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Elizabeth Pendzich

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Implied Liability for Violation of Stock Exchange and NASD Rules—After Rolf and Faturik

INTRODUCTION

Broker-dealers' owe affirmative duties of care, competence, and loyalty to their customers. As fiduciaries, they are liable to investors under a wide variety of federal, state, and self-imposed rules and regulations. The Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act), as well as numerous state blue-sky laws, impose rules and regulations on broker-dealers which may be enforced through express civil liability provisions. In addition, where no express language exists, various courts have implied civil sanctions from organizational codes and bylaws in order to promote the legislative goal of investor protection. Sections 61 and 27 of the 1934 Act, for example, have been recognized as the jurisdictional bases for implying civil liability for violations of stock exchange and National Association of Securities Dealers (NASD) rules. Courts also have permitted implied liability under the gen-

1. The term “broker” means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. 15 U.S.C. § 78c(a)(4)(1970). The term “dealer” means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business. 15 U.S.C. § 78c(a)(5) (1970).


3. Id. §§ 78a-78kk.


5. Sections 11, 12(1) and 12(2) of the 1933 Act and sections 9(e), 16(b) and 18 of the 1934 Act provide for express liability. 15 U.S.C. §§ 77k, 77I(1), 77I(2), 78(e), 78p(b) and 78r (1970). The relevant sections of the 1933 Act allow a plaintiff to recover damages caused by false registration statements, or misleading statements in connection with prospectuses and other communications. The relevant sections of the 1934 Act also allow recovery of damages for violations of prohibitions against manipulation of security prices, for short-term profits by insiders, and for misleading statements in any application or document filed pursuant to the 1934 Act.


7. Section 6 of the 1934 Act, 15 U.S.C. § 78f (1970), provides that an exchange may register with the Commission as a national securities exchange under the terms and conditions provided in the section.


9. The NASD is a voluntary association of securities dealers authorized by the 1934 Act.
eral anti-fraud provisions of the federal securities laws.¹⁰

Until recently, the test for liability and the degree of culpability necessary to establish an implied private cause of action for breach of a broker-dealer's fiduciary duty were unclear. In *Rolf v. Blyth Eastman Dillon & Co.*¹¹ and *Faturik v. Woodmere Securities, Inc.*¹² the District Court for the Southern District of New York and the Court of Appeals for the Second Circuit have attempted to establish limits and develop standards in these areas. This article examines the threshold problems courts face in implying civil remedies from federal regulatory statutes, New York Stock Exchange (NYSE) rules and NASD regulations. The discussion also includes an examination of the nebulous standards which frustrated courts and litigants before the decisions in *Rolf* and *Faturik*. Finally, the article analyzes those two decisions and suggests possible weaknesses in the criteria they established.

**The Jurisdictional Question**

Before extending an implied civil remedy to investors injured by a fiduciary's breach of a statutory duty, courts must first address

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¹⁰ See, e.g., § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), which 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—

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

See also rule 10b-5, 17 C.F.R. § 240.10b-5 (1977), which provides:

- It shall be unlawful for any persons 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.


the question of federal subject matter jurisdiction. An understanding of the nature and role of stock exchange regulations and NASD rules helps place the jurisdictional question in proper perspective. The 1934 Act regulates securities markets, brokers, and dealers through direct prohibitions and indirect self-regulatory provisions. Regulation of stock exchanges is accomplished through a relatively simple plan. While the Securities and Exchange Commission (SEC or Commission) is responsible for supervising broker-dealers engaged in the sale and distribution of securities in over-the-counter markets, members of a national securities exchanges are regulated by the exchanges themselves, subject to Commission scrutiny.

In this context, section 5 of the 1934 Act provides that it shall be unlawful for any broker, dealer, or exchange to use any instrumentality of interstate commerce for the purpose of using any facility of an exchange to effect any transaction in a security unless such exchange registers with the Commission under section 6 of the Act. Section 6 states that as a prerequisite to registration, an exchange must file a statement which includes an agreement to comply with and enforce the provisions of the Act and submit organizational

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13. Some of the prohibitions and direct requirements imposed are those which require stock exchanges to register or be exempt before lawfully doing business, those which prohibit manipulative or deceptive devices, and those which require particular information on proxy materials. Self-regulation, on the other hand, requires stock exchanges to adopt rules governing their practices and procedures, and the business conduct of their members. Responsibility for enforcement of these rules is delegated to the stock exchanges and the NASD. SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong., 1st Sess. 3 (1963) (hereinafter cited as SPECIAL STUDY). For a summary of the advantages and disadvantages of self-regulation, see SPECIAL STUDY, pt. 4 at 722.

14. Section 15, 15 U.S.C. § 78o (1970). See note 23 infra and accompanying text for a summary of this provision. The term over-the-counter market is perhaps a misnomer since there is no central market place. Rather, the term refers to a way of doing business. Instead of utilizing an “auction” market, where buyers and sellers meet to do business, dealers keep the stocks in inventory. Buyers are matched with sellers not on a trading floor, but through a massive network of telephone and teletype wires that link thousands of securities firms in the United States and abroad. See L. ENGEL, HOW TO BUY STOCKS 108 (5th ed. 1972).

15. Section 5, 15 U.S.C. § 78e (1970) provides as follows:

It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 6 of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

16. Id.

data and copies of its constitution, articles of incorporation, and bylaws. The registration requirements are effectuated through section 6(b) which provides:

No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.18

Section 15A of the 1934 Act provides for the regulation of broker-dealers.20 This section permits any association of brokers or dealers to register with the Commission as a national securities association, provided that such association meets certain prescribed standards21 and establishes disciplinary measures for punishing members who violate Commission and association rules.22 With respect to the regulation of broker-dealers who are neither members of the NASD nor members of a national stock exchange, the 1934 Act was amended in 1964 to regulate broker-dealers who trade in over-the-counter markets.23 Section 15 requires such broker-dealers to register with the Commission in accordance with any specific rules promulgated thereunder. Moreover, section 15 contains a sweeping anti-fraud provision which states that no broker-dealer registered under this section shall engage in any securities transaction by means of any manipulative, deceptive, or other fraudulent device or contrivance.

18. Id. § 78f(a)(1)(3).
19. Id. § 78f(b).
20. Id. § 78o-3.
21. Section 15A(b)(5), 15 U.S.C. § 78o-3(b)(5) (1970) provides for registration of associations, brokers or dealers with the Commission. The section provides that no person shall become a member and no natural person shall become a person associated with a member, unless such person is qualified to become a member or a person associated with a member in conformity with specified and appropriate standards with respect to the training, experience, such other qualifications of such persons as the association finds necessary or desirable, and in the case of a member, the financial responsibility of such member. The section suggests the following criteria should be considered in connection with establishing membership requirements: the type of business done and the type of securities sold, examinations for prospective members, and specific registration procedures.
22. Section 15A(b)(9), 15 U.S.C. § 78p-3(b)(9) (1970) requires associations to establish disciplinary measures. In addition, an applicant association shall not be registered as a national securities association unless it appears to the Commission that by reason of the number of its members, the scope of their transactions, and the geographical distribution of its members, such association will be able to comply with the provisions of the Act and carry out the purposes of this section. Securities and Exchange Act of 1934, § 15A(b)(1), 15 U.S.C. § 78o-3 (b)(1) (1970).
For the purposes of this subsection, the Commission is given the power to define practices which it deems improper or otherwise fraudulent.\textsuperscript{24}

In addition to compliance with direct statutory regulations, securities exchanges and broker-dealer associations also must comply with self-imposed proscriptions and bylaws. Pursuant to the Commission's mandate of self-regulation,\textsuperscript{25} the New York Stock Exchange has published a guide to regulate its members.\textsuperscript{26} The NASD has adopted similar material in its Code of Procedure.\textsuperscript{27} These rules were not promulgated under any enabling statute and do not provide for liability for violations. Nevertheless, they are given force and effect because they are promulgated pursuant to congressional policy expressed in the federal securities laws.

In light of these sections, the precise jurisdictional question is whether a violation of exchange rules or broker-dealer codes establishes an implied federal cause of action. Section 27 of the 1934 Act states: "The district courts of the United States... shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder..."\textsuperscript{28} Sections 6 and 15A(b)(8) of the 1934 Act require securities exchanges and broker-dealer associations to enact rules and regulations which meet congressionally specified standards.\textsuperscript{29} The emphasized language in section 27, when read in conjunction with these sections, clearly indicates that self-imposed bylaws and rules encompass 1934 Act duties and generate 1934 Act liability.

The United States Supreme Court in \textit{J.I. Case Co. v. Borak}\textsuperscript{30} implemented this reasoning to imply liability where it was not expressly mandated. In \textit{Borak}, the Court addressed the issue of whether sections 14a and 27 of the 1934 Act allowed an implied private cause of action to a corporate shareholder who alleged that he was damaged by misleading proxy statements issued in connection with a corporate merger. The Court allowed the claim; in addi-

\begin{itemize}
  \item[26.] 1-3 NYSE GUIDE (CCH).
  \item[27.] Code of Procedure for Handling Trade Practice Complaints, NASD MANUAL (CCH) ¶¶ 3001-26 (1973).
  \item[29.] \textit{Id.} §§ 78f and 78o-3(b)(8).
  \item[30.] 377 U.S. 426 (1964).
\end{itemize}
tion, it established general standards for determining remedies when it observed:

It is for federal courts "to adjust their remedies so as to grant the necessary relief" where federally secured rights are invaded. "And it is well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done." 31

The purpose of sections 6, 15 and 15A is to prevent broker-dealers from obtaining unfair advantages over investors by means of fraudulent acts or practices. 32 For example, this broad remedial purpose is apparent in the provisions which make it unlawful for exchanges, broker-dealer associations, and broker-dealers to effect any transaction involving a security in contravention of such regulations as the Commission may prescribe as necessary in the public interest. 33 This language makes no specific reference to a private right of action. Nevertheless, one of its primary objectives is investor protection, a goal which certainly implies the availability of judicial relief. 34 In fact, the availability of a federal cause of action for damages or injunctive relief is a necessary implication if the prohibitions contained in the rules are to be effective in deterring broker-dealer misconduct.

OTHER PROBLEMS OF IMPLYING LIABILITY

After resolution of jurisdictional matters, courts must address a complex substantive question: to what extent and under what circumstances may civil liability be implied? Many courts have found it helpful to examine legislative history, judicial precedent, and any

32. See notes 18, 20 and 23 supra and accompanying text for description of those provisions.
33. See, e.g., section 6(a)(2), 15 U.S.C. § 78f(a)(2) (1970), which provides that an exchange may register with the Commission upon submission of specified information and "such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;" § 15(a)(2), 15 U.S.C. § 78o(a)(2)(1970), which provides that "The Commission may by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors," exempt from registration any broker or dealer or class of brokers or dealers operating on the over-the-counter market; and section 15 A(a)(1), 15 U.S.C. § 78o-3(a)(1)(1970) which provides that any association of brokers or dealers may be registered with the Commission as a national securities association upon filing specified data and "such other information as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors."
applicable common law.\textsuperscript{35} As matters of policy, courts also have considered whether an implied right of action would provide an adequate incentive to foster investor enforcement of securities legislation and whether implied liability would provide direct relief to an injured party where no other remedy exists.\textsuperscript{36} However, courts generally have not examined the adequacy of possible state remedies because of the nationwide scope and character of the securities industry and the difficulties of proving common law fraud.\textsuperscript{37}

It is submitted, however, that courts must consider more specific criteria if the goal of investor protection is to be achieved. In addition to the factors listed, courts have examined whether the central purpose of a particular rule or regulation is to protect investors, and whether it is reasonable to infer that the Commission has refrained from exercising its rulemaking authority because it feels that the public is adequately protected by a regulatory scheme established by an exchange or broker-dealer association itself.\textsuperscript{38} Moreover, civil liability has been implied for self-regulatory bylaws with explicit proscriptions only.\textsuperscript{39} Allowing liability in situations where these criteria are met should ensure that spurious claims will be minimized and that duties broker-dealers know of or should know of will be properly enforced.

Two final substantive considerations concern the boundaries of the cause of action and remedies. Courts must decide whether to adopt standards for liability and remedies similar to those contained in existing analogous statutes or whether to formulate new requirements. In order to foster uniformity of enforcement,\textsuperscript{40} courts recently have adopted standards for liability and remedies similar to those required in rule 10b-5 claims.\textsuperscript{41}

\textsuperscript{35} These criteria were proposed in Note, \textit{Implying Civil Remedies from Federal Regulatory Statutes}, 77 Harv. L. Rev. 286 nn.12-15, 287-88 nn.23 & 24, 290 n.34 (1963).
\textsuperscript{36} Id.
\textsuperscript{37} Id.
\textsuperscript{39} Id.
\textsuperscript{40} Courts have allowed implied liability for violations of stock exchange and NASD rules promulgated pursuant to § 6 of the 1934 Act, 15 U.S.C. § 78f (1970), despite the fact that the section has no express provision for liability.
\textsuperscript{41} See the discussion of \textit{Rolf v. Blyth Eastman Dillon & Co.} and \textit{Faturik v. Woodmere Securities, Inc.}, at text accompanying notes 75-120 infra for the most recent consideration of these problems. Requiring the plaintiff to meet a high standard of proof fosters judicial economy and protects broker-dealers from spurious suits, while allowing plaintiffs with sub-
IMPLYING LIABILITIES BEFORE Rolf AND Faturik

An examination of the judicial precedent before the district court's decisions in *Rolf v. Blyth Eastman Dillon & Co.*\(^{42}\) and *Faturik v. Woodmere Securities, Inc.*,\(^{43}\) demonstrates that much uncertainty existed in the area. Two factors contributed to this trying state of affairs. First, the extent of liability was not clear since most courts allowed implied liability only against securities exchanges, while some permitted broker-dealers to be sued also. Second, courts had not adopted one predictable test for implying liability, but availed themselves of several slightly varying standards. The *Rolf* and *Faturik* decisions lend some stability to this area of the law by unequivocally extending implied liability to broker-dealers and by synthesizing all the possible bases of liability.

*Baird v. Franklin*,\(^{44}\) decided in 1944, was the first case to discuss the possibility of implying civil liability against a national securities exchange which had failed to supervise its members. In *Baird* the Court of Appeals for the Second Circuit held that the NYSE “violated a duty” when it refused to invoke disciplinary action against a stock exchange member who had converted the plaintiff's securities to his own use.\(^{45}\) This duty required the Exchange to investigate the dealings and the financial conditions of the members and to suspend or expel members it had reason to believe had been guilty of conduct inconsistent with just and equitable principles of trade.\(^{46}\) Nevertheless, the court denied recovery to the plaintiffs because they had failed to demonstrate that the Exchange's breach of duty was the proximate cause of their injury.\(^{47}\) Judge Clark argued in dissent that if section 6 of the 1934 Act was intended primarily for investor protection,

> [t]he fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from its

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\(^{44}\) 141 F.2d 238 (2d Cir. 1944).

\(^{45}\) Id.

\(^{46}\) Id.

\(^{47}\) Id.
breach and that the common law will supply a remedy if the statute gives none.\textsuperscript{48}

Interestingly, Judge Clark's view foresees the current trend of allowing implied liability against both stock exchanges and broker-dealers for violations of NYSE and NASD rules and regulations which of themselves do not provide for liability.

Similarly, the court in \textit{O'Neill v. Maytag}\textsuperscript{49} recognized a narrow class of defendants when, citing \textit{Baird}, it allowed the possibility of a cause of action against a securities exchange exclusively. The court stated that a suit based on exchange rules violations against a member company or its officers or agents was an "entirely new theory" and did not exist.\textsuperscript{50} Plaintiffs continued to experience frustration in obtaining adequate redress when a second circuit district court in \textit{Kroese v. New York Stock Exchange}\textsuperscript{51} acknowledged that a right of action could lie against the NYSE for failing to sanction a member company for a violation of the Exchange's rule 499. This rule provided that securities listed with the Exchange could be suspended from dealings or removed from the list at any time.\textsuperscript{52} However, the admitted facts of \textit{Kroese} did not show that the member company had failed to comply with the rule. Hence, the defendant's motion for summary judgment was granted,\textsuperscript{53} the court making no mention of the feasibility of a suit against the member company directly.

From the injured plaintiff-investor's point of view, a narrow and unsatisfactory right of action emerged from \textit{Baird, Maytag}, and \textit{Kroese}. This line of cases consistently held that only a securities exchange, not a member company or a broker, could be held liable for violation of exchange or NASD rules. Moreover, the exchange could be sued only if it had sufficient reason to believe that a member had violated a rule and only if the exchange's conduct was the principal cause of the plaintiff's loss.

After \textit{Baird}, not only was the class of potential defendants unsatisfactory, but there was no substantial theory under which to sue. The Second Circuit in \textit{Colonial Realty Corp. v. Bache & Co.}\textsuperscript{54} remedied this situation by setting out tests to aid courts in implying liability under NASD and NYSE rules. Again, the court permitted

\begin{itemize}
\item \textsuperscript{48} \textit{Id.} at 245.
\item \textsuperscript{49} 339 F.2d 764 (2d Cir. 1964).
\item \textsuperscript{50} \textit{Id.} at 770.
\item \textsuperscript{51} 227 F. Supp. 519 (S.D.N.Y. 1964).
\item \textsuperscript{52} \textit{Id.} at 520.
\item \textsuperscript{53} \textit{Id.} at 521.
\item \textsuperscript{54} 358 F.2d 178 (2d Cir. 1966).
\end{itemize}
a cause of action to be asserted against a stock exchange for the violation of its own bylaws, but refused to extend the cause to a member of the exchange. A federal claim for relief was denied to an injured investor who sought recovery for damages sustained due to his broker’s conduct, which allegedly was inconsistent with “just and equitable principles of trade” prescribed in section 6(b) of the 1934 Act. The court’s ultimate holding was the same as that in Maytag, but the Colonial court added a dimension to the analysis by refining the implied liability tests established in earlier cases:

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.

Further confusion was generated by the Seventh Circuit Court of Appeals in Buttrey v. Merrill Lynch, Pierce, Fenner & Smith. In contrast to the Second Circuit holding in Colonial, the Seventh Circuit in Buttrey allowed a private claim against a broker for violation of NYSE Rule 405. This was the first time a cause of action

55. In addition, the plaintiff brought his claim under the 1934 Act, § 15A(b)(7), 15 U.S.C. § 78o-3(b)(7) (1970), art. XIV of the Constitution of the New York Stock Exchange, 2 NYSE Guide (CCH) pp. 1094-1103, art. I, section 2a of the NASD Bylaws, NASD Manual (CCH) ¶ 1102(a)(1973), and art. III, section I, of the Rules of Fair Practice of the NASD, NASD Manual (CCH) ¶ 2151 (1970). Plaintiff was not successful on any of these claims because the alleged violations of the sections cited above were not pleaded with sufficient specificity.
56. 358 F.2d at 182 (emphasis added).
57. 410 F.2d 135 (7th Cir. 1969).
58. Rule 405 provides in part:

Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) [¶ 2342] to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.
Supervision of Accounts
(2) Supervise diligently all accounts handled by registered representatives of the organization.
Approval of Accounts
(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer
was allowed against a broker. In addition, a new test for liability was 
established: "the touchstone for determining whether or not the 
violation of a particular rule is actionable should properly depend 
upon its design 'for the direct protection of investors'."59 While 
Colonial focused on the nature of the particular rule and the place 
of the rule in the regulatory scheme, Buttrey focused on investor 
protection directly. The Seventh Circuit thus created uncertainty as 
to the boundaries for implying a cause of action under NASD and 
stock exchange rules. Nevertheless, the approach had advantages. 
Because it was not unique to the securities area,60 courts could find 
ample precedent and guidelines to justify their decisions. Fur- 
thermore, it had the potential to promote judicial economy and assure 
national uniformity of investor protection.

Similar reasoning was applied by the Second Circuit in Van Gem- 
ert v. Boeing Co.61 where a plaintiff was allowed to assert a federal 
cause of action against an issuer for violations of a NYSE listing 
agreement62 and section A10 of the NYSE Company Manual.63 The

may be approved by the manager of such branch office but the action of such 
branch office manager shall within a reasonable time be approved by a general 
partner, a principal executive officer or a person or persons designated under the 
provisions of Rule 342(b)(1) [¶ 2342]. The member, general partner, officer or 
designated person approving the opening of the account shall, prior to giving his 
approval, be personally informed as to the essential facts relative to the customer 
and to the nature of the proposed account and shall indicate his approval in writing 
on a document which is a part of the permanent records of his office or organization.

2 NYSE Guide (CCH) pp. 3697, 3701.
59. 410 F.2d at 142.
60. Id. at 143. See, e.g., Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969) for the 
proposition that a private cause of action can be implied for violation of NYSE rule 405 in 
order to protect the public. See also Securities and Exchange Commission v. First Sec. Co. 
of Chicago, 463 F.2d 981 (7th Cir. 1972), cert. denied, 409 U.S. 880 (1972) in which the court 
cited both Buttrey and Avern Trust and allowed a private damages action for violation of 
NASDAQ rule 27 on the theory that the rule served to protect the public. The rule provides in 
part:

(a) Each member shall establish, maintain and enforce written procedures which 
will enable it to supervise properly the activities of each registered representative 
and associated person to assure compliance with applicable securities laws, rules, 
regulations and statements of policy promulgated thereunder and with the rules of 
this Association.

(b) Final responsibility for proper supervision shall rest with the member. . . .

(c) Each member shall be responsible for keeping and preserving appropriate 
records for carrying out the member's supervisory procedures. Each member shall 
review and endorse in writing, on an internal record, all transactions and all corre-

sondence of its registered representatives pertaining to the solicitation or execu-

tion of any securities transaction.

NASDAQ Manual (CCH) ¶ 2177 (1976).
62. The NYSE requires issuers to sign a listing agreement with the exchange which
court cited previous case development in the area, but also noted than an implied right of action fostered the implicit guarantees of trustworthiness that the public expects from the exchanges. Thus, indirectly, the court focused on investor protection. The fact that the court relied on Buttrey, rather than formulating a new test, was a welcome development, given the fact that until that point each new decision had proposed a new test.

Thus, after Baird, Colonial, and Buttrey, the initial jurisdictional problem had been resolved, but the boundaries of implied liability for violation of stock exchange and NASD rules were still in a state of flux and development. In addition, a new issue was broached and this, too, muddled the area. After Colonial, culpability was added as a factor to be weighed when determining whether or not to imply liability against broker-dealers for violation of stock exchange and NASD rules.

One of the early and leading cases evaluating culpability standards was Hecht v. Harris, Upham & Co. In that case plaintiff was denied a right of action for his broker-dealer's violation of the NASD "suitability rule" which provides that broker-dealers who recommend to a customer the purchase or sale of any security must have reasonable grounds for believing that the recommendation is suitable for such customer. The recommendation should be based on any facts that the customer chooses to disclose regarding his holdings of other securities, his financial situation, and his needs or investment objectives. With regard to culpability, the court noted that the applicable federal securities laws are directed essentially at fraud, and not at the mere negligence or judgment errors of broker-dealers. In addition, the rules may be considered expressions of the

contractually binds the issuer to adhere to exchange requirements established for investor protection. For further discussion of listing agreements, see Note, Implication of Civil Liability Under the New York Stock Exchange Rules and Listing Agreement, 22 VILL. L. REV. 130, 134-37 (1976).

63. Section A10 of the NYSE Company Manual specifically defines the type of publicity required by the Listing Agreement as to redemption of debentures. 520 F.2d at 1376.

64. 520 F.2d at 1381. No mention was made of the requisite degree of culpability. By stressing the position that the Exchange occupies in relation to the investing public, the court impliedly adhered to the Buttrey test.


66. Art.III, § 2 of the NASD Rules of Fair Practice provides:

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

NASD MANUAL (CCH) ¶ 2152 (1976).

67. Id.

68. 283 F. Supp. at 430.
industry itself as to what constitutes proper conduct, and the violation of the rules, under certain circumstances, may amount to fraud. 69

Other courts have employed the "negligence plus" standard in analogous areas of the law. 70 Also, mere negligence has been held insufficient to support an implied right of action under at least two provisions of the NASD Rules of Fair Practice and NYSE regulations. 71 Finally, that standard has received limited indirect approval from the Second Circuit. For example, in *Buttrey* the court took no definite position with regard to the requisite degree of culpability, but stated that "... mere errors of judgment by defendant might not support a federal cause of action . . . ." 72

The *Hecht* decision is important because it introduced culpability as a determinative factor in the implication of a cause of action. The need for meeting a strict scienter standard as a basis for implied liability is consistent with the standards that courts have used in construing section 10(b) and rule 10b-5. 73 The adoption of similar standards for both anti-fraud provisions of the securities laws and self-imposed broker-dealer regulations assures uniformity in the application of the federal securities laws. Courts should attempt to balance the self-regulation policy of NASD and NYSE rules with

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69. *Id.* at 433. Commentators have classified NYSE rules into "housekeeping rules" which do not give rise to private causes of action, and rules designed for investor protection which obviously give rise to private actions. Examples of the former type are those which govern the composition and election of the Board of Governors, transfers of membership dues and other fees, the Gratuity Fund, registration of floor employees, and back-office procedures. NYSE Const. arts. II, X, XI, XVI-XVIII, 2 NYSE GUIDE (CCH) pp. 1053-63, 1079-80, 1113-20, and NYSE rule 35, 2 NYSE GUIDE (CCH) p. 2575. Examples of rules which could give rise to private liability actions are those which deal with overcharges in commission rates, failures of member firms to maintain adequate capital positions, and improper supervision by a member firm over discretionary accounts. NYSE rules 325 and 408, 2 NYSE GUIDE (CCH) pp. 3525, 3701-04. See also *Lowenfels, Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 28-29 (1966).

70. See, e.g., Cady, Roberts & Co., 40 S.E.C. 907 (1961); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), which applied that standard in § 10(b) and rule 10b-5 contexts. See also note 10 supra for the text of section 10b and rule 10b-5.


72. *410 F.2d* at 143.

73. The leading case on scienter requirements under rule 10b-5 is *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), in which the Court required that plaintiffs, customers of a securities firm which *Ernst & Ernst* had audited, show fraud before being allowed to bring a private claim against *Ernst & Ernst* under rule 10b-5. The Court based its decision on the language of rule 10b-5 itself as well as on the legislative history of § 10b and rule 10b-5. In addition, in footnote 33 the Court noted that a showing of fraud was necessary in order to avoid significantly broadening the class of plaintiffs who may seek to impose liability on accountants, attorneys, and other experts who perform services or express opinions with respect to matters under the securities acts. *425 U.S.* at 214 n.33.
the investor protection goal of the federal securities laws in order to achieve more equitable results.  

The series of cases discussed in this section appears to have settled the issue of who can be sued for violations of stock exchange and NASD rules. After Baird and Colonial only a member company could be sued in the Second Circuit. However, after Buttrey, an employee of a member company could be sued in the Seventh Circuit. Nonetheless, the standards to be applied in such litigation were far from clear. The Second Circuit in Baird imposed a duty to investigate on stock exchange members, while in Colonial the court focused on the nature of the rule allegedly violated and its place in the regulatory scheme as well as the type of duty imposed. The Seventh Circuit in Buttrey framed its test for implied liability in terms of investor protection. Since the stock exchange and NASD rules are promulgated pursuant to the 1934 Act, whose primary aim is investor protection, the Buttrey test was the most sensible one because it allowed liability only under those rules which furthered the purposes of the securities laws. In keeping with this emphasis on investor protection, Hecht and Buttrey stated that mere negligence would not be sufficient to support a cause of action. By implication, a stricter standard of scienter was required, a standard perhaps more akin to the one required under the most used and effective anti-fraud provisions of the 1934 Act, section 10b and rule 10b-5. Set against this background, Rolf and Faturik are significant because they extend the class of possible defendants and establish investor protection as the chief criterion for implying liability for violations of stock exchange and NASD rules. Rolf and Faturik are perhaps the beginning of a more predictable body of law in this area.

**Clearer Standards For Implied Liability**


In *Rolf v. Blyth Eastman Dillon & Co.*, the District Court for the Southern District of New York held that an investment firm, its registered representatives, and its agents may be liable for violations of the NYSE rules and the NASD Rules of Fair Practice under various theories, including breach of a fiduciary duty, aiding and abetting, and *respondeat superior*. In *Rolf*, plaintiff began to in-

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76. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) illustrates liability for breach of a
After Rolf and Faturik

vest his earnings in the stock market in 1950. By 1962 his portfolio was worth $400,000. In 1963 plaintiff took his securities to the investment firm of Blyth Eastman Dillon and Co. (Bedco) which entrusted them to a partner and prominent investment adviser with the firm. Under the adviser's control, the account grew substantially and the plaintiff was satisfied with the growth. In March of 1969, however, the investment adviser left Bedco, and from that time until May of 1969 no one attended to the million-dollar account. At the plaintiff's request, Michael Stott, a registered representative with Bedco, recommended another investment adviser to handle plaintiff's account. The new adviser, Akiyoshi Yamada, was regarded as a brilliant analyst. When Yamada obtained control of plaintiff's account in April of 1969 it was worth nearly $1.5 million. Twenty months later the value of the plaintiff's account had plummeted to a mere $225,000.

The plaintiff sued Yamada, Stott, and Bedco to recoup his losses. The claims against Yamada were dismissed in return for his testimony against Stott and Bedco. As to Stott and Bedco, the court ruled that both had a duty to supervise Yamada pursuant to NYSE rule 405 and article III, section 2, of the NASD Rules of Fair Practice. NYSE rule 405 provides that every member organization is to "supervise diligently all accounts handled by registered representatives of the organization." Article III, section 2 of the rules of the NASD imposes a similar duty on its member companies. The court held that the plaintiff's trading authorization to Yamada did not relieve him of this duty. Stott was found liable for violating the rules himself and for aiding and abetting Yamada's violations of the rules. Although Bedco was a member of the NYSE and the NASD and was subject to all the duties flowing from that membership, it was not held liable under the rules because the court found


77. 424 F. Supp. at 1027.
78. Id. at 1029, 1034.
79. For the text of rule 405, see note 58 supra.
80. For the text of art. III, § 2, of the NASD Rules of Fair Practice, see note 66 supra.
81. For the text of rule 405, see note 58 supra.
82. 424 F. Supp. at 1043.
83. Id. Some of the duties imposed on Bedco by its membership with the NYSE are listed in note 69 supra. The NASD membership imposed, for example, "high standards of commercial honor and just and equitable principles of trade." Art. III, section 1 of the Rules of Fair Practice of the NASD, NASD MANUAL (CCH) ¶ 2151 (1970).
it did not act with the requisite scienter. Instead, Bedco was held liable under the theory of *respondeat superior* and under section 20 of the 1934 Act. The latter provides that controlling persons may be liable for the misconduct of the individuals they control. Therefore, since Stott had a duty to supervise, and since Bedco controlled Stott, Bedco had an implied duty to supervise. The court cited two decisions in which the Commission, under similar facts, had held that brokers had a duty to make extensive public disclosures and to inform their clients about speculative and financially unsound investments. Because the plaintiff had expected Bedco to exercise informed judgment on his behalf, the court held that Bedco was not relieved of its duty to supervise. Stott was not relieved of his duty to supervise, as he had participated directly in the management of the plaintiff’s account. Finally, the defendants were unable to point to language in the NYSE rules which indicated that broker’s duties were lessened when an investment adviser handled the account.

The court began its opinion by recognizing the fiduciary duties of broker-dealers under section 10b and rule 10b-5, the common law, and NYSE and NASD rules. The court recognized the sensitive nature of the securities market, which requires confidence and trust between broker-dealers and their customers in order to function efficiently. Within this framework, the court left no doubt that im-

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> Section 20. (a) Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

> (b) It shall be unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under the provisions of this title or any rule or regulation thereunder through or by means of any other person.

> (c) It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report, or information under this title or any rule or regulation thereunder without just cause to hinder, delay, or obstruct the making or filing of any such document, report, or information.


86. 424 F. Supp. at 1038.

87. *Id.*

88. *Id.* at 1039.

89. For the text of § 10b, see note 10 supra.

90. For the text of rule 10b-5, see note 10 supra.

91. For a discussion of the various duties of broker-dealers, see Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker- Dealers*, 57 *CORNELL L. REV.* 869, 871 (1972). The author focuses on the broad liability which is imposed under 10b-5, but notes that broker-dealers must conform “to a wide variety of rules and regulations in addition to 10b- 5” which govern behavior in narrow areas.
plied liability is necessary for investor protection and that a violation of self-imposed regulations would trigger sanctions.92

Significantly, a major portion of the court's rationale for the implication of liability was based on the policies described in earlier case law.93 The Rolf court adopted the Second Circuit's reasoning in Colonial Realty Corp. v. Bache & Co.94 when it agreed that it was necessary to consider the nature of the particular rule and its place in the entire regulatory scheme.95 Without mentioning Colonial specifically, this court found that NYSE and NASD rules were not substitutes for Commission regulation.96 The Commission has similar, but separate, suitability and supervisory rules.97 Nevertheless,

92. For explanation and analysis of the particular sanctions examined by the Rolf court, see note 106 infra.

94. 358 F.2d 178 (2d Cir. 1966).
95. 424 F. Supp. at 1040.
96. Id. at 1041. Finally, the Colonial rationale appeared again when the Rolf court decided that the duties imposed on the defendants by the rules were unknown at common law. Id.
97. 424 F. Supp. at 1041. The SEC counterparts of NYSE rule 405 and art. I, § 2 of the NASD rules are rules 15b10-3 and 15b10-4, 17 C.F.R. §§ 240.15b10-3 and 240.15b10-4 (1977). The latter provide:

**Suitability of recommendations.**

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.

**Supervision of associated persons.**

(a) Every nonmember broker or dealer shall exercise diligent supervision over all the securities activities of all of his associated persons.

(b) Every associated person of the nonmember broker or dealer shall be subject to the supervision of a supervisor designated by such broker or dealer. The supervisor may be a partner, officer, office manager, or any other qualified associated person, or in the case of a sole proprietor the broker or dealer.

(c) As part of his responsibility under this section, every nonmember broker or dealer shall establish, maintain and enforce written procedures, a copy of which shall be kept in each business office, which shall set forth the procedures adopted by the broker or dealer to comply with the following duties imposed by this section, and shall state at which business office or offices the nonmember broker or dealer keeps and maintains the records required by § 240.15b10-6:

1. The review and written approval by the designated supervisor of the opening of each new customer account;

2. The frequent examination of all customer accounts to detect and prevent irregularities or abuses;

3. The prompt review and written approval by the designated supervisor of all
the court reasoned that when exchange or association rules are sufficiently similar to the Commission rules, a violation of the former may give rise to an implied right of action if these rules are sufficiently precise. NYSE rule 405 and article III section 2 were deemed precise enough to sustain a cause of action. In addition, the Rolf court found investor protection to be the only purpose of NYSE rule 405 and article III section 2 of the NASD rules. Thereby it impliedly adopted the standard utilized in Buttrey v. Merrill Lynch which was designed to ensure that liability would be implied only under statutes enacted for investor protection.

The court recognized that the rules in question were directed at fraud. Therefore, in the interest of uniformity of enforcement, the court supported its rationale for implication by examining rules 10b-5 and 15c1-2 of the 1934 Act, which are the primary anti-fraud rules under the securities laws. Because fraud is narrowly defined under the latter rules, the court believed that any definition of what is actionable under NYSE rule 405 and article III section 2 of the NASD Rules of Fair Practice also must be narrowly drawn. The court concluded that since rules 10b-5 and 15c1-2 require a showing of fraud in order to assert a cause of action, violations of NYSE and NASD rules must assert broker conduct which is "tantamount to fraud" as well. The crux of the court's analysis was the require-

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securities transactions by associated persons and all correspondence pertaining to the solicitation or execution of all securities transactions by associated persons;
(4) The review and written approval by the designated supervisor of the delegation by any customer of discretionary authority with respect to his account to a stated associated person or persons of the broker or dealer and the prompt written approval of each discretionary order entered on behalf of that account; and
(5) The prompt review and written approval of the handling of all customer complaints.
(d) Every nonmember broker or dealer who has designated more than one supervisor pursuant to paragraph (b) of this section shall designate from among his partners, officers or other qualified associated persons, a person or group of persons who shall:
(1) Supervise and periodically review the activities of the supervisors designated pursuant to paragraph (b) of this section; and
(2) Periodically inspect each business office of the broker or dealer to insure that the written procedures are enforced.

98. 424 F. Supp. at 1041.
99. Id. at 104.
100. 410 F.2d 135 (7th Cir. 1969).
101. Id. at 142. This test will be applied to designate those substantive rules which will give rise to liability. See note 69 supra for the substantive rules under which liability will be imposed.
103. Id.
ment of fraud. In order to establish an implied cause of action for violation of securities exchange rules and appropriate broker-dealer bylaws a plaintiff must prove that a fraud resulted and that the defendant acted with a requisite degree of scienter. The court concluded that Yamada, Bedco, and Stott each committed a fraud against plaintiff. Only Stott, however, acted with the requisite scienter because he gave the plaintiff false assurances regarding the quality of the securities Yamada was trading. Moreover, he permitted his silence to be interpreted as a recommendation of Yamada's securities when in fact he had the duty to disclose that the securities were "junk."

The court limited its holding to violations of the "know your customer" requirement of rule 405 and the suitability and supervision requirements of rule 405 and article III section 2. However, it is possible to conclude by negative implication that the Rolf decision endorses implied liability for violations of more than those two

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104. Id. For a discussion of the fraud requirement in the 10b-5 context, see note 73 supra.
105. Id.
106. Id. at 1042. On appeal the Second Circuit affirmed as to liability, but Judge Mansfield wrote a strong dissent arguing that the majority "... not only patches together watered-down motions of fraud and scienter in arriving at a result indistinguishable in any significant respect from that reversed by the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), but also overlooks findings below and undisputed evidence that foreclose Rule 10b-5 liability." [1978] FED. SEC. L. REP. (CCH) ¶ 96,275 at 92,776-77 (Jan. 18, 1978). Because, in his view, the record did not support a finding of aiding and abetting on Stott's part, he would have granted defendants' motion and dismissed the action.

As to damages in the district court plaintiff was awarded damages for the rules violations in an amount equal to the commissions earned by Stott and Bedco plus the interest he had paid on his margin account. The court decided that net trading losses would be an unfair measure of damages between plaintiff's losses were also due partially to a bear market. Nor were punitive damages allowed. The court disallowed them because plaintiff set forth no state law claim, because there was no federal precedent for allowing punitive damages for violations of federal securities laws, and because allowance of punitive damages would not help to deter future violations of securities laws any more than the law suit did itself. 424 F. Supp. at 1045.

On appeal the Second Circuit affirmed the district court's finding of liability as to Stott and Bedco. However, the court reversed and remanded as to damages. The court held that recission was the most appropriate measure of damages in this case. Consequently, the district court was instructed to determine as nearly as possible the time when Stott began to aid and abet Yamada's fraud and to compute the market value of Rolf's portfolio on that date. Second, the district court was ordered to subtract the value of the portfolio on the date when Stott's participation in and assistance to the fraudulent scheme ceased from the value on the date when Stott became an aider and abettor. This amount would be Rolf's gross economic loss. Rolf's gross economic loss then was to be reduced by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value of the national securities market over the duration of Stott's aiding and abetting activities. Finally, the district court judge was requested to reconsider his decision on the question of prejudgment interest. [1978] FED. SEC. L. REP. (CCH) ¶ 96,275 at 92,776-77 (Jan. 18, 1978).

107. 424 F. Supp. at 1041. For the text of these provisions, see notes 58 and 66 supra. These are substantive rules and liability can be implied for their violation. See note 69 supra.
stock exchange and NASD rules. Had the court intended its rationale to be limited to article III section 2 and rule 405, it probably would not have relied on *Buttrey* and *Colonial*, which had already been applied to numerous other stock exchange and NASD rules violations. Additionally, the court probably would not have attempted to set the limits of liability in conformity with other securities statutes.\footnote{108}

**Faturik v. Woodmere Securities, Inc.**

Five months later, the same district court expanded the boundaries of implied liability established in *Rolf*. In *Faturik v. Woodmere Securities, Inc.*,\footnote{109} the plaintiff opened a trading account at Woodmere Securities (Woodmere), a trading brokerage firm, and subsequently granted a power of attorney to Woodmere and to Kahn, Woodmere’s registered representative. Both ignored the instructions in the power of attorney\footnote{110} and traded extensively in the plaintiff’s account with resultant losses to the plaintiff. Bear Stearns, Woodmere’s clearing broker, effected the actual transfers of funds and securities, maintained records of numerous transactions in the plaintiff’s account, mailed confirmation slips and monthly statements to the plaintiff, and communicated directly with the plaintiff whenever additional funds were required from the plaintiff.

In denying Bear Stearns’ motion to dismiss, the court held that Bear Stearns, as a clearing broker, could be liable for the manipulative or deceptive schemes of a trading broker if it aided and abetted Woodmere in the violation of NYSE rule 405.\footnote{111} Citing *Buttrey*, the court stated that a “. . . violation of rule 405 can, in some cases, create a private claim for relief”\footnote{112} and concluded that Bear Stearns might be liable for a violation of rule 405 if there were irregularities or suspicious circumstances putting it on notice of a possible violation of that rule.\footnote{113}

\footnote{108. For other rules to which the *Rolf* rationale might be applied, see the non-house keeping rules listed at note 69 supra.}

\footnote{109. 431 F. Supp. 894 (S.D.N.Y. 1977).}

\footnote{110. The power of attorney enabled Kahn and Woodmere to trade for plaintiff’s accounts, but specifically instructed Kahn to use the power of attorney only in the event of a drastic market downturn and only during a two-week period in which plaintiff was to be out of the country. 431 F. Supp. at 895.}

\footnote{111. Id. at 897. This case resulted from Bear Stearns’ motion to dismiss plaintiff’s claim for failure to state a claim upon which relief could be granted, rule 12(b)(6), Fed. R. Civ. P. The court in the instant case denied the motion. Manipulation is a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities. 425 U.S. at 199.}

\footnote{112. 431 F. Supp. at 897.}

\footnote{113. Id.}
Faturik extended the scope of liability and loosened scienter requirements. Under the Faturik test, a clearing broker may be liable as an aider and abettor for a trading broker's violation of rule 405 if the clearing broker has notice thereof. There is no requirement that a clearing broker commit a fraudulent act or act with scienter. Apparently, the court believed that the clearing broker had an imperative duty to investigate the trading account and was willing to imply liability solely on the broker's notice of irregularities in Woodmere's activities. While this rationale may be desirable from a plaintiff's point of view, it imposes an additional burden on brokers which is inconsistent with the higher scienter standards required by similar securities statutes.\(^1\) In addition, while the notice requirement may have been appropriate in Faturik, where the clearing broker was closely involved in the questionable conduct, perhaps it is unreasonable generally to hold clearing brokers liable based solely on notice of irregularities in the trading broker's activities because of the tenuous connection between the clearing and trading broker.

A final question concerns the policy behind implying liability. The 1933 and the 1934 Acts impose liability as a means of protecting investors. Because the Rolf court also was committed to investor protection, it was appropriate to pattern the scope of liability imposed on the supervising broker after that imposed under the securities laws. For example, the Rolf court chose to impose a requirement of fraud and scienter for a violation of stock exchange and NASD rules; the same requirement is imposed for rule 10b-5 violations.\(^2\) This approach has several advantages; it protects investors, but allows broker-dealers the requisite latitude needed to conduct business by leaving them room for independent business judgments. It promotes uniformity in enforcement of the securities laws.\(^3\) In addition, a requirement of fraud limits the class of potential plaintiffs but provides a remedy in situations where the investor truly has been defrauded. Finally, a large body of law is available in this area to guide courts, litigants and attorneys.

In contrast, the Faturik test allows the implication of liability for violations of exchange and association rules solely on a demonstra-

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\(^{1}\) See, e.g., SEC v. Texas Gulf Sulphur Co., 410 F.2d 833 (2d Cir. 1968) (interpreting section 10(b) and rule 10b-5); J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (interpreting § 14(e) proxy requirements).


\(^{3}\) For a discussion of the scienter requirement for rule 10b-5 violations, see note 73 supra. See also Heald & Mulhern, *Directed Trustee Liability Under ERISA*, 9 LOY. CHI. L.J. 617 (1978).
tion that a clearing broker had notice of irregularities or suspicious circumstances which indicate a violation of the rules by the trading broker. This liberal standard of proof may have been justified in the Faturik fact setting because of the proximity of the brokers involved. However, use of a negligence standard for a private 10b-5 type claim raises the specter of an inordinately large class of plaintiffs putting tremendous pressure on attorneys, accountants, and other experts operating under the securities laws.\textsuperscript{117} Up to the present, this danger has been minimized because the class of possible plaintiffs alleging violations of broker-dealer codes has been limited to customers of the brokerage firms and the individual brokers. The class of possible defendants has been limited to the trading brokerage firm and its employees and the clearing brokerage firm.\textsuperscript{118} So limited, the Faturik standard serves adequately to promote the goal of investor protection. However, there are other individuals or organizations involved in the purchase, sale, and exchange of securities who may have notice of stock exchange or NASD violations, e.g., attorneys and accountants. If Faturik is read broadly, it is possible that a wide range of experts could face implied liability. It is questionable whether investor protection demands such an expansive reading of Faturik and whether mere notice is appropriate for those in a temporary or remote relationship with the actual wrongdoer.

\textbf{CONCLUSION}

Although the underlying policies of earlier case law led to the inconsistent application of implied broker-dealer liabilities, courts consistently have been guided by a similar objective—investor protection. Nonetheless, after forty-three years of struggle, there is consensus on the jurisdictional question only. Rolf and Faturik, however, have added important dimensions to the development of implied liability. Specifically, Rolf synthesized the existing case law and unequivocally allowed implied liability against broker-dealers. It also established the degree of culpability required to assert an implied right of action and suggested that the violation of a securities exchange or NASD rule is a breach of a broker-dealer’s common

\textsuperscript{117} For Supreme Court support of this fear, see Ernst & Ernst v. Hochfelder, 425 U.S. 185, at 214 n.33 (1976).

\textsuperscript{118} In addition, the class is further limited to stock exchange or NASD members because they are the only entities subject to the rules. The question was left open as to whether liability based on notice of violations exposes brokers to undue burdens by inhibiting their freedom in risk-taking and decision-making.
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Faturik expanded the number of possible defendants and loosened the scienter requirement. While Rolf is unassailable in the sense that it is in keeping with the traditional requirements for imposing liability for fraudulent violations of securities acts, Faturik raises policy questions concerning the limits of imposing liability on securities experts in the name of investor protection. These are difficult questions which Congress and the courts have not addressed in the context of liability for violations of stock exchange and NASD rules. Rolf and Faturik may mark the beginning of the development of a consistent body of law in the area of implied liability for violations of exchange and association rules. If the securities markets are to function efficiently, however, the remaining issues must be resolved.

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119. In light of a recent Supreme Court pronouncement, this latter suggestion may be of particular relevance. Although the 1933 and 1934 Acts have brought many types of securities transactions within the jurisdiction of the federal courts and the SEC, the Supreme Court recently announced its intent to defer regulation of certain types of securities-related wrongdoing to the state courts. In Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477-80 (1977), the Court held that minority shareholders who had been “squeezed out” in a short form merger could not assert a federal claim under rule 10b-5 to set aside the merger. The majority of the Court concluded that section 10(b) was not intended to regulate the misconduct in question, as the case merely involved “internal corporate mismanagement,” an area traditionally left to state regulation. The Court announced the following policy: “Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.” Id. at 479. For a discussion of the adequacy of certain state law fiduciary principles in policing parties to mergers, see Murdock, Delaware: The Race to the Bottom—Is an End in Sight, 9 Loy. Chi. L.J. 643 (1978). This decision may lend support to the suggestion in Rolf and may foreshadow increasing state court involvement in the regulation of broker-dealer conduct under exchange and association rules. Given the national scope of many, if not most, broker-dealer transactions, the application of divergent state law fiduciary principles may well create substantial problems in coordinating broker-dealers’ conduct throughout the country.