subject to untold and unknown possibilities and combinations that are today unpredictable. The thing to be avoided is the placing of this complex and important mechanism in a strait jacket.

Your committee has considered as an alternative suggestion that the proposed enactment cover in its detailed provisions all known unfair, inequitable, and unsocial practices by express provisions with a minimum discretionary power of regulation by the governmental body responsible for enforcement:

While it is possible to fix by law certain basic standards as a guide to conduct in the matter of regulation of exchanges, these must be limited to minimum requirements. The point specifically is that while certain provisions might be included in any regulations, such provisions should not be the only power of correction left open to an administrative agency, but it should have broad discretion to operate directly on various abuses as the future may prove them to exist. It is not proposed that the Government so dominate exchanges as to deprive these organizations of initiative and responsibility, but it is proposed to provide authority to move quickly and to the point when the necessity arises.

STOCK EXCHANGE REGULATION STUDY, *supra* note 21, at 6.

39. JAFFE, *supra* note 28, § 1.04.

40. SEC REPORT, *supra* note 5, at 7.

41. *Id.* See also S. REP. NO. 88-379, at 42 (1963) (stating that self-regulation allows regulation of "unethical as distinct from illegal conduct").

42. H.R. REP. NO. 73-1383, at 15.

43. Maloney Act, Pub. L. No. 719, ch. 677, 52 Stat. 1070 (1938).

44. S. REP. NO. 75-1455, at 3 (1938); H.R. REP. NO. 75-2307, at 4 (1938). The 75th Congress articulated the problem with direct government regulation of industry norms when it compared the Maloney Act with a "second" option of "cooperative regulation":

The first would involve a pronounced expansion . . . of the [SEC]; the multiplication of branch offices; a large increase in the expenditure of public funds; an increase of the problem of avoiding the evils of bureaucracy; and a minute, detailed, and rigid regulation

theme of protecting “decent competitor[s]” was not just hollow rhetoric, as securities brokerage industry trade groups sponsored and supported the Maloney Act.⁴⁵ Ultimately, the Maloney Act gave rise to the National Association of Securities Dealers, Inc. (the NASD), the only “Securities Association” ever registered pursuant to section 15A of the ’34 Act.⁴⁶ As the NASD puts it, it “is not an organization that was imposed upon the investment banking and securities business by Congress The privilege of self-regulation was actively sought by the securities business”⁴⁷ Virtually every registered broker-dealer is now required to be a member of the NASD.⁴⁸ The effect of the NASD is to nationalize the standards of professional conduct applicable to broker-dealers.⁴⁹

In 1964, Congress acted again to further professionalize the securities brokerage industry and raise business standards.⁵⁰ The premise of the Securities Acts Amendments of 1964 (the ’64 Amendments)⁵¹ was to give specificity to the ’34 Act’s “general objective” of protecting “investors against malpractices in the securities and financial markets.”⁵² In fact, Congress determined that further action was required because of “the reliance which the investing public necessarily places upon the competence and character of professionals” in the securities markets.⁵³ Congress found that “inexperienced or unqualified persons” subjected the “investing public to undue hazards.”⁵⁴ To remedy perceived shortcomings in the then existing statutory scheme, Congress drafted section 15(b)(7),⁵⁵ which required the NASD to promulgate rules mandating that any person associated with a member broker-dealer meet standards of “training, experience; . . . and such other qualifica-

of business conduct by law. It might very well mean expanding the present process of registration . . . to include the proscription not only of the dishonest, but also of those unwilling or unable to conform to rigid standards of . . . professional conduct

S. REP. NO. 75-1455, at 3-4; H.R. REP. NO. 75-2307, at 4-5.

45. VI LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2789-90 (1990).

46. JACKSON & SYMONS, *supra* note 3, at 662.

47. NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *MANUAL* 160 (2000) [hereinafter *NASD MANUAL*]. According to the NASD, “[w]ithout legislative authority, . . . the problem of effectively promoting self-regulation was a difficult one.” *Id.* at 159.

48. See 15 U.S.C. § 78o(b)(8) & (9) (2000).

49. See S. REP. NO. 88-379, at 42 (1963) (“In the light of . . . the desirability of uniform application of standards,” it would be “anomalous” to allow membership in SROs to be optional).

50. See Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565.

51. *Id.*

52. H.R. REP. NO. 88-1418, at 4 (1964).

53. S. REP. NO. 88-379, at 43.

54. *Id.*

55. 15 U.S.C. § 78o(b)(7) (2000).

tions” as the NASD may prescribe.⁵⁶ This legislation was enacted in response to an SEC Special Study of the Securities Markets completed in 1963.⁵⁷ A consistent theme of the Special Study underlying the promulgation of the '64 Amendments was the SEC's stated need to upgrade industry standards⁵⁸ and to further professionalize the brokerage industry.⁵⁹ In line with this theme, the Commission recommended competency standards and character and fitness standards as in “the legal profession.”⁶⁰ Ultimately, the industry, through the NASD, adopted rigorous standards of character and fitness requiring that members and associated persons be “capable of complying with” all laws and regulations and of “observing high standards of commercial honor and just and equitable principles of trade.”⁶¹ It is notable that the securities industry itself was virtually unanimous in its support of this regulatory initiative to strengthen the hand of the SEC in imposing higher industry standards.⁶² After the '64 Amendments, standards of professional competence and integrity were imposed upon all broker-dealers as recommended by the Special Study.⁶³

In 1975, Congress again acted to give more power to the SEC to enforce industry standards. First, the SEC was given power to directly enforce SRO rules and regulations.⁶⁴ Second, the Commission was given enhanced authority to disapprove changes in an exchange's rules

56. *Id.*

57. See REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 88-95, pt. 1, at 151 (1st Sess. 1963) [hereinafter SPECIAL STUDY]. The Special Study was authorized by Congress in order to assess any inadequacies in the regulation of the securities brokerage industry. *Id.* at 1. Congress was concerned that speculative excesses had once again permeated the nation's securities exchanges and wanted to assure the maintenance of investor confidence. *Id.* at 1-2.

58. As the SEC stated: “The functions of this report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise standards of investor protection, thus preserving and enhancing the level of investor confidence.” *Id.* at v (letter of transmittal dated Aug. 8, 1963).

59. Graham L. Sterling, Jr., *National Association of Securities Dealers and the Securities Acts Amendments of 1964*, 20 BUS. LAW. 313 (1965) (“A consistent theme of the Special Study is the professionalization or upgrading of the industry.”). Congress stated that one of the “major subjects” of the '64 Amendments was to “strengthen qualification standards and disciplinary controls” over securities industry personnel. H.R. REP. NO. 88-1418, at 2 (1964). Congress specifically intended the '64 Amendments to impose standards of “training, experience and competence” for securities industry personnel. *Id.*

60. SPECIAL STUDY, *supra* note 57, at 161.

61. NASD MANUAL, *supra* note 47, Rule 1014(a)(3), at 3120.

62. See H.R. REP. NO. 88-1418, at 3 (1964).

63. SPECIAL STUDY, *supra* note 57, at 159-61. It is significant that Congress in 1964 recognized the intent to protect investors from “malpractices” in the securities markets. *Supra* note 50. Malpractice is a term that has long been associated with professional liability for negligence. BLACK'S LAW DICTIONARY 971 (7th ed. 1999) (defining malpractice to mean “[a]n instance of negligence or incompetence on the part of a professional”); see also BLACK'S LAW DICTIONARY 1111 (4th rev. ed. 1968) (citing *Gregory v. McGinnis*, 134 S.E. 527, 529 (S.C. 1926)).

64. See 15 U.S.C. § 78u(a)(1) (2000).

and to review disciplinary actions taken by an exchange so as to provide for more uniform sanctions and standards.⁶⁵ As part of this effort, Congress in 1975 reviewed the history of mandatory self-regulation and made many statements that bore directly upon the issue of the intent of the '34 Act. The 94th Congress stated that the 73d Congress opted to allow self-regulation to continue to "govern the conduct and professional standards of professional participants in the securities markets."⁶⁶ The 94th Congress also recognized that "the SEC is charged with supervising the exercise of this regulatory power in order to assure that it is used . . . to protect investors and assure fair dealing in securities."⁶⁷

Finally, in 1995, Congress overhauled private litigation under the federal securities laws. The Private Securities Litigation Reform Act of 1995 (PSLRA)⁶⁸ stemmed from an attitude in the courts as well as in Congress (eager to respond to industry clamor) that private securities litigation is often "vexatious."⁶⁹ While the PSLRA raised the bar dramatically on plaintiff claims, Congress did not change the ability of the SEC to mandate industry standards in the securities industry, did not alter the method or procedure by which customer broker disputes were arbitrated, and evinced no intent to allow enforcement means other than private statutory claims to be diluted. The PSLRA demonstrates that both the industry and Congress remain as committed as ever to the SEC's ongoing role of imposing professional standards in lieu of *caveat emptor* in the securities industry.

Viewing the legislative history of the '34 Act, as well as the legislative history of the major amendments promulgated by Congress subsequent to 1934, certain elements of consistent legislative and political intent

65. See 15 U.S.C. § 78s(b) & (c) (2000).

66. In fashioning the Securities Exchange Act of 1934, Congress considered the question whether to continue in effect the system of regulation by which the industry voluntarily undertook to govern the conduct and professional standards of professional participants in the securities markets or to rely instead on direct regulation by governmental authority. Convinced that an attempt to regulate the industry directly through government on a wide scale would be "ineffective," the Congress chose to develop a unique pattern of regulation combining both industry and government responsibility. This pattern, which has remained substantially unchanged for 40 years, calls upon industry organizations—the exchanges and the NASD—to exercise delegated governmental power in order to enforce at their own initiative compliance by members of the industry with both the legal requirements laid down in the Securities Exchange Act and ethical standards which go beyond those requirements. H.R. REP. NO. 94-123, at 6 (1975). See also S. REP. NO. 94-75, at 22 (1975) (same).

67. *Id.*

68. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

69. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) ("[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."). One particularly graphic critic of securities lawyers was former Senator Alfonse D'Amato of New York, who stated that plaintiffs' securities lawyers were "sharks, sharks for hire" and "bandits." 141 CONG. REC. S17,935-36 (daily ed. Dec. 5, 1995) (statement of Sen. D'Amato).

emerge. For example, one consistent theme is that Congress valued certain elements of self-regulation and did not want to regulate the brokerage on a wide scale.⁷⁰ Nor did Congress ever undertake to displace state law claims generally or state fiduciary duty claims in particular.⁷¹ Nevertheless, Congress did intend to impose “professional standards” and “ethical standards” for “professional participants” in the securities brokerage industry.⁷² In this initiative, Congress (and President Roosevelt) certainly wanted to enhance investor remedies, impose more demanding professional obligations, and thereby increase investor confidence.⁷³

B. The Text of the '34 Act

The text of the '34 Act (as amended) embodies this intent of the political branches. The foundation of federally mandated self-regulation consists of 15 U.S.C. §§ 5,⁷⁴ 6,⁷⁵ 15A⁷⁶ and 15(a)(8).⁷⁷ Section 5 requires the registration of all securities exchanges.⁷⁸ Section 15(a)(8) requires that all broker-dealers be members of either an exchange or a registered securities association.⁷⁹ Sections 6 and 15A specify the requirements of registration for national securities exchanges and registered securities associations, respectively.⁸⁰ The only “securities association” registered with the SEC is the NASD.⁸¹ Both the NASD and the various stock exchanges registered with the SEC (such as the NYSE) are defined in the '34 Act as “self-regulatory organization[s].”⁸² All of this means that every broker-dealer is a member of some self-regulatory organization.

The registration requirements mandate that SRO rules “are designed to prevent fraudulent and manipulative acts and practices” and “promote just and equitable principles of trade.”⁸³ These mandates are

70. *Supra* note 37.

71. See 15 U.S.C. § 78bb (2000).

72. *Supra* notes 8, 9, 19, 27, 32, 33, 44, 52, 53, 60, 63 and 66.

73. *Supra* notes 9, 29, 52, 58 and 59.

74. 15 U.S.C. § 78c (2000) (prohibiting securities transactions except on registered exchanges).

75. 15 U.S.C. § 78f (2000).

76. 15 U.S.C. § 78o-3 (2000).

77. 15 U.S.C. § 78o (2000).

78. *Supra* note 74.

79. *Supra* note 77.

80. *Supra* notes 75 and 76.

81. *Supra* note 46 & accompanying text.

82. 15 U.S.C. § 78c(26) (2000).

83. 15 U.S.C. § 78f(b)(5) (2000). More specifically, the SEC must deny registration to an exchange unless its rules:

are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged

specific requirements of a transcendent goal to “protect investors and the public interest.”⁸⁴ The registration requirements for SROs further mandate disciplinary procedures for violations of the '34 Act and SRO rules and mandate sanctions for such violations including censures, fines, suspensions, and expulsions.⁸⁵ Moreover, an SRO may “summarily” suspend anyone who has been expelled, barred, or suspended by any other SRO.⁸⁶ In other words, SROs have the power to impose the professional death penalty upon the career of any securities professional. Thus, each stock exchange and the NASD must require members to treat customers not in accordance with the concept of *caveat emptor* but rather in accordance with concepts of professionalism, and they must enforce such standards of conduct. Certainly, the statutory language requiring rules that “promote just and equitable principles of trade” is consistent with professionalism and inconsistent with *caveat emptor*.⁸⁷

The '34 Act's reach extends beyond the broker-dealer itself to any “person associated with a broker-dealer.”⁸⁸ Under the Act, these individuals must take and pass entry examinations.⁸⁹ In addition, such persons may not enter or remain in the securities industry unless they satisfy certain standards of character and fitness.⁹⁰ Moreover, any person who violates any SRO rule is also subject to an SEC enforcement action or administrative proceeding which may result in a bar from the industry, fines, injunctive relief, or ancillary equitable relief including disgorgement of any ill-gotten gains.⁹¹ The '34 Act also provides criminal sanctions against any person who willfully violates the Act, any person who knowingly makes a false statement on any form or application filed pursuant to the Act, or any person who knowingly files a false application with an SRO.⁹² Thus, each person who has any

in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

Id. See also 15 U.S.C. § 78o(b)(6) (2000) (stating identical requirements for registration of national securities association).

84. 15 U.S.C. § 78f(b)(5) (2000); 15 U.S.C. § 78o-3(b)(6) (2000); 15 U.S.C. § 78b (2000) (stating that one purpose of the '34 Act is to insure “fair and honest markets” for securities transactions).

85. 15 U.S.C. § 78f(b)(6) (2000); 15 U.S.C. § 78o-3(b)(7) (2000).

86. 15 U.S.C. § 78f(d)(3) (2000); 15 U.S.C. § 78o-3(h)(3) (2000).

87. 15 U.S.C. § 78f(b)(5) (2000).

88. *Supra* note 17.

89. 15 U.S.C. § 78o(b)(7) (2000).

90. *E.g.*, 15 U.S.C. § 78o(b)(4) (2000).

91. *E.g.*, 15 U.S.C. § 78u(d)(1) (2000) (authorizing SEC to bring action “to enjoin” violation of securities laws or SRO rules). Among the most significant provisions of the securities laws are the broad antifraud provisions specifically applicable to broker-dealers. 15 U.S.C. § 78o(c) (2000).

92. 15 U.S.C. § 78ff (2000).

degree of responsibility in the securities brokerage industry is subject to detailed regulatory strictures and powerful civil and even criminal sanctions.

Consistent with the '34 Act's theme of supervised self-regulation, however, the SEC has power to supervise the SROs in virtually all regulatory aspects.⁹³ If an SRO fails in its enforcement duties, the SEC may directly impose sanctions for violations of SRO rules.⁹⁴ If an SRO enacts a rule or regulation that the SEC deems inappropriate, the SEC may "abrogate, add to, and delete from" the rule as it sees fit.⁹⁵

C. SRO Rules of Professional Conduct

Because SRO rules are fundamentally focused upon customer protection and investor rights, even the charters, constitutions, and bylaws of such organizations recognize that they exist in part to assure the protection of investors. The National Association of Securities Dealers, Inc., Certificate of Incorporation states that the NASD was formed to "adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts," "to promote . . . high standards of commercial honor," and "to promote just and equitable principles of trade for the protection of investors."⁹⁶ The NYSE constitution contains similar language articulating essentially the same goals.⁹⁷

The NASD, the NYSE, and all other SROs are governed by their members. These members are broker-dealers, meaning that the brokerage industry itself is responsible for imposing and enforcing SRO standards.⁹⁸ Still, the SEC has broad oversight power over the SROs,

93. The Commission, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as "amend") the rules of a self-regulatory organization (other than a registered clearing agency) as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this [Act] and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this [Act]

15 U.S.C. § 78s(c) (2000).

94. *E.g.*, 15 U.S.C. § 78u (2000).

95. 15 U.S.C. § 78s(c) (2000).

96. NASD MANUAL, *supra* note 47, at 1011 (Paragraphs (1), (3) and (4)). The NASD is required by law to impose rules designed to "promote just and equitable principles of trade," but appears to have gone a step further in requiring "high standards of commercial honor." *See* 15 U.S.C. § 78o-3 (2000). *See also* NASD MANUAL, *supra* note 47, Rule 2110, at 4111.

97. *See* NEW YORK STOCK EXCHANGE, INC., CONSTITUTION AND RULES 1021 (1996) (Paragraph (2)) [hereinafter NYSE MANUAL].

98. NASD MANUAL, *supra* note 47, at 1012, 1014, 1301-03 (noting provisions of the Certificate of Incorporation and By-Laws that limit membership to registered broker-dealers, endow members with the right to elect Governors, and give Governors the right to manage the NASD).

and federal law operates as the ultimate enforcement mechanism.⁹⁹ The SEC has plenary power over SRO rules.¹⁰⁰ The SROs similarly are the primary enforcers of their rules; still, the SEC has *de novo* appellate review over all such sanctions.¹⁰¹ Federal law also provides that discipline by one SRO is grounds for discipline by another SRO, such that if a member is expelled by one SRO they are essentially barred from participating as a member of any other SRO, and hence the entire securities industry.¹⁰²

The role of federal law and the SEC has not been prominent in the promulgation of industry standards and SRO regulations. Rather, the SEC and the prospect of further federal legislation have combined to enforce a kind of self-discipline whereby the industry-dominated SROs are able to successfully impose high standards of conduct upon an industry wary of further government regulatory action.¹⁰³ This is another purpose for the existence of SROs: "To promote self-discipline among members . . ." ¹⁰⁴ This combination of primary industry self-regulation with close government supervision and government-backed enforcement has proven to be a powerful recipe for high standards of professional conduct.

The Commission in particular interpreted the scheme of self-regulation imposed by the '34 Act as sufficient to support broad professional duties for registered broker-dealers under what has become known as the "shingle-theory."¹⁰⁵ In the seminal case of *In re Duker &*

99. The SEC has recently exercised this broad power over SROs against the NASD. In 1996, the SEC published a detailed report of its investigation of administrative enforcement proceedings and settlement of charges against the NASD for its operation of the NASDAQ market and its oversight of the market. In connection with the SEC actions, the NASD entered into lengthy settlement undertakings with the SEC to remedy its shortcomings. See generally SEC REPORT, *supra* note 5, at 1-4.

100. *Supra* note 93.

101. 15 U.S.C. § 78s(e)(1) (2000).

102. An expulsion, suspension, or bar from associating with a member of an SRO is defined as a "statutory disqualification." 15 U.S.C. § 78c(a)(39) (1994). A statutory disqualification is grounds for being barred from associating with a member of the NASD (15 U.S.C. § 78b-3(g)(3)(A) (2000)) or any stock exchange (15 U.S.C. § 78f(d)(3)(A) (2000)).

103. DOUGLAS, *supra* note 8, at 82.

104. NASD MANUAL, *supra* note 47, at 1011 (Paragraph (4)).

105. Professor Louis Loss is credited with coining the term "the Shingle Theory" to encapsulate the basis for inherent professional obligations:

[I]n 1939 . . . the Commission for the first time held in the course of a broker-dealer revocation proceeding that it was a fraud under the securities laws for a dealer to sell securities to a customer at a price not reasonably related to the current market. This has nothing to do with any agency obligation. The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public. It is an element of that implied representation, the theory goes, that his prices will bear some reasonable relation to the current market unless he discloses to the contrary. Therefore,

Duker,¹⁰⁶ the Commission stated: "Inherent in the relationship between a dealer and [its] customer is the vital representation that the customer will be dealt with fairly and in accordance with the standards of the profession."¹⁰⁷ By 1943, the SEC's "shingle theory" had the benefit of court imprimatur, evidencing a broad consensus among authorities that the '34 Act had imposed inherent professional obligations upon broker-dealers, indeed even upon dealers acting in a principal capacity.¹⁰⁸

The SRO rules governing broker-dealer conduct attest to the success of this regime in giving rise to a scheme of self-regulation that imposes a code of conduct that both protects customers and allows the industry to impose efficient business practices. These standards of professional conduct generally fall into four categories of professional duties in favor of customers of registered broker-dealers: first, brokers must only make recommendations of securities to customers that are suitable in light of the customer's investment objectives and capabilities; second, broker-dealers may not engage in "churning," the exercise of control over an account to generate excessive transactions (and commissions) in light of a customer's investment objectives; third, the SRO rules impose broad supervisory duties upon broker-dealers; and fourth, a broker must observe general "high standards of commercial honor" and "just and equitable principles of trade."

1. Suitability

The suitability requirement means that a broker has an affirmative duty to take "reasonable efforts" to assure that a recommendation is in accordance with a customer's objectives and financial status.¹⁰⁹ The NYSE has its own version of the suitability requirement, and in some respects the NYSE has interpreted its rule in a more demanding manner

charging a price that does not bear such a relation is a breach of the dealer's implied representation and works a fraud on the customer.

Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948).

106. 6 S.E.C. 386 (1939).

107. *Id.* at 388.

108. *See, e.g., Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943).

109. Business Conduct Rule 2310(a), for example, requires that any recommendation a broker makes to a customer be supported by a reasonable belief that the recommendation is "suitable." Business Conduct Rule 2310(b) requires that before executing transactions recommended to non-institutional customers, other than transactions limited to money market mutual funds, "a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable . . . in making recommendations to the customer." NASD MANUAL, *supra* note 47, at 4261.

than the NASD obligation.¹¹⁰ Additionally, industry-sponsored arbitration fora have spawned numerous cases where brokers have been held liable under the suitability doctrine for allowing customers to undertake excessively risky trading.¹¹¹ Ultimately, these industry authorities insist that suitability requirements demand an “ongoing supervision” of a customer’s trading to avoid allowing the securities markets to devolve into casinos.¹¹²

2. Churning

The prohibition against “churning” precludes a broker from using control over a customer’s account to generate excessive trading activity, in view of the customer’s financial resources, objectives, and needs, in order to maximize commissions.¹¹³ The NASD has prohibited such excessive trading through interpretive memoranda.¹¹⁴ In determining whether activity is excessive, the SEC has used its administrative powers

110. See NYSE MANUAL, *supra* note 97, Rule 405, at 3696 (requiring every member of the Exchange to use “due diligence” to obtain “essential” facts relative to every customer and every order). For example, the NYSE has indicated that its rule even applies to discount brokers, who typically offer mere transaction facilities. See Michael Siconolfi, *Discounters Must Watch Out for Customers, Big Board Says*, WALL ST. J., July 19, 1991, at C1.

111. See Rebecca Buckman, *Discount and Online Brokers Worry About Investor Cases*, WALL ST. J., Nov. 25, 1998, at C1; Michael Siconolfi, *“Dramshop” Awards Increasingly Slapped on Brokerage Firms*, WALL ST. J., Sept. 4, 1992, at A4. The Supreme Court has ruled that brokerage firms may require their customers to submit disputes to industry-sponsored arbitration fora, such as the arbitration procedure administered by the NASD. *E.g.*, *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 486 (1989) (holding that because “resort to the arbitration process does not inherently undermine any of the substantive rights afforded . . . under the Securities Act[s],” such claims are arbitrable). A ruling in such an arbitration proceeding will not be disturbed by the courts absent a showing that the arbitrators acted in manifest disregard of the law. *Sanders v. Gardner*, 7 F. Supp. 2d 151, 158 (E.D.N.Y. 1998) (citing *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 941 (1995)). Indeed, the NASD Code of Arbitration Procedure does not even require that the arbitrators be lawyers. See NASD MANUAL, *supra* note 47, at 7501-7633. Thus, these arbitration proceedings provide excellent examples of industry standards applied to customer-broker disputes.

112. *Peterzell v. Charles Schwab & Co.*, NASD Arb. No. 88-0268, 1991 WL 202358, at *2 (June 17, 1991). See also *Cass v. Shearson Lehman Hutton*, NASD Arb. No. 91-01484, 1994 WL 1248585, at *5 (Jan. 31, 1994) (“it was especially improper to allow [the customer] to continue his disastrous trading” at a point when the broker knew he had insufficient resources for high risk trading, because “Shearson holds out its registered representatives to be not merely brokers but ‘financial consultants’” and “[a] competent financial consultant never would have permitted” such a trading strategy). The NASD Department of Enforcement echoes this view of the professional obligations of brokers in the context of the suitability requirement. See *In re Robert J. Kernweis*, NASD Disciplinary Proceeding No. C02980024 (2000), available at <http://www.nasdr.com/2657c.asp> (stating that there is a difference between aggressive investing and excessive trading and that an investment objective of speculation does not excuse excessive trading) (citing *In re Shearson Lehman Hutton Inc.*, Exchange Act Release No. 34-26766, 49 S.E.C. 1119 (1989), available at 1989 WL 257097 (Apr. 28, 1989)).

113. See generally JAFFE, *supra* note 28, §§ 15.01-15.04.

114. NASD MANUAL, *supra* note 47, IM-2310, at 4262. See also NYSE MANUAL, *supra* note 97, Rule 435.

to define and prohibit "churning."¹¹⁵ The courts have also played a significant role in defining when a broker controls an account as well as when trading is "excessive."¹¹⁶ In fact, the SEC long ago recognized that a broker may inappropriately control an account even in the absence of a formal grant of discretionary trading authority.¹¹⁷ Together, the suitability requirement and the churning prohibition mean that brokers may not put their interests before the customer, and they must exercise care in recommending transactions.

3. Supervisory Duties

An additional source of mandated industry standards arises from the SRO requirement that all firms maintain compliance manuals designed to assure that firms and their agents comply with the securities laws and SRO rules and regulations.¹¹⁸ Every broker-dealer also may use compliance manuals as a means of transmitting its own higher standards of professional conduct to its agents. Courts typically hold firms to their own articulated standards of professionalism.¹¹⁹ Examples of firms imposing higher standards include such undertakings as terminating accounts to protect customers from their own excessively risky trading when circumstances so demand.¹²⁰

115. 17 C.F.R. § 240.15c1-7 (2001). Indeed, the SEC essentially created the churning prohibition in 1937 through the promulgation of Rule 15c1-7. JAFFE, *supra* note 28, at 307. See also *In re Insera*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,334 (Sept. 30, 1988) (assessing extent of margin indebtedness, commissions as a percentage of account equity, and turnover ratio to determine if trading was excessive); *In re E. H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (stating that churning requires a showing that the broker induced activity in the customer's account which, in view of the character and financial resources of the account, was excessive).

116. *E.g.*, *Shamsi v. Dean Witter Reynolds, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,356, at 95,356 (D. Mass. July 16, 1990) (holding that churning may occur even though the broker did not have formal discretionary authority); *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591 (S.D.N.Y. 1981) (holding that control over the customer may be shown if the customer "routinely" follows the broker's recommendations).

117. "[V]iolation of the excessive trading principle may be found to exist wherever the broker or dealer enjoys practical discretionary power in that, by reason of the trust and reliance of the customer, he is able to dictate or influence the timing and frequency of the transactions." *In re Grubbs*, 28 S.E.C. 323, 328 n.10 (1948).

118. "Each member shall establish . . . a system . . . that is reasonably designed to achieve compliance with applicable securities laws . . . and with the Rules of this Association." NASD MANUAL, *supra* note 47, Rule 3010, at 4831. At a minimum, this requires the establishment of written procedures. *Id.*

119. See, e.g., *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 822 (9th Cir. 1980) (utilizing internal manual to support finding of fiduciary duty).

120. See, e.g., *Fahnestock Compliance Manual* (on file with author). Most courts have not imposed a duty to terminate excessive trading, although SROs have imposed such a duty. *E.g.*, *Powers v. Francis I. DuPont & Co.*, 344 F. Supp. 429 (E.D. Pa. 1972). See also *supra* notes 111-113.

4. High Standards of Conduct

General requirements of “high standards of commercial honor” and “just and equitable principles of trade” have given rise to numerous other interesting applications.¹²¹ For example, a broker acting in a principal capacity (selling securities out of the broker’s inventory) may not charge a customer an “excessive” markup in price.¹²² Similarly, a broker may not use knowledge of a customer’s order to generate personal profits by “interpositioning” a trade of a broker or by “front-running” ahead of the order.¹²³ This transcendent obligation of fairness has been extended to require brokers to obtain the best transaction executions available for customers,¹²⁴ to refrain from taking improper steps to evade liability,¹²⁵ and to assure that the public has a bona fide opportunity to participate in initial public offerings of securities that become “hot issues.”¹²⁶ In sum, this industry standard imposes broad obligations of fairness and disclosure.¹²⁷

In general, and with certain important exceptions, these industry standards correlate to fiduciary duties of care, loyalty, and disclosure. The obligations imposed under these industry standards, however, are particularized to the broker-dealer context and do not have the same kind of general breadth associated with broad fiduciary duties. Moreover, nowhere in the statutory scheme is the term “fiduciary” used in connection with the mandatory general industry standards imposed under the ’34 Act. The legislative history of the Act does include one reference to the term “fiduciary.” However, the great weight of the legislative history and the language used by President Roosevelt in support of the ’34 Act evinces an intent to avoid invoking the term. Thus, interpreting the plain meaning of the statute and its legislative history leads to a clear conclusion: the ’34 Act did not intend to impose a federal fiduciary obligation upon broker-dealers, provide any federal fiduciary duty remedies, or in any way disturb or interfere with the

121. NASD MANUAL, *supra* note 47, Rule 2110, at 4111 (“A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.”).

122. *Id.*, IM-2440, at 4351 (establishing a guideline of five percent markups).

123. *Id.*, IM-2110-3, at 4123.

124. *Id.*, Rule 2320, at 4265.

125. *E.g.*, Cosse Int’l Sec., Inc., SEC Release No. 34-26424 (1989) (affirming SRO findings that belatedly delivering documents and seeking execution of certain assignment forms was a violation of just and equitable principles of trade).

126. NASD MANUAL, *supra* note 47, IM 2110-1, at 4112.

127. The NASD has also stated that any violation of the SEC’s shingle theory is “usually” a violation of fair and equitable principles of trade. *See* NASD MANUAL, *supra* note 47, IM-2310-2, at 4262-63. The Commission has recognized that “when a securities dealer opens his business he is, in effect, representing that he will deal fairly with the public.” *Id.* Thus, the NASD has essentially adopted the “shingle theory” as part of its articulation of “just and equitable principles of trade.”

development of fiduciary principles under state law. The next Part of this Article addresses the intent of the drafters of the federal securities laws with respect to the effect of SRO rules upon the civil liability of brokers to customers.

III. SRO RULES AND PROFESSIONAL LIABILITY

The conclusion that Congress did not intend to impose federal fiduciary principles is central to the broker-dealer regulation provisions of the '34 Act. The Act reflects a determination to raise industry standards within the context of the traditional self-regulation of the securities brokerage industry. Self-regulation, in its most modern form, has three primary advantages: first, "industry participants bring to bear expertise and intimate knowledge of the securities industry and thereby should be able to respond quickly to regulatory problems;" second, "self-regulation supplements the resources of the government and reduces the need for large government bureaucracies;" and third, SROs can adopt and enforce compliance with "ethical standards beyond those required by law."¹²⁸ Imposing broad fiduciary obligations or detailed statutory mandates would frustrate the foundations of self-regulation. This Article posits that Congress rejected traditional notions of *caveat emptor* as well as any broad federal fiduciary obligation and instead chose a third means of raising industry norms: professionalization and accompanying liability for malpractice under state law.¹²⁹

A. SRO Rules and Implied Private Actions

Noticeably absent from the entire scheme of mandatory self-regulation is any authorization of a private right of action for a violation of an SRO rule or regulation. Instead, in terms of broker misconduct short of fraud, Congress seems to have intended state law claims to play the dominant role.¹³⁰

128. SEC REPORT, *supra* note 5, at 7.

129. *Supra* note 50.

130. The rights and remedies provided by this [Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this [Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this [Act] shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this [Act] or the rules and regulations thereunder.

15 U.S.C. § 78bb(a) (2000).

Shortly after the promulgation of the '34 Act, both the courts as well as the SEC broadly interpreted the Act's provisions to support private rights of action.¹³¹ More recently, however, federal courts have restricted private rights of action.¹³² Under the more modern approach to implying private rights of action under a federal statute, courts presume a lack of congressional intent to authorize such suits in the absence of some statutory provision supporting such a private right of action.¹³³ Courts have thus ruled that violations of SRO rules do not support implied rights of action.¹³⁴ In the case of professional obligations in the securities industry, it is therefore difficult to show that Congress intended to provide investors with federal private rights of action.

On the other hand, the breach of an SRO rule may play a role in private actions under Rule 10b-5. Here, courts use SRO rules as evidence of fraud or standards by which to judge whether conduct is consistent with scienter.¹³⁵ Scienter requires at least a showing of recklessness, and SRO rules have been used to support a finding that a broker recklessly omitted to disclose a material fact.¹³⁶ This approach seems consistent with Congressional intent, as breach of industry standards is not tantamount to showing an intent to defraud, but such a breach does reveal much about a securities professional's state of mind, especially since a professional can be presumed to know industry standards.¹³⁷

Aside from the lack of congressional intent, implied rights of action from breach of SRO rules suffer from other infirmities. They would, for example, involve the federal judiciary in a meddlesome and activist role in the securities brokerage industry that runs contrary to the premise of

131. See, e.g., *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (allowing private right of action under Rule 10b-5).

132. See generally Donald H. Ziegler, *Rights, Rights of Action, and Remedies: An Integrated Approach*, 76 WASH. L. REV. 67, 68 (2001).

133. See *Cort v. Ash*, 422 U.S. 66, 78-85 (1975).

134. See *Colman v. D. H. Blair & Co.*, 434 F. Supp. 37 (D.D.C. 1977) (citing *Cort v. Ash*, 422 U.S. 66 (1975)); *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (holding that section 6 of the '34 Act neither confers rights on private parties nor prescribes any conduct as unlawful and thus evinces lack of intent to create a private cause of action); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1419 (11th Cir. 1983) (deciding there is no implied private cause of action for a violation of SRO suitability rules); *Zemaitis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 583 F. Supp. 1552, 1553 (W.D.N.Y. 1984) (explaining that a violation of SRO suitability rules does not create an implied cause of action under federal securities laws). See also *Kirkland v. E.F. Hutton & Co.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,470.

135. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981); *Mihara v. Dean Witter & Co.*, 619 F.2d 814 (9th Cir. 1980).

136. E.g., *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 897 (10th Cir. 1992).

137. E.g., *Shivangi v. Dean Witter Reynolds, Inc.*, 825 F.2d 885, 888 n.6 (5th Cir. 1987).

self-regulation.¹³⁸ Additionally, transforming industry standards into “legal” claims necessarily substitutes judges for industry experts in the process of applying the standards.¹³⁹ Thus, the securities industry seems particularly ill-suited for recognition of private claims against violators of SRO rules.

B. *Fiduciary Obligations of Securities Brokers Under State Law*

Whether described as “considerable confusion” or as “judicial smoke,” it is clear that courts have not always consistently articulated the fiduciary obligations of broker-dealers under state law.¹⁴⁰ Even a cursory review of authorities shows deep division within the courts regarding the fiduciary duties of broker-dealers.¹⁴¹ Some courts seem to follow the traditional rule that a broker always owes a customer a fiduciary duty.¹⁴² Other courts seem to impose fiduciary duties only upon a showing that a customer has authorized a broker to trade on the customer’s behalf in a discretionary account.¹⁴³ Sometimes, courts within the same jurisdiction seem to take drastically different approaches to the issue of fiduciary duties owed by a stockbroker.¹⁴⁴ But by any

138. See *supra* notes 32 and 40.

139. In professional malpractice cases, an expert typically applies the industry standard, not the court. See *infra* note 200.

140. See Hicks, *supra* note 11, at 709; Goforth, *supra* note 11, at 442. See also Weiss, *supra* note 11, at 68 (“Fiduciary duty as applied to broker-dealers is difficult to understand without some explanation of its many disparate strands. Courts have often failed to do a careful analysis of the duty, resulting in erroneous, confusing or poorly explained opinions.”).

141. See Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523, 530 (5th Cir. 1986); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978); Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co., 800 F.2d 177, 182 (7th Cir. 1986) (noting the fiduciary relation arises where dealings between customer and broker have caused customer to repose special trust or confidence); Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985) (explaining that broker must control customer’s account before fiduciary duty arises). See also Roberson v. PaineWebber, Inc., 998 P.2d 193, 198 (Okla. 2000) (holding that existence of fiduciary duty owed by broker is an issue for the trier of fact to decide).

142. See Roth v. Roth, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978); Twomey v. Mitchum Jones & Templeton, Inc., 69 Cal. Rptr. 222, 236 (Ct. App. 1968) (quoting CHARLES H. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES 253 (1931)).

143. See Independent Order of Foresters v. Donald, Lufkin & Jenrette, Inc. 157 F.3d 933, 940 (2d Cir. 1998) (“[T]here is no general fiduciary duty inherent in an ordinary broker/customer relationship.”); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Boeck, 377 N.W.2d 605, 608 (Wis. 1985); Shearson Hayden Stone, Inc. v. Leach, 583 F.2d 367 (7th Cir. 1978); Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 111 (N.D. Ala. 1971), *aff’d*, 453 F.2d 417 (5th Cir. 1972).

144. Compare Shaw v. Dreyfus & Co., 314 N.Y.S.2d 372, 379 (N.Y. Civ. Ct. 1969) (noting that broker/customer relationship is a “sensitive fiduciary relationship”), with Sherman v. Sokoloff, 570 F. Supp. 1266, 1269-70 (S.D.N.Y. 1983) (maintaining that broker owes a duty only when broker controls the customer’s account).

measure, it is clear that courts are approaching the issue of fiduciary duties in a more restrictive fashion than in the past.¹⁴⁵

In 1934, Congress assumed that an ordinary stockbroker owed fiduciary duties to clients with respect to the giving of investment advice.¹⁴⁶ This concept of fiduciary duty was general and wide-ranging.¹⁴⁷ The courts in pre-1934 days applied the fiduciary concept to brokers in a variety of circumstances, but with a less professionalized industry in mind.¹⁴⁸ Thus, there was no corollary to the churning prohibition or the suitability doctrine.¹⁴⁹ A dealer on the other hand, called a "jobber" in many sources, was held to deal with customers on a principal-to-principal basis rather than as agent-to-principal.¹⁵⁰ The logical upshot of this distinction is that dealers generally did not owe fiduciary duties.¹⁵¹ The '34 Act gives short shrift to this distinction, and

145. Compare *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 676 (S.D.N.Y. 1966) ("[T]he duties of a securities broker are, if anything, more stringent than those imposed by general agency law."), *aff'd*, 367 F.2d 157 (2d Cir. 1966), with *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 52d, 537 (2d Cir. 1999) (stating that a broker-customer relationship is not ordinarily a fiduciary relationship and that a broker's fiduciary obligation, if any, is generally limited to completion of the transaction).

146. H.R. REP. NO. 73-1383, at 15 (1934) ("There is an inherent inconsistency in . . . acting both as a broker and a dealer. It is difficult to serve two masters. And it is particularly difficult to give impartial advice to a client if the dealer-broker has his own securities to sell . . ."). See also generally CHARLES H. MEYER, *THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES* §§ 40-46 (1931). By 1933, there were numerous reported decisions holding that brokers must observe fiduciary standards in giving investment advice. *Id.* § 46 (1933 Supp.) ("The broker . . . is held to a high degree of skill and integrity.").

147. As one commentator stated:

By the early twentieth century, the body of common law governing brokers as agents was well developed. The broker, acting as an agent, was held to a fiduciary standard and was prohibited from self-dealing, acting for conflicting interests, bucketing orders, trading against customer orders, obtaining secret profits, and hypothecating customers' securities in excessive amounts—all familiar concepts under modern securities law. Under common law, however, a broker acting as principal for his own account, such as a dealer or other vendor, was by definition not an agent and owed no fiduciary duty to the customer. The parties, acting principal to principal as buyer and seller, were regarded as being in an adverse contractual relationship in which agency principles did not apply.

Weiss, *supra* note 11, at 67 (emphasis omitted).

148. See generally *Galigher v. Jones*, 129 U.S. 193, 201 (1889) (stating that stockbroker-client relationship should be viewed as a "trust relation"); *Warwick v. Addicks*, 157 A. 205, 206 (Del. 1931) (stating that broker owes customer fiduciary duty of "utmost good faith and loyalty" regarding "all dealings concerning or affecting the subject matter of his agent"); *Haight v. Haight & Freese Co.*, 98 N.Y.S. 471, 473 (N.Y. App. Div. 1906) (stating that broker owes a fiduciary duty); *Poor & Co. v. Mathis*, 14 Ohio Law Abs. 453 (Ohio 1933) (holding that the relation of broker-customer was fiduciary).

149. The churning prohibition and suitability doctrine date to a 1937 SEC decision. JAFFE, *supra* note 28, at 307.

150. See generally William O. Douglas & George E. Bates, *Stock "Brokers" as Agents and Dealers*, 43 YALE L.J. 46, 53, 56 (1933) (stating that a broker is a "fiduciary-agent" liable for negligence and that a dealer acts adversely to a customer).

151. *Id.*

the SEC has in many ways obliterated it in its "shingle theory" cases.¹⁵² Thus, in terms of both fiduciary duties¹⁵³ and minimum professional standards of conduct,¹⁵⁴ modern law makes no distinction between the obligations that brokers and dealers have to their customers.¹⁵⁵

Congress nowhere contemplated the concept of limited fiduciary duty that has recently emerged in the securities brokerage industry.¹⁵⁶ Some courts have sharply circumscribed the limits of a general fiduciary duty in a typical broker-client relationship.¹⁵⁷ Under this approach, a broker may dispense with most traditional fiduciary obligations simply by refraining from exercising discretion¹⁵⁸ over an account.¹⁵⁹ In these circumstances, a broker's fiduciary duty is limited to proper execution of trades—which is roughly akin to requiring a car salesman to discharge a fiduciary obligation through proper execution of a bill of sale.¹⁶⁰ Indeed, after twenty-five years, this narrow conception of fiduciary duty has never given rise to liability for improper execution of trades in a reported decision.¹⁶¹

Although Congress may not have predicted that over time states would greatly relax the fiduciary obligation of securities brokers, the result is fully consonant with the intent of the '34 Act.¹⁶² Section 28 has always operated to leave state claims to state law, and state courts have

152. See *supra* notes 106-109 and accompanying text.

153. See generally Weiss, *supra* note 11, at 75.

154. For example, the NASD Rules of Conduct include no distinction between dealers and brokers. See generally NASD MANUAL, *supra* note 47, at 4101-4985.

155. Specifically, the key customer protection elements of broker-dealer regulation turn upon considerations other than whether the given defendant is a broker or a dealer. Suitability turns upon whether a recommendation was made. *Supra* notes 109-112. Churning turns on control or recommendations. *Supra* notes 113-117.

156. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953, 955 (E.D. Mich. 1978) (explaining that in the context of a non-discretionary account, a broker owes a fiduciary duty only on a transaction-by-transaction basis, and these "limited" transactional duties "cease" after the "transaction is completed"); Commentators have recognized that *Leib* was a "seminal" case in terms of articulating a restrictive approach to a broker's fiduciary duty. E.g., Weiss, *supra* note 11, at 114.

157. See, e.g., *Gouger v. Bear, Stearns & Co.*, 823 F. Supp. 282, 286 (E.D. Pa. 1993) (stating that fiduciary duties flowing from securities broker to customer are "circumscribed") (citing *Schenck v. Bear, Stearns & Co.*, 484 F. Supp. 937, 947 (S.D.N.Y. 1979) (noting that the fiduciary duty of a broker is generally "limited to the completion of the transaction").

158. Discretion has been defined to turn upon issues of broker control instead of formalistic authority to trade without prior approval of the customer. E.g., *Leib*, 461 F. Supp. at 954.

159. See *Hotmar v. Lowell H. Listrom Co.*, 808 F.2d 1384 (10th Cir. 1987) (finding that lack of control precluded a finding of fiduciary duty); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057 (2d Cir. 1977) (holding no fiduciary duty owed to a speculative investor in non-discretionary account).

160. "Since Stotler operated a nondiscretionary account for Dierschke, it did not owe him a fiduciary duty." *Stotler & Co. v. Dierschke*, No. 88-C-7135, 1993 WL 128141, at *2 (N.D. Ill. Apr. 21, 1993). See also *supra* note 156.

161. See generally Weiss, *supra* note 11.

162. See *supra* note 132.

consequently been the final arbitrators of the fiduciary obligations owed by securities brokers.¹⁶³ Implicit in this regime is the fact that state regulation (through claims of breach of fiduciary duty) may be an inadequate means of imposing high standards of commercial conduct in the securities industry.¹⁶⁴

In the final analysis, concepts of fiduciary duty fall short of the goal of conservative investor protection in the securities brokerage industry. Fiduciary duty may serve well as a state-by-state ceiling upon broker obligations, where states may need to balance investor protection against the possibility of raising business costs to prohibitive levels. However, a federal minimum standard of professional conduct, embodied in SRO rules, has the immeasurable benefit of being promulgated and supported by industry expertise and experience.¹⁶⁵ A judge sitting in equity jurisdiction, or a jury sitting to determine damages, is a poor substitute for industry leaders and experts in determining appropriate conduct.¹⁶⁶ Thus, fiduciary duty has operated, and probably should continue to operate, restrictively as a basis for imposing nationalized standards of professional conduct in the securities industry.¹⁶⁷

163. See *Greenwood v. Dittmer*, 776 F.2d 785, 788 (8th Cir. 1985) (noting the existence of a fiduciary duty must be determined by reference to state law); *McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 736 F.2d 1254, 1258 (8th Cir. 1984) (explaining that whether a fiduciary duty exists between a broker and a customer is a question of state law).

164. Indeed, Congress enacted the securities laws in full view of the shortcomings of state legislation in the securities industry. H.R. REP. NO. 73-85, at 1 (1933) ("In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.") (message from President Franklin D. Roosevelt to Congress, Mar. 29, 1933).

165. *Supra* notes 35, 36, 65, and 130.

166. As Professor Hicks has observed:

There are two main risks which result from relying on a tool as powerful and amenable as the fiduciary principle to establish a foundation for broker and dealer duties. First, it invites the creation of extravagant duties. Second, the choice of an exacting model of accountability can, by itself, invite carelessness by courts and regulators in thinking through the soundness of specific proposed duties. The purpose of this Article is to stress the need for grounding broker-dealer duties in sound, articulated understandings of the investment markets, as well as defensible statements of the responsibilities and expectations of both customers and market professionals. This important need will be demonstrated through the use of several cases illustrating problematical or failed processes by which broker-dealer duties have been established.

Hicks, *supra* note 11, at 711-12.

167. This is not to say that those courts that have adhered to a restrictive approach to fiduciary duties are not resting upon a weak policy basis. See *infra* Part IV. Nor is this to say that these courts are resting upon a sound doctrinal analysis. Commentators have appropriately recognized that:

The key issue in determining the broker's duty is control. At a minimum, broker-dealers are charged with a duty of loyalty when acting as agents. That is, when transacting business on behalf of customers. As the broker's control of the account increases, so does the broker's fiduciary duty. Acting solely as an agent in executing orders, the broker is charged only with

C. SRO Rules and State Law Professional Liability Claims

The language and legislative history of the '34 Act certainly addressed broker duties even if they failed to impose either a broad new federal fiduciary duty or private rights of action against errant brokers.¹⁶⁸ Additionally, the specific intent of the '34 Act was to elevate commercial standards of conduct within the brokerage industry to higher and more uniform standards and to create a durable scheme of regulation to protect investors and restore investor confidence.¹⁶⁹ The '34 Act uses terminology consistent with fiduciary obligations, but in the end it opts for terms more akin to professional obligations and high commercial standards rather than broad fiduciary obligations.¹⁷⁰ This, in turn, is fully consistent with the Act's aim to preserve industry self-regulation while placing such regulation on a firmer foundation.¹⁷¹ Because the similarity between the concepts underlying fiduciary principles and the mandatory federal standards is so apparent (and at least at one point in the legislative record downright invisible),¹⁷² and because in the context of the securities field they bear similar functions, it is somewhat understandable that the legal analysis of brokers' professional obligations has essentially been subsumed into the analysis of fiduciary duties.¹⁷³ Nevertheless, in the final analysis, the mandatory federal standards are best viewed as professional standards.¹⁷⁴ The remainder of this Article will therefore use this terminology when referring to the structure of industry standards built upon the foundation of the '34 Act.

a duty of timely execution according to the customer's instructions. When the broker takes it upon himself to make a recommendation to the customer, the duty increases; a reasonable basis for the recommendation is required. In the case of a discretionary account, or an account controlled in fact by the broker, the broker's duty approaches that of a trustee. Accordingly, a limitation of duty, and liability therefore, is contingent to diminishing the broker's control over the customer's account and refraining from making recommendations.

Weiss, *supra* note 11, at 119.

168. *Supra* note 66.

169. *Supra* notes 9 and 10.

170. *See supra* Part II.

171. *See supra* text accompanying notes 36 and 38.

172. *Supra* note 132.

173. *See Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1290 (S.D. Ohio 1996) (holding that a broker malpractice claim is "redundant" to contract and fiduciary duty claims). The use of the term "redundant" seems odd in this context since professional negligence could well extend a remedy in a situation where a plaintiff could prove neither fraud nor a fiduciary duty.

174. This appears to be the most frequently used terminology in Congress. *Supra* notes 44, 52, 53, 60, and 66.

Congress intended to elevate industry standards and to enhance enforcement mechanisms, all in the name of investor protection.¹⁷⁵ In light of this, it would be anomalous to conclude that Congress intended to leave standards of conduct unchanged or to leave investors with no remedies at all for the newly mandated industry standards.¹⁷⁶ This is especially so given the “broad remedial purposes” of the federal securities laws.¹⁷⁷ Accordingly, there must be a strong presumption that Congress intended to enhance the hand of investors against broker-dealers who violated Congress’s new uniform standards of professional conduct.¹⁷⁸ The strong sanction provisions of the ’34 Act further suggest that Congress did not wish to skimp upon enforcement methods for industry standards.¹⁷⁹ Private enforcement has always been deemed integral to the overall regulatory scheme of the federal securities laws.¹⁸⁰ Government agencies do not enjoy sufficient funding stability to shoulder the sole burden of enforcement.¹⁸¹ Prominent government regulators themselves have emphasized the importance of private enforcement to the efficacy of the securities laws.¹⁸²

175. *Supra* note 7.

176. *Supra* notes 7 and 10.

177. *See* *United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986) (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983)). *See also supra* note 7.

178. *See* S. REP. NO. 73-792, at 12 (1934).

Experience . . . has demonstrated the inadequacy of criminal penalties as the sole sanction. Customers are ordinarily reluctant to resort to criminal proceedings, and in the absence of complaints . . . , the discovery of violations is often impossible. Furthermore, if an investor has suffered a loss by reason of illicit practices, it is equitable that he should be allowed to recover

Id.

179. *See* 15 U.S.C. § 78u (2000) (granting enforcement authority to the SEC for SRO rule violations); 15 U.S.C. § 78u-2 (2000) (granting authority to the SEC to impose administrative sanctions for SRO rule violations); 15 U.S.C. § 78c(39) (2000) (defining SRO sanctions as a “statutory disqualification” which can lead to being barred from the industry).

180. *E.g.*, *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (stating that private actions are indispensable for the enforcement of securities laws).

181. *See, e.g.*, *Berner v. Lazzaro*, 730 F.2d 1319, 1322 (9th Cir. 1984) (“The resources of the [SEC] are adequate to prosecute only the most flagrant abuses.”). Experience has taught that the funding of the SEC is, unfortunately, subject to political caprice. For example, during the 1980s, when regulation of all sorts was out of vogue, the SEC was chronically underfunded. It was not until the end of the decade, when the pervasive crime in our financial markets began to manifest itself, that Congress authorized appropriate funding. *See The Market Reform Act of 1989: Joint Hearings before the Subcomm. on Sec. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 101st Cong. 11 (1989) (statement of Sen. Sasser) (noting approval of eighteen percent increase in SEC funding after it was “underfunded throughout the 1980’s at a time when volume and complexity in the markets has increased enormously”).

182. The former SEC Chief of Enforcement has stated: “Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.” *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Secs. of the Sen. Comm. on Banking, Hous., and Urban Affairs*, 103d Cong. 113 (1993) (statement of William R. McLucas, Director,

Under legal principles extant in 1934, this congressional imposition of a mandatory self-regulatory regime that articulated high standards of professional conduct had great significance.¹⁸³ Then, as now, professionals owed duties of due care to observe professional standards of conduct.¹⁸⁴ Holding securities professionals to these uniform, expertly promulgated standards is fully in accordance¹⁸⁵ with the intent of the '34 Act and each significant Congressional effort to amend the Act with respect to broker-dealer regulation since 1934.¹⁸⁶

Setting industry standards had enormous legal implications under state law principles in 1934, and it has enormous implications under state law principles today.¹⁸⁷ Courts have imposed higher standards

Division of Enforcement, SEC) [hereinafter *Private Litigation Hearings*]; see also David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 1989 WIS. L. REV. 1167, 1168 (pointing out, as former Chairman of the SEC, that "private securities litigation plays an essential role in federal securities regulation" and that approximately ninety percent of securities cases were privately pursued in 1988). Indeed, a representative of the North American Securities Administrators Association, an organization representing all fifty state securities regulators, stated: "[P]rivate actions . . . are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace." *Private Litigation Hearings*, *supra*, at 124 (statement of Mark J. Griffin, Director, Division of Securities, Utah Department of Commerce).

183. See *Smith v. Marks Isaacs Co.*, 147 So. 118 (La. Ct. App. 1933) (holding that a beauty shop operator was not liable where the operator adhered to standards in industry); *Pratt v. E.W. Edwards & Son*, 237 N.Y.S. 372 (N.Y. App. Div. 1929) (noting that by soliciting patronage, a beauty shop operator assures the public it has requisite skill and knowledge to discharge the occupation); *Shatz Realty Co. v. King*, 10 S.W.2d 456 (Ky. 1928) (holding a real estate broker to the professional standard of care); *Milliken v. Woodward*, 45 A. 796 (N.J. 1900) (holding an insurance broker to the professional standard of care). See also *O'Connor v. Burns, Potter & Co.*, 36 N.W.2d 507, 519 (Neb. 1949) (holding an investment firm that held itself out as specially skilled to that degree of care and skill as would be exercised by other investment firms); *Hardt v. Brink*, 192 F. Supp. 879, 881 (W.D. Wash. 1961) (noting that where an insurance agent holds himself out to be an expert, he will be held to a commensurate standard of care).

184. Experienced milk haulers, hockey coaches, expert skiers, construction inspectors, and doctors must all use care which is reasonable in light of their superior learning and experience, and any special skills, knowledge or training they may personally have over and above what is normally possessed by persons in the field.

Professional persons in general, and those who undertake any work calling for special skill, are required not only to exercise reasonable care in what they do, but also to possess a standard minimum of special knowledge and ability.

W. PAGE KEETON ET AL., *PROSSER AND KEETON ON TORTS* 185 (5th ed. 1984). This more demanding professional standard of care has also been held applicable to pharmacists, pilots, nurses, karate teachers, veterinarians, and travel agents. *Id.* at 185-86 and n.31. More recently, it has been applied to social workers, bankers, and health care payors. *Id.* § 32, at n.31 (Supp. 1987).

185. *E.g.*, *Jacques v. First Nat'l Bank*, 515 A.2d 756, 763 (Md. 1986) (finding that holding bank to negligence standard was consistent with legislative regulation of banks and public policy of the state).

186. *Supra* notes 17-96.

187. "[C]ourts have turned to published ethical standards and practices of real estate brokers to determine the requisite skill and knowledge, and acceptable practices, of members in good standing in that occupation." *Menzel v. Morse*, 362 N.W.2d 465, 471 (Iowa 1985) ("Application of [Restatement § 299A] requires a plaintiff . . . to produce evidence to show the standards of conduct and practices, or bench marks, that establish the requisite skill and knowledge of members in good standing in the defendant's trade or profession."). *Menzel* involved a claim of real estate broker malpractice, but courts have relied upon

upon professionals specifically “because the higher standards of care imposed on them by their profession and by . . . licensing requirements engenders trust in them by clients that is not the norm of the marketplace.”¹⁸⁸ The law usually imposes a duty of care upon persons holding themselves out to the public as having specialized skill. Under the Restatement (Second) of Torts,¹⁸⁹ professionals (or those engaged in a skilled trade) are duty-bound to exercise a professional standard of care—meaning they must observe industry standards.¹⁹⁰ This professional obligation inheres in the professional relationship and may be enforced either in an action sounding in tort or contract.¹⁹¹ In other words, professionals implicitly warrant that they will exercise the degree of skill and judgment that can reasonably be expected from similarly situated professionals.¹⁹² Generally, breach of professional standards gives rise to favorable construction of statutes of limitations,¹⁹³ restricted defenses such as comparative negligence,¹⁹⁴ and freedom from the restrictions of the “economic loss doctrine,” which is recognized in

professional or trade standards to evidence the standard of liability in a myriad of trades or professions. *See, e.g.,* Hansen v. Wightman, 538 P.2d 1238, 1250 (Wash. App. 1975) (lawyers); Avey v. St. Francis Hosp. & Sch. of Nursing, Inc., 442 P.2d 1013, 1020-22 (Kan. 1968) (nursing); Darling v. Charleston Cmty. Memorial Hosp., 211 N.E.2d 253, 256 (Ill. 1965) (hospitals).

188. *See* Hosp. Computer Sys., Inc. v. Staten Island Hosp., 788 F. Supp. 1351, 1361 (D. N.J. 1992).

189. RESTATEMENT (SECOND) OF TORTS § 299A (1965) (“[O]ne who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade . . .”). It is noteworthy that this heightened standard of care applies to both a “trade” as well as a “profession.” This standard is thus applicable even if a broker is technically deemed not a professional within a given jurisdiction. *See* Hilliard v. Black, 125 F. Supp. 2d 1071 (N.D. Fla. 2000) (holding that broker may still be liable for negligence even though F.S.A. § 95.11(4)(a) defines profession as a vocation requiring a four-year college degree); Kuntz v. Muehler, 603 N.W.2d 43, 46-47 (N.D. 1999) (holding that a financial planner is not a professional because financial planners are not required to get a college degree, for the purposes of statute of limitations and reversing summary judgment to allow negligence claim to go forward).

190. *E.g.,* Fantini v. Alexander, 410 A.2d 1190, 1192 (N.J. App. 1980) (holding a karate instructor to the industry standard of care).

191. *E.g.,* Collins v. Reynard, 607 N.E.2d 1185, 1186 (Ill. 1993) (holding that an attorney malpractice claim may be brought in contract or tort).

192. *E.g.,* Grotto Pizza v. Endecon, Inc., No. 96C-01-031, 1997 Del. Super. LEXIS 100 (Del. Super. Ct. Mar. 26, 1997).

193. Hermann v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 564 P.2d 817 (Wash. App. 1977) (applying the continuous representation doctrine in an action for stockbroker negligence). *See also* Int'l Engine Parts, Inc. v. Feddersen & Co., 888 P.2d 1279, 1288-89 (Cal. 1995) (holding that in an accountant malpractice claim alleging negligent preparation of tax return, the statute of limitations does not begin to run until the IRS assesses a final deficiency); Morrison v. Watkins, 889 P.2d 140, 146 (Kan. App. 1995) (holding that continuous representation of an attorney tolled the statute of limitations for an attorney malpractice claim).

194. *See* Williams v. Runion, 325 S.E.2d 441, 446 (Ga. App. 1984) (stating that reliance upon professionals justified the denial of a directed verdict based upon comparative negligence); Erlich v. First Nat'l Bank of Princeton, 505 A.2d 220, 240 (N.J. Super. 1984) (stating in an investment adviser malpractice case that the “[p]laintiff’s negligence is less than that of defendants because defendants were the professionals charged with the duty to give prudent [investment] advice”).

various jurisdictions.¹⁹⁵ While expert testimony is generally required to establish the violation of industry standards,¹⁹⁶ the establishment of such a violation is evidence that may support a jury finding of professional negligence.¹⁹⁷ Indeed, in the specific context of SRO rules, violations have been found in the absence of a finding of scienter.¹⁹⁸

Predictably, some jurisdictions are more restrictive than others in imposing the obligation of professional care.¹⁹⁹ Even in such jurisdictions, liability may well obtain under the industry standards imposed by the SROs and the SEC.²⁰⁰ The Restatement applies an identical standard to skilled trades.²⁰¹ Professional malpractice claims have both a contractual and tort basis.²⁰² In the context of securities brokerage accounts, every account has a customer account agreement, and this agreement, being drafted by the broker, is to be strictly construed against the broker.²⁰³ Moreover, every broker has an agreement with an SRO.²⁰⁴ These agreements necessarily are intended to benefit and protect investors by imposing standards of high business ethics.²⁰⁵ All of these agreements are drafted by brokers and the brokerage industry and ought to be construed strictly in favor of investors.²⁰⁶ Under these principles, a breach of industry standards would be an actionable breach

195. *E.g.*, *Moransais v. Heathman*, 744 So.2d 973, 982 (Fla. 1999) (holding that the economic loss doctrine does not apply to professional malpractice claims).

196. *See Boyle v. Welsh*, 589 N.W.2d 118 (Neb. 1999) (requiring expert testimony in attorney malpractice case); *Wessel v. Erickson Landscaping Co.*, 711 P.2d 250, 253 (Utah 1985) (holding that a structural engineer could establish the standards applicable to landscapers in building retaining wall); *Cross v. Huttenlocher*, 440 A.2d 952, 954 (Conn. 1981) ("To prevail in a malpractice case the plaintiff must establish through expert testimony both the standard of care and the fact that the defendant's conduct did not measure up to that standard.").

197. *E.g.*, *McCann v. Davis, Malm & D'Agostine*, 669 N.E.2d 1077, 1078 (Mass. 1996).

198. *See, e.g.*, *Holland v. SEC*, 105 F.3d 665 (9th Cir. 1997) (citing *Erdos v. SEC*, 742 F.2d 506, 508 (9th Cir. 1984)).

199. *See cases cited supra* note 189.

200. *Id.*

201. *See* RESTATEMENT (SECOND) OF TORTS § 299A *supra* note 189.

202. *E.g.*, *Collins v. Reynard*, 607 N.E.2d 1185 (Ill. 1992) (holding that professional malpractice may be pursued as either a tort or contract claim).

203. *E.g.*, *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 52, 62 (1995) (construing an ambiguous account agreement against the broker).

204. *See supra* notes 97-98. Exchange rules constitute a contract between members and, as between those members, have the force of law. With some qualifications, such rules also bind nonmembers who employ members to execute their business. *See Bibb v. Allen*, 149 U.S. 481, 489 (1893) (utilizing New York Cotton Exchange rules and regulations); *see generally* CHARLES H. MEYER, *THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES* 1-12 (1931).

205. *See supra* notes 97-98.

206. *Supra* note 203.

of contract under either professional malpractice standards²⁰⁷ or a third-party-beneficiary contract analysis.²⁰⁸

The reluctance of Congress to federalize industry regulation and create broad federal remedies should not act to blur what Congress did achieve:²⁰⁹ it mandated elevated standards of industry conduct and professionalism that would have profound effect under existing state law principles of negligence, professional liability, and contract, both in 1934 as well as under present state law. Thus far, only a few courts have utilized the industry standards arising from mandatory self-regulation in precisely this manner.²¹⁰ The next Part of this Article will show that this approach to broker liability rests upon a sound policy basis: the need to prevent economic disruptions associated with speculative bubbles.

IV. THE ECONOMIC RISKS OF *CAVEAT EMPTOR* IN THE SECURITIES PROFESSION

It is no accident that the '34 Act was promulgated in the aftermath of the greatest economic catastrophe in U.S. history.²¹¹ The law and

207. Prior to the Supreme Court's application of the principle that contracts should be strictly construed against the drafter in the specific context of the broker-customer relationship, some authorities suggested that SRO rules were not necessarily incorporated into a customer-broker agreement. *E.g.*, *Smythe v. Prescott, Merrill, Turben & Co.*, 252 N.E.2d 524 (Ohio 1969). Even in such jurisdictions, however, SRO rules do support professional malpractice liability as evidence of the standard of care. *E.g.*, *Ferritto v. Olde & Co.*, 577 N.E.2d 101, 104-106 (Ohio App. 1989). Also, when the broker-customer agreement provides that SRO rules govern the relationship, the rules are deemed incorporated into the agreement and a violation of the rules is a breach of contract. *See Brumm v. McDonald & Co.*, 603 N.E.2d 1141 (Ohio 1942).

208. RESTATEMENT (SECOND) OF CONTRACTS § 304 (1981) ("A promise in a contract creates a duty in the promisor to any intended beneficiary to perform the promise, and the intended beneficiary may enforce the duty.")

209. The Supreme Court has consistently recognized that private enforcement is "a most effective weapon" in the enforcement of the federal securities laws and "a necessary supplement" to government enforcement. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

210. *See Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222 (1968).

211. National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

15 U.S.C. § 78b (2000). It is difficult to capture the trauma of The Great Depression. "Between September 1, 1929, and July 1, 1932, the value of all stocks listed on the [NYSE] shrank . . . 83 percent." JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 1 (2d ed. 1995). During the Great Depression, unemployment soared from 3.2% in 1929 to 25.2% in 1933 and remained above 10% until World War II. Real Gross National Product plunged from \$709.6 billion in 1929 to \$498.5 billion in 1933. *See ROBERT J. GORDON, MACROECONOMICS* 190-94 (5th ed. 1989). Similarly, investor confidence was so low before the enactment of the federal securities laws that the issuance of new corporate securities had plunged from \$9.4 billion in 1929 to \$380 million in 1933. *See* I LOUIS LOSS & JOEL SELIGMAN, *SECURITIES*

macroeconomics of the Act was patent: Roosevelt sought to place the American capitalistic system upon a firmer legal and regulatory foundation.²¹² Most urgently, Roosevelt sought to take positive action to restore investor confidence and spur more investment transactions leading to greater economic growth.²¹³ Since the Great Depression, the legal foundation laid under the financial system has not cracked in any significant way; instead, our nation has had more than sixty-five years of largely uninterrupted economic growth. In light of this record of success (and perhaps, more importantly, lack of failure), high standards of professionalism in the securities brokerage industry must be considered fundamental to efficient capital markets. Recognition of professional liability for violation of these high standards of conduct would serve to strengthen financial markets.

In addition to facilitating investment transactions, the '34 Act also served to address the risks implicit in speculative bubbles.²¹⁴ The central lesson of the Great Depression was that a precipitous decline in stock prices can have significant macroeconomic consequences, and that excessive speculation can lead directly to severe economic disruptions.²¹⁵

REGULATION 216 (3d ed. 1998). This is the reason lawmakers pursued aggressive policies to restore investor confidence, including enacting the federal securities laws.

212. H.R. REP. NO. 73-85, at 2 (1933) ("The purpose of the legislation . . . is to protect the public with the least possible interference to honest business.") (quoting message of President Roosevelt to Congress).

213. See I LOUIS LOSS & JOEL SELIGMAN, *supra* note 211, at 217 ("[I]ncreasing investor confidence . . . may have important economic consequences. By reducing the perceived risk of corporate securities, compulsory disclosure would tend to reduce the risk premia that issuers . . . would have to pay, thus increasing the funds available for economic growth.")

214. There has been revealed, on the part of certain persons occupying high positions in the banking and financial world, an attitude toward the interests committed to their charge which is not in accordance with those high standards and ideals which the public had been led to expect of them. There has also been revealed on the part of the general public a tendency toward unintelligent and senseless speculation which, lending itself to exploitation by high pressure selling methods and through the medium of marginal trading and some of the other practices revealed in the investigation, has stimulated security values to unsound levels from which they have inevitably receded with disastrous consequences to the whole national economy.

STOCK EXCHANGE REGULATION STUDY, *supra* note 21, at 3.

215. Market fluctuations caused by the condition just outlined have repercussions which extend far beyond the stock exchanges and the circle of individuals who trade in securities. There is a relationship between fluctuations in the stock market and unsettlement in business conditions, based on the fact that stock-exchange movements are apt to be regarded by both business men and the general public as an indicator of underlying conditions. A violent fall in the stock market consequently may lead business men to curtail commitments and activities, thereby increasing unemployment, while on the other hand a sharp rise in the stock market may lead to expansion of business activity beyond the bounds of sound economics. Likewise, the stock market vitally affects credit, which in turn directly affects commercial conditions. In part this is due to the practice of banks in making loans upon stock-market collateral. In part it is due to the fact that institutions such as savings banks and insurance companies hold as investments securities listed on the exchanges, and fluctuations in

Even today, prominent economists recognize that speculative bubbles²¹⁶ can have severe adverse impacts upon macroeconomic performance, without fully understanding the relationship between fiscal policy, monetary policy, and the negative effects of a burst asset bubble like stock price swoons.²¹⁷ While the link between a professionalized securities industry and containment of speculative pressure seems sound and has been assumed to be significant by both contemporary observers and Congress in 1934, it is by no means definitively proven.²¹⁸ Nevertheless, it does seem to benefit from both a powerful logical argument and the track record of American securities markets since 1934.²¹⁹ Current conditions in the U.S. equity markets seem to illustrate the point further. First, recently the United States saw a dramatic expansion in the degree of participation in the stock market generally.²²⁰

quotations affect the apparent financial soundness of these institutions. When these considerations of general economic welfare are united to practices and methods which are either unethical or unsound, or both, the country has seen in a succession of financial disasters whose consequences affect the whole Nation.

Id.

216. Although a speculative bubble is difficult to define precisely, it generally refers to a situation in which prices greatly exceed the real economic value of an asset group. In the context of stocks, for example, policymakers have recognized that:

So far as possible, the aim should be to try to create a condition in which fluctuations in security values more nearly approximate fluctuations in the position of the enterprise itself and of general economic conditions—that is, tend to represent what is going on in the business and in our economic life rather than mere speculative or “technical” conditions in the market

Id. at 5.

217. See Robert J. Samuelson, *Into the Great Unknown*, WASH. POST, Mar. 21, 2001, at A29 (discussing macroeconomic risks of speculative stock bubble); Robert J. Samuelson, *Can Japan Come Back?*, WASH. POST, Mar. 28, 2001, at A23 (discussing Japan’s “bubble economy” of the 1980s).

218. If you think of how persistently investors have been sold overvalued shares in recent years, [one] might . . . agree[] with a famous Wall Street bear in the 1920s, Jesse Livermore, who described Wall Street as a “giant whorehouse”, where brokers were “pimps” and stocks “whores”, and where customers queued to throw their money away. Plus [sic] change.

Of Pimps, Painters and Equities, THE ECONOMIST, Mar. 24, 2001, at 95, 96 (reviewing B. MARK SMITH, TOWARD RATIONAL EXUBERANCE: THE EVOLUTION OF THE MODERN STOCK MARKET (2001)).

219. Much debate surrounds the efficacy of the federal securities laws. Compare George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964) (“[S]tudies suggest that the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public.”), with Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964) (“We doubt that any person reasonably well acquainted with the evolution of stock-market practices between the pre- and post-S.E.C. periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets.”). This Article posits that the period of 1935 (the first full year after the enactment of the Exchange Act) to the present has been marked by steady economic growth with no severe economic disruptions in part because of the enactment of the securities laws in general, and the professionalization of the securities industry. See also Friend & Herman, *supra*, at 386 (“Stigler of course is aware . . . that since the advent of the S.E.C. the stockmarket has had no debacle corresponding to that in the early 1930’s . . .”).

220. See Carol Bertaut & Martha Starr-McCluer, Household Portfolios in the United States (Federal Reserve Board of Governors working paper dated April 26, 2000) (showing that share ownership rocketed

Second, stock prices ran up to historic highs in defiance of nearly all professional assessments.²²¹ Third, stock prices suffered a dramatic depreciation after the bubble burst.²²² Fourth, macroeconomic policy makers seem to be quite challenged in assessing the degree of damage done generally to the economy from the speculative excesses.²²³ A fundamental erosion in the degree to which investment decisions were professionally guided seems central to any explanation of how the bubble developed.

John Maynard Keynes recognized, after the Great Depression, that a gradual increase in the frequency of equity ownership is generally accompanied by an increase in investors that have “no special knowledge . . . in the valuation of investments.”²²⁴ This, in turn, can be expected to increase price volatility as the “mass psychology of a large number of ignorant individuals” begins to dominate the market.²²⁵ Eventually, even professional investors begin to chase the market rather than exert a rational influence on market prices.²²⁶ Keynes thus showed how market professionals succumb to mass psychology, a phenomenon that seems to have repeated itself more recently in the American stock market.²²⁷ However, the proposal for a more professionalized securities brokerage industry would serve to stem “mass psychology” at the

from 31.6% of households in 1989 to 49% in 1998 and that percentage of household wealth in the stock market went from 15% in 1983 to 35% in 1998) (on file with author).

221. *Id.*

222. “Since last March’s peak, the market has lost about \$4.9 trillion in value.” Samuelson, *Into the Great Unknown*, *supra* note 217, at A29.

223. *E.g., id.*

As a result of falling share prices, the net worth of American households fell in 2000 for the first time since records began 55 years ago. Lower share prices are denting confidence. In a recent survey by the University of Michigan (carried out before the latest plunge in stocks), two-thirds of respondents believed that the economy was already in recession. The challenge for the Fed is to stabilise the economy without prompting suspicions that it is cutting interest rates to bail out investors. The central bank is to be commended, therefore, for having the nerve to cut interest rates by a bit less than the market was expecting this week, while making it clear that it will cut further if the economy continues to weaken.

Can the World Escape Recession?, THE ECONOMIST, Mar. 24, 2001, at 21.

Of particular concern to policymakers is the degree to which the American markets, and their historic decline, is correlated to foreign markets. *Dancing in Step*, THE ECONOMIST, Mar. 24, 2001, at 90 (“The correlation between changes in American and European share prices has risen from 0.4 in the mid-90s to 0.8 last year.”).

224. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 153 (1936).

225. *Id.* at 154.

226. *Id.* at 154-55.

227. In early 2000, the success of the American stock market in generating superior returns had become too seductive for professionals to resist. See Lauren R. Rublin, *The Good Times Roll On: And Chances are the Stock Market Will Enjoy Another Rewarding Year*, BARRONS, Jan. 3, 2000, at 29 (stating that Dow Jones Average soared 197% and the NASDAQ index 907% in the last five years).

source; professional brokers would be widely available to investors who have “no special knowledge” and “mass psychology” would be more informed.²²⁸

Nevertheless, many neoclassical economic theorists assume that parties should enjoy freedom of contract to negotiate any fiduciary duties as a matter of efficiency.²²⁹ Commentators have generally responded to this by pointing out that fiduciary duty is a concept premised upon extra-contractual operation and the vindication of non-contractual values.²³⁰ This Article seeks to demonstrate that mandatory professional duties are more efficient than contract-based duties, in that a lack of investor confidence in the fairness of the securities brokerage industry leads to fewer investment transactions, not more.²³¹ Congress was faced with this scenario when it enacted the '34 Act.²³² At that time, greater freedom of contract had led directly to the near extinction of the securities industry.²³³ The empirical evidence therefore strongly suggests that more wealth maximizing transactions will occur under a mandatory professional standards regime.

Of course, in a context where a rule of law gives rise to more economic growth in a relatively clear and ascertainable manner, any neoclassical justification is beside the point.²³⁴ This is because neoclassical economic analysis assumes too much and posits benefits that are too

228. This assumes that the prospect of civil liability would induce brokers to take further steps in dispensing prudent investment advice pursuant to the suitability doctrine, thereby stemming the urge to churn. See *supra* notes 97-129.

229. This thinking has infected the approach of the courts to the issue of fiduciary duties in investment related relationships. See *Shearson Hayden Stone, Inc. v. Leach*, 583 F.2d 367, 372 (7th Cir. 1978) (“To make this defendant or any other broker the guardian of a customer . . . would destroy an important part of the marketplace.”) (quoting *Robinson v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 337 F. Supp. 107, 113 (N.D. Ala. 1971)); *Holtz v. Hilliard*, 1 F. Supp. 2d 887, 897 (S.D. Ind. 1998) (holding no fiduciary duty for account trustee to notify customer of adverse estate tax consequences because such “paternalistic responsibilities” would add transaction costs to investment transactions). See also *In re E. F. Hutton & Co.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,334 (July 6, 1988) (Grundfest, Comm., dissenting).

230. E.g., Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 682-88 (1996).

231. “New corporate securities—which had equaled . . . \$9.4 billion in 1929—had fallen to \$644 million in 1932” I LOSS & SELIGMAN, *supra* note 211, at 216.

232. *Id.*

233. Brokers simply had far fewer investment dollars to generate profits after the crash. The total loss of securities value from 1929 to 1932 was \$93 billion. *Id.* at 167.

234. The limits of microeconomic theory are well-recognized in both law and economics. Economists have long struggled to explain the inability of welfare economics, i.e., Pareto Efficiency, with its general equilibrium analysis, to explain macroeconomic phenomena such as large-scale unemployment, credit crises, business-cycle fluctuations, or even wide-spread bank failures. Peter Howitt, *Macroeconomics: Relations with Microeconomics*, reprinted in THE NEW PALGRAVE, THE WORLD OF ECONOMICS 394 (J. Eatwell et al. eds., 1991).

theoretical—namely, mere efficiency.²³⁵ In essence, neoclassical economic modeling requires profligate assumptions such as perfect information, perfect mobility of resources, and zero transaction costs.²³⁶ Under these assumptions, human beings, as rational maximizers, will transact until resources are allocated to their most valuable use.²³⁷ Consequently, either wealth or utility will be theoretically maximized.²³⁸ But that is it. Under those unrealistic assumptions, wealth or utility will be maximized but not growth, jobs, or productivity.²³⁹ Neoclassical theory has never posited that efficiency leads to more output or more jobs or more of any other macroeconomic aggregate.²⁴⁰

There are other non-economic reasons for imposing professional standards upon the brokerage industry. Just as the social context of 1934 demanded political action to repair our economic system, the social context of the twenty-first century presents a context that is at

235. Pareto Efficiency is defined as “[a]n allocation of resources in which it is impossible by reallocation to make some consumers better off without simultaneously making others worse off.” RICHARD G. LIPSEY & PETER O. STEINER, *ECONOMICS* 952 (6th ed. 1981).

236. A perfectly competitive economy achieves Pareto Efficiency. EDWIN MANSFIELD, *MICROECONOMICS: THEORY AND APPLICATIONS* 447 (4th ed. 1982) (stating that “a perfectly competitive economy satisfies the three sets of conditions for welfare maximization”). A perfectly competitive economy requires: (i) that the product of any one seller, in a given market, is the same as all other sellers, *i.e.*, homogeneity; (ii) that no market participant has sufficient power to affect price—all market participants are price takers; (iii) that all resources are perfectly mobile; and (iv) that all market participants have perfect knowledge of relevant economic data. *Id.* at 248-49. Note that Pareto Efficiency is not the same as saying that maximum GNP has been achieved. Allan M. Feldman, *Welfare Economics*, reprinted in THE NEW PALGRAVE, *THE WORLD OF ECONOMICS* 715 (J. Eatwell et al. eds., 1991). Some commentators, in recognition of the rather prodigious assumptions of microeconomics, have sought shelter in other, more obscure, definitions of efficiency, such as “Kaldor-Hicks” efficiency. *Id.* at 14. Changing the definition of efficiency from Pareto Efficiency, however, serves only to weaken the utility of the analysis; only Pareto Efficiency theoretically supports welfare maximization and general equilibrium. Also, Kaldor’s work has been shown to be internally inconsistent. See Feldman, *supra*, at 720; see also Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 *HOFSTRA L. REV.* 509, 519-20, 527 (1980) (“Unlike happiness or well-being, wealth is not something of intrinsic value.”).

237. Microeconomic theory hinges upon Pareto Efficiency, because only that concept is theoretically consistent with welfare maximization. Welfare maximization, or general equilibrium, is the microeconomic analysis which hypothesizes that all resources are optimally allocated. Microeconomic modeling and analysis can, therefore, only address the concept of Pareto Efficiency and not which standard will give rise to a maximum level of GNP.

Ramirez, *supra* note 230, at 683-84.

238. Even Judge Posner has come around to recognizing that human beings are not rational maximizers. See RICHARD A. POSNER, *OVERCOMING LAW* 419 (1995).

239. For example, as Judge Posner candidly admits, efficiency is not about “mysterious macroeconomic phenomena” such as “inflation unemployment [or] business cycles.” RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.1, at 3 (5th ed. 1998).

240. *Id.*

least as compelling.²⁴¹ First, the breadth of securities ownership now is greater than ever.²⁴² Broadening securities ownership is certain to result in a higher percentage of inexperienced, unsophisticated, and less educated securities owners than if ownership were largely limited to a small class of society.²⁴³ Second, an age crisis is looming in America and abroad. Right now, more Americans than ever are depending upon the securities markets to deliver returns sufficient to provide for retirement.²⁴⁴ Experience has proven that unleashing a securities industry dominated by a *caveat emptor* mentality upon less sophisticated investors, who will be dependent upon securities markets for retirement, will result in countless personal tragedies.²⁴⁵ Examples of securities professionals fleecing small investors abound.²⁴⁶

241. For example, in 1934, Congress recognized that the increasing breadth of stock ownership in our society meant that stock exchanges are "affected with a national public interest." S. REP. NO. 73-1455, at 5 (1934).

242. For example, from 1965 to 1997, the frequency of stock ownership rose from 10.4% of Americans to 43% of Americans. These investors frequently rely on such investments for their retirement savings. See PETER D. HART RESEARCH ASSOCIATES, A NATIONAL SURVEY AMONG STOCK INVESTORS, CONDUCTED FOR THE NASDAQ STOCK MARKET (1997). Ironically, Congress recognized in 1934 that broadening stock ownership presented increased risks to society and that unbridled access to stock markets could cause economic instability. S. REP. NO. 73-1455, at 5 (1934).

243. See generally James A. Fanto, *We're all Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Protection*, 49 CASE W. RES. L. REV. 105 (1998).

244. *Id.* at 112-18.

245. As the SEC chairman has noted:

Take the sale of \$8 billion of limited partnerships during the 1980s by Prudential Securities. Sadly, many people saving for retirement were misled about the risks of these investments. The SEC, with the help of state regulators, investigated and reached a settlement with Prudential at the end of last year, which has already returned almost \$825 million to more than 100,000 defrauded investors.

Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Speech to National Association of Investors Corporation, Memphis, Tenn. (Aug. 27, 1995), available at 1995 WL 520185; see also KURT EICHENWALD, SERPENT ON THE ROCK 7 (1995) ("More than \$8 billion worth of risky partnerships packaged by Prudential-Bache collapsed after they had been falsely sold as safe and secure."); Chuck Hawkins, *The Mess at Pru-Bache: Questions About the Broker's Dealings Could Cause Long Term Damage*, BUS. WK. Mar. 4, 1991, at 66 (stating that Prudential-Bache Securities, Inc. sold more than \$6 billion in limited partnerships to 100,000 investors who suffered huge losses without disclosing conflicts of interest or criminal convictions of key promoters).

246. As stated in *United States v. Mulheren*, 938 F.2d 364 (2d Cir. 1991):

In the late 1980's a wide prosecutorial net was cast upon Wall Street. Along with the usual flotsam and jetsam, the government's catch included some of Wall Street's biggest, brightest, and now infamous—Ivan Boesky, Dennis Levine, Michael Milken, Robert Freeman, Martin Siegel, Boyd L. Jeffries, and Paul A. Bilzerian—each of whom either pleaded guilty to or was convicted of crimes involving illicit trading scandals.

Id. at 365; see also JAMES B. STEWART, DEN OF THIEVES 535-36 (1991) (noting that Dennis Levine confessed to \$12.6 million in insider-trading profits, Ivan Boesky agreed to pay \$100 million in sanctions, and Michael Milken agreed to pay \$600 million); Dennis B. Levine, *The Inside Story of An Inside Trader*, FORTUNE, May 21, 1990, at 80 (admitting that Dennis Levine "built \$39,750 into \$11.5 million" through seven weeks of insider trading); *The Insider-Trading Case's Cast of Characters*, WASH. POST, Sept. 8, 1988, at E4 (detailing law enforcement activity against the web of inside traders on Wall Street).

The securities brokerage industry has also evolved in a manner that supports industry standards of professional conduct. The reality facing the industry today is that technology has progressed to a point where the market price for a broker acting as mere order taker can achieve revenue of about ten dollars per trade.²⁴⁷ The industry survives by its ability to sell a bundle of services that at bottom consists of professional services and professional advice; the technological reality of the year 2002 is that an investor can buy securities through a machine without seeing or talking to a real person. Under these circumstances, the securities industry can hardly tolerate a public profile akin to used car salespersons. Indeed, the ability of any broker-dealer to sell its professional services is compromised every time an investor is victimized by a competitor that fails to adhere to professional standards.²⁴⁸ Under these circumstances, strictly enforcing industry norms of professionalism is fundamental to commercial survival.²⁴⁹

Securities markets should not be operated as if they are casinos. That market is well occupied, and regulated broker-dealers are not well-suited to hawking securities as games of chance. Similarly, banks, investment companies, and insurance companies each sell investment products and investment management services that compete with broker-dealers. But brokers have the ability to offer a myriad of investment products in a single account that is individually tailored and managed with professional advice and guidance. This is the market niche that allows broker-dealers to thrive in a market with revenues in excess of those available to a mere order taker. It is particularly appropriate to impose professional standards upon market participants who hold themselves out to the public, either through advertising or service pricing, as "full-service" securities professionals.²⁵⁰ Put simply, this market niche must be defended by limiting entry to true professionals.

The abolition of *caveat emptor* in the securities brokerage industry in 1934 was the appropriate response to the Great Depression. From virtually any analysis, further erosion of the abolition of *caveat emptor* is not appropriate. The securities brokerage industry is central to investor perspectives on securities markets. The efficiency of these markets,

247. Current advertised rates for mere order takers are down to eight dollars a trade. Valerie Leroux, *Discount Brokers Challenge Full Service Firms*, AGENCE FRANCE-PRESSE, Jan. 21, 2000, available at 2000 WL 2717674.

248. See S. REP. NO. 75-1455, at 3 (1938) (stating that one purpose of the Maloney Act was "to protect the investor and the honest dealer alike from [the] dishonest and . . . submarginal element in the industry").

249. See H.R. REP. NO. 73-1383, at 3 (1934) (stating that unregulated exchanges can lead to "mad booms" and "terrible depressions" and that the '34 Act seeks "to save not destroy stock markets and business").

250. See, e.g., *In re Duker & Duker*, 6 S.E.C. 386 (1939); cases cited *supra* note 112.

central to our economic system, is at stake if industry standards erode. *Caveat emptor* is not a sustainable standard of business in the securities brokerage industry in a modern capitalist system.²⁵¹

V. CONCLUSION

For reasons that are not clear, there are few reported decisions holding a securities broker to the standard of care to which virtually every other trade or profession is held. From real estate brokers to beauty shop owners and from landscaping companies to lawyers, courts have insisted that professionals adhere to the standards of the industry and exercise professional care. This standard of care is evidenced by codes of conduct or codes of ethics, usually promulgated by the relevant profession itself. In the securities industry, SROs like the NYSE and the NASD have promulgated detailed codes of conduct specifically designed by the industry to inculcate standards of “high honor” or “just and equitable principles of trade” throughout the securities brokerage industry. There is no good reason for courts to decline to hold the industry to its own professional standards and thereby frustrate the fundamental purpose of self-regulation—investor protection. The text and legislative history of the '34 Act, on the other hand, furnish a sound basis upon which a law of broker malpractice ought to be built. Indeed, insulating the industry from such liability is ultimately destructive of the very professional standards that the industry thrives upon.

Separate and apart from the question of why courts have largely insulated brokers from legal principles that apply to virtually every other skilled trade or profession is the question of the economic risks that such legal machinations pose. Holding that the imposition of professional duties only raises transaction costs misses several compelling economic points. Speculative bubbles and unfair securities markets marked by principles of *caveat emptor* instead of professionalism will devastate investor confidence, as it has so dramatically in the past, and greatly diminish transactions in securities regardless of costs. We as a society already have “been there and done that” when it comes to *caveat emptor* in the securities markets and have found that—regardless of any efficiency justification—it is prone toward economic catastrophe. In 1933, just before the enactment of the federal securities laws, efficiency offered little comfort to Wall Street in the midst of an eighty-three percent decline in share prices. In the final analysis, the economic foundations of raising industry conduct to instill investor confidence was

251. *Supra* notes 1, 10, and 30.

sound policy in 1934 and it is sound policy today. Courts should recognize professional liability in the securities brokerage industry as a means of reversing recent judicial hesitancy to hold brokers to the standards of professionalism that those brokers hold out to the public.