

1-1-2005

Suitability Claims and Unrecommended Securities Purchases: An Agency Theory of Broker-Dealer Liability

Frederick Mark Gedicks
BYU Law, gedicksf@law.byu.edu

Follow this and additional works at: https://digitalcommons.law.byu.edu/faculty_scholarship



Part of the [Securities Law Commons](#)

Recommended Citation

Frederick Mark Gedicks, *Suitability Claims and Unrecommended Securities Purchases: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535 (2005).

This Article is brought to you for free and open access by BYU Law Digital Commons. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.

SUITABILITY CLAIMS AND PURCHASES OF UNRECOMMENDED SECURITIES: An Agency Theory of Broker-Dealer Liability

Frederick Mark Gedicks[†]

A novice investor who lost nearly \$160,000 while “feverishly” trading through First Security Investor Services, Inc. has won a \$70,000 award from the securities brokerage. Dorene Nulph, then 37, was newly divorced with little work experience and no investing experience when she opened a [discount] account at . . . FSIS in 1995. Nulph was investing her divorce settlement [of \$250,000] to meet her long-term financial needs and the educational expenses of her children. . . . She did not know the difference between a full-service and discount account, and the terms were not explained to her by FSIS “She thought, ‘I need to make some stock investments because that’s what everyone does,’” [her attorney] said. “Soon she was just feverishly trading.” Nulph made approximately 100 trades in 14 months, relying on investment tips offered by Internet chat groups, court documents said. She would place orders with FSIS staff, then panic and sell within hours or days Nulph closed her account in 1996 after FSIS asked her to confirm in writing that her trading had been consistent with her investment goals

– Salt Lake Tribune[‡]

[O]nce in a while, we’ll be faced with an arbitration from somebody who says, “Hey, you should have stopped me from selling myself into a hole” “What do you mean, we should have stopped you? It was a self-managed account.”

– Michael Anderson, National Discount Brokers Group^{‡‡}

[†] Professor of Law, J. Reuben Clark Law School, Brigham Young University; gedicksf@lawgate.byu.edu. I researched and wrote most of this article while visiting at the University of North Carolina School of Law during Fall Semester 2003, and am indebted to UNC law research librarian Ann Marie Berti for her assistance in compiling bibliographies and locating sources. I am also grateful to my BYU colleagues Brett Scharffs, who shared his fiduciary duty research with me, and Jim Gordon, who commented on an early draft. I received valuable comments and criticisms from the UNC law faculty (especially Tom Hazen) and the BYU law faculty during workshop presentations of earlier versions of this article on November 13, 2003, and September 16, 2004, respectively. Finally, Lee Andelin, Kristen Kemerer, and Kim Pearson provided excellent research assistance.

[‡] Sheila R. McCann, *Novice Investor Wins \$70,000 After Losses*, SALT LAKE TRIB., Oct. 27, 1999, at E1 (discussing judicial confirmation of a customer award in *Lee v. First Sec. Investor Servs., Inc.*, No. 97-05371, 1998 WL 1179858, at *1–*2 (NASD Nov. 19, 1998) (Owen, Lewis, & Mainardi, Arbs.)). The author filed an expert report and testified for the claimant in this arbitration.

^{‡‡} Rebecca Buckman, *Discount and Online Brokers Worry About Investor Cases*, WALL ST. J., Nov. 25, 1998, at C1, available at 1998 WL 18993484.

I. INTRODUCTION.....	537
II. THE ORIGINS AND EVOLUTION OF BROKER-DEALER LIABILITY ON SUITABILITY GROUNDS.....	547
A. <i>Suitability Obligations for Recommended Purchases of Securities</i>	547
1. “Customer-Specific” Suitability.....	547
2. “Reasonable-Basis” Suitability	549
B. <i>Suitability as a Fiduciary Duty</i>	550
1. The Agency Theory	550
2. The “Special Circumstances” Theory	553
3. The “Shingle” Theory	557
C. <i>The Relaxation of Constraints on Suitability Claims</i>	562
1. The Eclipse of Law by Equity.....	562
2. The Removal of the Account Executive from the Order- Execution Process	566
D. <i>The “Order Clerk” Shibboleth</i>	569
III. AN AGENCY THEORY OF BROKER-DEALER LIABILITY: A DUTY TO WARN THAT AN UNRECOMMENDED PURCHASE IS UNSUITABLE	574
A. <i>Unrecommended Purchases and the Agent’s Duty To Provide Relevant Information</i>	574
1. Unrecommended Securities Lacking Customer-Specific Suitability	576
2. Unrecommended Securities Lacking Reasonable-Basis Suitability	579
B. <i>Unrecommended Purchases and the Agent’s Duty of Loyalty</i>	580
C. <i>The Role of Customer Sophistication</i>	581
D. <i>Paternalism, Investor Protection, and Contracting Out of the Duty To Warn</i>	584
E. <i>A Duty To Rescue?</i>	586
IV. CONCLUSION.....	588

I. INTRODUCTION

One of the many stories to emerge from the bull market of the 1990s was the explosive growth of online broker-dealers who supply order-execution and other investment information and services over the Internet.¹ Traditionally, these services have been provided in meetings with account executives employed by or otherwise associated with a broker-dealer. Unmediated transmission of customer orders and investment information via the Internet, however, has proven to be cheaper, faster, and more popular with many investors than written, telephonic, or face-to-face communication through account executives.² Not only did longstanding discount firms shift the bulk of their operations online during the 1990s, but numerous online-only discount firms entered the broker-dealer market, and most full service firms introduced online order-execution and other online services.³ The resulting competition has driven down order-execution commissions and given individual investors unprecedented access to research reports, stock quotes, and other industry services and information

1. See, e.g., SEC Commissioner Laura S. Unger, Empowering Investors in an Electronic Age: Remarks at IOSCO Annual Conference (May 17, 2000), at 2000 WL 893258, at *1, *5 (observing that online accounts rose from approximately 3.7 million in 1997 to more than 12 million in 2000, and that approximately twenty percent of those who invest in U.S. securities markets now do so through online accounts); see also Renée Barnett, Comment, *Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1090 (2000) ("More people currently use the Internet to trade securities than to purchase books, CDs or any other products online.").

2. Barnett, *supra* note 1, at 1096.

3. See Barnett, *supra* note 1, at 1097; Steven B. Caruso, *On-Line Trading: The New Frontier*, 1131 PRAC. L. INST. / CORP. 247, 252 (July-Aug. 1999); see also *Taking Action: Choosing a Broker*, SMARTMONEY.COM (observing that the creation of websites and adoption of online execution by longstanding discount brokers has "blurred [the lines] between discount and online-only brokers"), at <http://university.smartmoney.com/Departments/TakingAction/ChoosingABroker> (last visited Feb. 3, 2005).

The broker-dealer industry has long been divided between so-called "full service" and "discount" firms. "Full service" firms provide general financial information and investment advice, recommendations to purchase or to sell specific securities, and execution of purchase and sell orders, whereas "discount" firms generally provide only general financial information and order-execution services. *Id.* "Online" is often used as a synonym for "discount" in reference to brokers. However, though virtually all discount brokers are online brokers, not all online brokers are discount brokers. *Id.* Unless otherwise indicated, the terms "discount" or "discounters" will be used in this article to describe those brokers that offer unbundled order-execution services at a greatly reduced price, and the terms "full service" or "full service firms" to refer to those brokers that offer the full range of traditional services.

previously available only from the registered representatives of full service firms.⁴

Although the online revolution has afforded individual investors personal control of their investment portfolios and direct access to market information and services, profits have proven more elusive.⁵ Assembling drastically under-diversified portfolios, trading on impulse and rumor, and blithely leveraging their holdings with margin loans, many of these “self-directed” investors incurred substantial losses in self-managed online accounts despite the relentless appreciation of equities during the 1990s.⁶

4. See, e.g., Matthew J. Benson, *Online Investing and the Suitability Obligation of Brokers and Broker-Dealers*, 34 SUFFOLK U. L. REV. 395, 396 (2001) (noting that the Internet “provides individual investors with an abundance of financial information and instantaneous access to securities market resources traditionally available only to market professionals”); Douglas J. Schulz, *Internet Trading: Take a Walk on the Wild Side* (1999), at *2 (“The Internet trader of today may be better equipped than the stock broker or money manager of just 10 years ago.”), available at <http://www.securitiesexpert.com/articles/article1.html>; Barnett, *supra* note 1, at 1096–97:

[O]nline trading has democratized America’s capital markets by enabling an increased number of middle-class Americans to participate in the stock market. With the ability to execute a trade for as little as five dollars, online trading is particularly attractive to smaller investors who may not have been able to afford to pay the higher fees associated with traditional, “offline” brokerages.

Id. (footnotes omitted)); Jan M. Rosen, *For Most Online Investors, Information Beats Speed*, N.Y. TIMES, June 7, 2000, at H6 (“The Internet has empowered people . . . Investors used to be hostage to their brokers; if they wanted stock quotes, they had to call their brokers, and only the brokers had access to research reports. The Internet has broken down the information wall. Now investors can eliminate the middleman.”) (quoting Robert N. Gordon, President, Twenty-First Securities Corp.); Unger, *supra* note 1, at *1 (“The ease of Internet access, the unprecedented availability of on-line investment information and reduced transaction costs have empowered individual investors to enter the financial markets in record numbers.”).

5. See Barnett, *supra* note 1, at 1110. The numerous ways in which one can lose money through online trading were repeatedly discussed by then-SEC Chairman Arthur Levitt as the late bull market approached its peak. See, e.g., Arthur Levitt, Plain Talk About On-line Investing, Speech to the National Press Club (May 4, 1999), at <http://www.sec.gov/news/speech/speecharchive/1999/spch274.htm>; Arthur Levitt, Financial Literacy and Roles of the Media, Speech at the Media Studies Center (Apr. 26, 1999), at <http://www.sec.gov/news/speech/speecharchive/1999/spch269.htm>.

6. See, e.g., Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 483 (2003) (observing that “[l]ack of portfolio diversification” and especially “over-concentration in technology or ‘microcap’ stocks, over-leveraging through margin borrowing, and excessive trading” were clear signs of “irrational” investor behavior during the late 1990s) (footnotes omitted); Rosen, *supra* note 4, at H6:

Financial professionals have long warned against trading impulsively on supposedly hot tips, saying many people cannot resist buying shares of what will surely be the next Microsoft the minute they hear about it from the guy in the office down the hall. And with Internet chat rooms creating even more hype, people with poor impulse control can lose money even faster. After all,

Others were misled by the initial appreciation of their holdings, misunderstanding this as confirmation that their risky strategies were sound, when in fact they were not.⁷ After the market turned in early 2001, it became clear that many self-directed investors lacked basic knowledge

it's just a few mouse clicks from chat room to trade, with no one to toss out a caveat or suggest an alternative.

Id.; Larry Getlen, *Do-It-Yourself Investors Seeking Professional Advice*, BANKRATE.COM (Oct. 9, 2002), at <http://www.bankrate.com/bnm/news/investing/20021009a.asp>:

[Online discounters] made it easy for investors to facilitate their own trades without professional advice at a time when owning only three stocks seemed like a wise investment strategy to some [M]any self-investors lacked the knowledge to assemble the kind of diversified portfolio that translates into long-term security . . . [and] "most do-it-yourself [investors lacked] a formal financial plan [that enabled] informed and intelligent decision[s] about short- and long-term goals without responding to what happened in the market in the last five minutes

Id. (quoting Jeff Gembis, First Vice President of Investments, Merrill Lynch); Landon Thomas, Jr., *Markets & Investing: Full-service Brokers Are in Demand*, N.Y. TIMES, Jan. 2, 2003, at C2 (observing that during the latest bull market, "investors large and small became obsessed with buying individual stocks—either via full-service brokers or on their own online"); Marcia Vickers & Gary Weiss, *Wall Street's Hype Machine: It Could Spell Trouble for Investors*, BUS. WK., Apr. 3, 2000, at 112 (describing "a new type of Wall Street loser: the armchair momentum player," a naive investor who trades (usually at a loss) on breaking public news or noise), available at 2000 WL 7825596.

7. See, e.g., Guy Dixon, *Working Life: Day-Trading Dream Becomes Elusive*, GLOBE & MAIL (Toronto), May 2, 2000, at B14 (concluding that "[m]ost day traders . . . are investors who have been transformed into 'geniuses' by the bull market, [and who possess] 'a little bit of skill matched to a whole lot of luck, which makes them seem more expert than they really are'" (quoting Joey Anuff, a book author and former day trader); Stacy Forster, *The People: The Cop*, WALL ST. J., June 12, 2000, at R18 ("The market has been so strong and vibrant—which is wonderful for most investors—that people have a false sense of security that it is hard to lose money in this market.") (quoting SEC Commissioner Laura Unger), available at 2000 WL-WSJ 3032514; Tom Petruno, *Special Report: Is 'Buy and Hold' Dead? The Lure of Trading: 'Get Rich Quicker' Is the Message, and It's Getting Through*, L.A. TIMES, Apr. 11, 1999, at C1 ("[A]ctive trading 'only works in an up market.'" (quoting Jack Brennan, Chairman, Vanguard Group), available at 1999 WL 2149136; Getlen, *supra* note 6 (During the 1990s, "[e]verybody thought they could pick stocks because you could throw a dart at a board and it would go up" (quoting Jason Whitby, financial consultant, Noesis Capital Management); see also Rick Aristotle Munariz, *Don't Discount These Brokers*, Feb. 12, 2003, at <http://www.fool.com/news/take/2003/mft/mft03021202.htm> ("Selling the discount broker dream was easy in the 1990s. With stocks climbing and wealth spilling out to the individual investor by the bucketful, you had to love companies providing the tools for personal financial empowerment at rock-bottom prices."); Unger, *supra* note 1, at *1 (observing that until the market turned in 2000, online trading "seemed like a 'no-lose' proposition").

Writing before the market turn, one commentator noted that the then-current bull market had fortuitously covered many investor errors, and presciently predicted that in the event of a general market decline, "many unsophisticated investors may experience financial ruin because they held investments that were too risky for their financial situations." Barnett, *supra* note 1, at 1109 (footnote omitted).

about securities markets and investing generally, and as a result incurred substantial losses when their under-diversified, speculative, and over-leveraged portfolios evaporated in the bursting of the technology bubble and the subsequent market decline.⁸ (Similar accounts can be found following the end of prior market advances.⁹) Self-directed investors have fared little better since, generally falling victim to “in-and-out” and “whipsaw” trading as the market has ebbed and flowed, “buying high” after a few weeks or months of market appreciation, and then “selling low” in a panic when short term gains disappear in a market pullback.¹⁰

A signal characteristic of bull markets, particularly in their late stages, is their tendency to pull inexperienced and unsophisticated investors into equity investments. Prior to the growth of online order-execution services, it was thought that the professional standards of the broker-dealer industry and liability under the securities laws protected such investors from the risk of loss that accompanies unknowledgeable investment in the stock market.¹¹

8. See, e.g., Black & Gross, *supra* note 6, at 483 (“In retrospect, it is clear that many investors, caught up in the frenzy of the trading markets of the past decade, engaged in risky trading and investing strategies without an understanding of the risks involved.”); Barnett, *supra* note 1, at 1108 (observing that the low fees and account minimums of online firms tend to attract “smaller, unsophisticated investors”); Vickers & Weiss, *supra* note 6, at *4 (observing that investors often “have no idea what they’re doing,” and summarizing research that “found that most investors trade poorly and perform worse the more they trade—systematically buying and selling the wrong stocks,” and “trading more and holding [their] stocks for shorter time periods”); Unger, *supra* note 1, at *1, *7 (observing that “too many investors are not well informed about such investment basics as transaction costs, margin trading and best execution,” and that investors “may not fully appreciate the risks they undertake when they trade on margin”); see also Forster, *supra* note 7 (quoting Commissioner Unger’s observation that “the easy access to trading and information [has given] investors perhaps a false sense of security in terms of knowing everything there is to know about the markets and about securities”).

9. See, e.g., CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 336–41 (2d ed. 1997) (observing that “[public] investors . . . had lost their shirts by speculation in worthless companies” during the “hot issue” markets of 1959–62 and 1968–69).

10. See Carla Fried, *Investing: A Land of Market Timing (and Broken Watches)*, N.Y. TIMES, Oct. 5, 2003, § 3, at 6 (quoting various analysts who believe that self-directed investors tend to overreact to market advances and pull-backs, “jumping in and out of different asset classes—usually at the wrong time”), available at 2003 WLNR 5654002.

11. See Joseph A. Grundfest, *The Future of United States Securities Regulation: An Essay on Regulation in an Age of Technological Uncertainty*, 75 ST. JOHN’S L. REV. 83, 105 (2001) (noting the “disappearance of an important ‘gatekeeper’ in the investment process: the professional regulated broker with an affirmative obligation to ‘know the customer’ and to recommend only investments and strategies that are suitable to the customer”); Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 446 (observing that “the policy of restricting free access into the securities business” reflected in the 1964 amendments to the Securities Acts “followed from the conclusion that adequate investor protection depends to a great extent on the professional attitude and responsibility of the broker-dealer community”).

It is well-established that full service broker-dealers have an affirmative fiduciary obligation to inform themselves of each customer's investment objectives and general financial situation, so as to ensure that each security they recommend is "suitable" to the customer's investment objectives and financial situation.¹² There seems to be widespread agreement among courts, regulators, and commentators, however, that a broker-dealer cannot incur liability on suitability grounds unless it first recommends a securities transaction to a customer.¹³

Thus, although the suitability obligation is fiduciary, its scope—and therefore the protection it affords to inexperienced and unsophisticated investors—is circumscribed by its dependence on a prior broker-dealer recommendation. It is widely believed that in the absence of a recommendation, broker-dealers owe their customers no more than prompt,

12. See, e.g., NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL, Conduct Rule 2310 (2003) (requiring that any recommendation a broker makes to a non-institutional customer be supported by a reasonable belief that the recommendation is "suitable" for the customer, and requiring further that before executing transactions recommended to non-institutional customers, the broker obtain information about the customer's financial and tax status, his or her investment objectives, and "such other information used or considered to be reasonable . . . in making recommendations to the customer") [hereinafter NASD MANUAL]; NEW YORK STOCK EXCHANGE RULES AND CONSTITUTION, Rule 405 (West 2005) (requiring that every member of the Exchange use "due diligence" to obtain the "essential facts" about every customer and every order) [hereinafter NYSE MANUAL]; AMERICAN STOCK EXCHANGE OFFICIAL RULES, Rule 411 (2004) [hereinafter AMEX MANUAL] (same).

13. See, e.g., *Parsons v. Hornblower & Weeks-Hemphill Noyes*, 447 F. Supp. 482, 495 (M.D.N.C. 1977), *aff'd*, 571 F.2d 203 (4th Cir. 1978) ("[T]he NASD suitability rule requires that a broker act in accordance with his knowledge of the customer's financial capabilities only when he *recommends* the purchase, sale, or exchange of any securities."); *Canizaro v. Kohlmeier & Co.*, 370 F. Supp. 282, 289 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975):

[A] broker who recommends a security or who volunteers an 'investment opinion' or makes a prediction in order to effect a sale or purchase must have a reasonable basis for what he tells his customer. . . . However, the broker who has not been engaged in attempting to effect a sale or purchase, who has neither solicited the order nor recommended the securities, but who has merely received and executed a purchase order, has a minimal duty, if any at all, to investigate the purchase and disclose material facts to a customer.

Id. (footnotes omitted); Benson, *supra* note 4, at 401 ("In the traditional relationship between broker-dealer and customer, a suitability obligation applies only where the broker-dealer makes a specific recommendation to a customer that he knows or should have known would be unsuitable for that customer's needs.") (footnote omitted); Black & Gross, *supra* note 6, at 484 ("It is settled law . . . that brokers are not liable for their customers' losses unless they made an unsuitable recommendation"); Commissioner Laura S. Unger, Securities Law and the Internet, Remarks before the Practising Law Institute (June 13, 2000), at *1 ("[W]e all know (and most of us can accept) that suitability only applies when a broker makes a recommendation"), available at <http://www.sec.gov/news/speech/spch386.htm>; see also *infra* Part II.D. But see NYSE MANUAL, *supra* note 12, Rule 405 (applicability of Rule 405 not dependent on recommendation).

fair, and effective execution of purchase orders as and when they are received.¹⁴ Accordingly, discount broker-dealers have long argued that they are necessarily immune from liability on suitability claims because they act as “order clerks” who merely execute unsolicited customer orders to purchase unrecommended securities;¹⁵ online discounters have adopted the same position.¹⁶ Regulators have rejected the discount argument for per se immunity, however, reasoning that some information and services provided by online discount firms might amount to implied recommendation of a security for which the firm would be liable on suitability grounds.¹⁷

Full service firms make a similar argument on reciprocal facts. If the recommendation of a security is a condition precedent to suitability liability, then it follows that even a full service broker-dealer cannot be liable for its customer’s purchase of an unsuitable security when the broker-dealer merely executed the customer’s purchase order without having recommended or otherwise encouraged the order. It follows that under the conventional understanding of liability for breach of the suitability obligation, the critical distinction is not whether the broker-dealer is a full

14. *E.g.*, *Hill v. Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817, 824 (10th Cir. 1986); *see also infra* notes 126–140 and accompanying text.

15. *See, e.g.*, Letter from Carl L. Shipley, SEC No-Action Letter, to Hon. Harold Williams, Chairman, Securities and Exchange Commission *1 (Apr. 24, 1980), *available at* 1980 WL 15131 [hereinafter Shipley Letter] (agreeing with the discount industry position that the suitability obligation of former Rule 15b10-3, 17 C.F.R. § 240.15b10-3 did not apply to a “completely ‘unbundled’ discount brokerage ‘transaction service’ [supplied] on an unsolicited basis,” in which the discount broker “only provides a discount brokerage ‘service’ in response to an unsolicited request to buy or sell securities for an investor”). The Commission emphasized, however, that a discount firm would owe suitability obligations to a customer if it “engage[d] in a course of conduct that would constitute a ‘recommendation.’” Letter from Jeffrey L. Steele, Asst. Chief Counsel for SEC, to Carl L. Shipley, Esq., NASD, SEC No-Action Letter *2 (May 27, 1980), *available at* 1980 WL 15131. For a discussion of the origin and implications of the “order clerk” paradigm, *see infra* notes 126–140 and accompanying text.

The term “unrecommended” is used throughout this article to describe customer purchases that were not recommended by the broker-dealer.

16. *See* Schulz, *supra* note 4.

17. *E.g.*, Shipley Letter, *supra* note 15, at *2 (emphasizing that a discount firm would owe suitability obligations to a customer if it “engage[d] in a course of conduct that would constitute a ‘recommendation’”); *see* LAURA S. UNGER, COMMISSIONER, SEC, ON-LINE BROKERAGE: KEEPING APACE OF CYBERSPACE 25 (Nov. 1999), *available at* <http://www.sec.gov/pdf/cybrtrnd.pdf>; *see also* Unger, *supra* note 1, at *6 (observing that “broker-dealers [have the] technological capability to customize investment information and investment services for on-line investors,” and this makes it “difficult to determine what is a recommendation and what is not a recommendation on-line”).

The exchanges have rejected the discount position outright, holding that the exchanges’ respective “know your customer” rules apply even in the absence of a recommendation. *See* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1572 (1999); Schulz, *supra* note 4; *see also supra* notes 151–158 and accompanying text.

service, discount, or online firm, but whether it recommended the purchase of a security.

Despite the apparent bounds placed on suitability liability by the recommendation requirement, broker-dealer liability for damages in private actions for breach of suitability obligations is a matter of serious and increasing concern within the industry.¹⁸ Discount broker-dealers continue to lobby for adoption of a rule of per se discount broker immunity from suitability claims when the broker did not recommend the disputed securities,¹⁹ and full service and discount firms alike remain intensely hostile to the idea of suitability liability in the absence of a recommendation.²⁰ Although courts are virtually unanimous in their rejection of private rights of action based on a breach of suitability obligations,²¹ it has been widely held that investors may recover on federal and state law fraud, fiduciary duty, and negligence theories for such breaches.²² Since the emergence of the suitability obligation as an industry standard in the 1960s,²³ breach of the obligation has grown into the most

18. See Lowenfels & Bromberg, *supra* note 17, at 1558; Rebecca Buckman, *Discount and Online Brokers Worry About Investor Cases*, WALL ST. J., Nov. 25, 1998, at C1, available at 1998 WL 18993484; see also Lowenfels & Bromberg, *supra* note 17, at 1557 ("Because they are the most common yet most ambiguous of all client accusations, . . . 'unsuitability' claims can often create significant problems for your firm. This is because what constitutes a viable unsuitability claim is open to debate.") (quoting NASD Avoidance and Prevention Advisory).

19. See, e.g., Unger, *supra* note 1, at *6 ("[Discount brokers] are interested in obtaining clarification that they are not responsible for the suitability of unsolicited transactions effected by their customers, even when such a transaction would not be appropriate for the customer."); see also Sam Scott Miller & Robert D. Popper, *Discount Brokers' Obligations Under the "Suitability" Doctrine*, 5:11 INSIGHTS 7, 7 (Nov. 1991) (noting that although two awards against discount brokers on suitability grounds "cannot be said to constitute a 'trend,' discount brokers and their lawyers are concerned").

20. See Lowenfels & Bromberg, *supra* note 17, at 1558.

21. See MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 9.03[2], at 9-18 to 9-21 (2000); Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1025 (2002).

22. See, e.g., O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 897 (10th Cir. 1992); Clark v. John Lamula Investors, Inc., 583 F.2d 594, 602 (2d Cir. 1978); Boettcher & Co. v. Munson, 854 P.2d 199, 208 (Colo. 1993) (citing *Clark*, 583 F.2d at 599-600); Minneapolis Employees Ret. Fund v. Allison-Williams Co., 508 N.W.2d 805, 809 (Minn. Ct. App. 1993); see also Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 550 (2002) (noting the "deep division within the courts regarding the fiduciary duties of broker-dealers").

23. See Mundheim, *supra* note 11, at 465 (reporting in 1965 the absence of any reported decision "in which a plaintiff has recovered damages on the ground that unsuitable securities were recommended and sold to him"). Professor Loss did not include a discussion of suitability in his treatise until 1969. See 4 LOUIS LOSS, *SECURITIES REGULATION* 3708-27 (2d ed. Supp. 1969).

commonly alleged basis of investor recovery against broker-dealers.²⁴ Even more ominous for the industry, a line of arbitration decisions established itself during the last decade, holding discount brokers liable on apparent suitability grounds for client losses on unrecommended investments,²⁵ notwithstanding the apparent agreement of authorities that recommendation is a prerequisite for such liability,²⁶ and in the face of the widespread perception that industry-sponsored arbitration is systematically biased against investor claims.²⁷

24. Barnett, *supra* note 1, at 1100; *see also* Lowenfels & Bromberg, *supra* note 17, at 1557 (reporting that “unsuitability claims account for ninety-five percent of filings under NASD members’ errors and omissions insurance policies”) (citation omitted).

25. *E.g.*, Desmond v. Ameritrade, Inc., No. 98-04397, 2000 WL 726360 (Jan. 14, 2000) (finding online discount broker liable for \$20,609 of claimant’s alleged \$75,000 in losses trading Internet and technology stocks in margin account, plus \$2,061 in interest and \$17,844 in fees and costs) (Meadow, Fletcher & Guy, Arbs.); Lee v. First Sec. Investor Servs., Inc., No. 97-05371, 1998 WL 1179858 (NASD Nov. 19, 1998) (finding discount broker liable for \$70,000 of claimant’s alleged \$157,723 in stock trading losses, plus \$8,400 in interest) (Owen, Lewis, & Mainardi, Arbs.); Oliver v. Charles Schwab & Co., No. 93-00656, 1994 WL 479165 (NASD July 6, 1994) (finding discount broker liable for \$10,000 of claimant’s alleged \$41,023 in options trading losses) (Jeroslow, Fineberg, & Sciaudone, Arbs.); Johnson v. Quick & Reilly, Inc., No. 91-03881, 1992 WL 479429 (NASD July 27, 1992) (finding discount broker liable for \$174,225 of claimant’s alleged \$250,000 in options trading losses, plus prejudgment interest of \$27,876 and expert witness fees of \$10,000) (arbs. not reported); Peterzell v. Charles Schwab & Co., No. 88-02868, 1991 WL 202358 (NASD June 17, 1991) (finding discount broker liable for \$39,500 of claimant’s alleged \$132,870 in options trading losses, on ground that broker “failed to maintain any ongoing supervision of the Claimant’s suitability,” and thus failed to recognize that claimant’s “losses were disproportionate to his claimed net worth and annual income”) (2-1 decision) (arbs. not reported); Quick & Reilly, Inc. v. Barton, 1990 WL 306396 (NYSE Feb. 15, 1990) (Shoemaker, Hall, & Grigsby, Arbs.) (finding discount broker liable for \$106,653 of claimant’s options trading losses despite fact that broker made no trading recommendations); *see also* Quick & Reilly, Inc. v. Walker, Nos. 89-55085, 89-55116, 930 F.2d 29, 1991 WL 42938 (9th Cir. Mar. 28, 1991) (affirming jury verdict finding discount broker liable for \$192,500 of plaintiff’s alleged \$350,000 in options trading losses, plus prejudgment interest, on ground that broker was fifty-five percent negligent for failing to “warn [plaintiff] of the magnitude of the risk to which she was exposing herself,” and for making general, positive comments regarding plaintiff’s trading and account).

Arbitrators generally provide only skeletal descriptions of the facts and rarely give a justification or explanation of their decisions. Additional facts relating to some of the foregoing arbitration decisions are reported in Buckman, *supra* note 18; Max Knudson, *Utah Judge Backs Investor’s Claim Against Brokerage*, DESERET NEWS, Oct. 27, 1999, at B8; Sheila R. McCann, *Novice Investor Wins \$70,000 After Losses*, SALT LAKE TRIB., Oct. 27, 1999, at E1; Michael Siconolfi, *‘Dramshop’ Awards Increasingly Slapped on Brokerage Firms*, WALL ST. J., Sept. 4, 1992, available at 1992 WL 637974 [hereinafter Siconolfi, *Dramshop Awards*]; Michael Siconolfi, *Discounters Must Watch Out for Customers, Big Board Says*, WALL ST. J., July 19, 1991, at C1, available at 1991 WL-WSJ 599675.

The author filed an expert report and testified for the claimant in *Lee*, 1998 WL 1179858.

26. *See supra* notes 1–3 and accompanying text.

27. *See, e.g.*, Barnett, *supra* note 1, at 1105 (noting widespread criticism of the arbitration process as “pro-industry and anti-investor”). Others have argued that, notwithstanding the

Looming in the background is the coming social security funding crisis. Dealing with this funding shortfall will almost certainly require future retirees to fund significantly larger portions of their retirement incomes from private self-directed investment and savings, such as IRA and 401(k) plans.²⁸ At the same time, the data show that self-directed investors are largely ignorant about investment basics and generally do a poor job of managing their investment portfolios.²⁹

Nevertheless, the dramatic increase in self-directed investing is not likely to reverse itself.³⁰ Although the move toward self-directed investing was temporarily interrupted by the recent stock market decline,³¹ discount and online trading volume is again increasing in tandem with the stock market

perception of industry bias, the arbitration process affords significant advantages to investors over litigation, including swifter resolution of claims, easier collection of judgments, and no need to educate fact-finders about basic investment principles and the intricacies of particular investments. *See, e.g.,* Dagen McDowell, *Dear Dagen: In Defense of Stuart*, at www.thestreet.com/funds/deardagen/805727.html (Oct. 27, 1999). The number of claimants who prevail in arbitration varies between fifty and sixty percent. *Id.*; *see also infra* notes 102–113 and accompanying text

28. President Bush's recent Social Security reform proposal, for example, would index benefits increases to the rate of inflation rather than the historically higher rate of wage increases, thereby substantially reducing benefits for each successive generation of retirees; the President projects that much of this reduction would be made up with gains from private accounts funded from a portion of existing Social Security taxes. *See, e.g.,* David Wessel, *Some Bush-Style Social Security Scenarios*, WALL ST. J., Feb. 17, 2005, at C1, available at 2005 WL-WSJ 59841388 (reporting multiple scenarios under which the President's proposal would result in reduced benefits for retirees, even with tax-funded private accounts). Writing before the President's proposal, Alicia Munell and Annika Sundén argued that already-scheduled increases in the full-benefit retirement age from sixty-five to sixty-seven, Medicare Plan B premiums, and taxation of Social Security benefits, together with the cost of eliminating the program's structural deficit, will cause Social Security benefits as a percentage of preretirement income to fall from 41.3% in 2004 to 27% by 2030, even assuming no other changes in the program. ALICIA H. MUNNELL & ANNIKA SUNDÉN, *COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS* 180–81 (2004).

29. Munnell and Sundén, for example, conclude that self-directed 401(k) participants do not save enough, MUNNELL & SUNDÉN, *supra* note 28, at 55, are confused by the array of investment choices in their plans, *id.* at 71–73, and do not diversify their plan balances away from the sponsoring company's stock and across a range of companies and industry sectors, *id.* at 80–83.

30. *See* Cory Johnson, *Advertising Lights the Candle as Online Brokers Catch Fire* (Apr. 22, 1999), at www.thestreet.com/pf/comment/siliconbabylon/737371.html (arguing that “the success of [online discounters] suggests that the Wall Street establishment has two big problems on its hands. The general public seems to believe in the Internet—whether Wall Street is ready or not. And the general public seems ready to abandon traditional brokerages—whether Wall Street is ready or not”); Petruno, *supra* note 7 (“[T]he resources and information available to investors online offer a tremendous advantage that didn't exist before the Internet. Once you have access to the Net, you'll probably never give it up.”).

31. Getlen, *supra* note 6.

recovery.³² Accordingly, whether and to what extent broker-dealers can be held liable on suitability claims involving unrecommended securities purchases are likely to remain important questions for the foreseeable future.³³

This article argues that the common law of agency supplies a powerful justification for holding broker-dealer firms liable for customer losses from unrecommended securities investments. Part II traces the doctrinal contours of the suitability obligation, showing that it was judicial application of the doctrine largely in the context of customer disputes with full service broker-dealers that led to establishment of the recommendation as a condition precedent to broker liability for breach of the suitability obligation. The stringent standards for pleading and proof of securities fraud made it difficult for customers to recover damages on suitability grounds for purchases that the broker-dealer did not recommend, and, in any event, the necessity of a customer's interacting with a full service account executive to place a purchase order tended to derail customer-initiated purchases of unsuitable securities. The industry's shift to private adjudication of customer disputes in the late 1980s (which undermined judicially developed limitations on suitability liability), combined with the further shift to unbundled online order-execution in the early 1990s (which significantly reduced the incidence of customer interaction with account executives), opened the door to liability on suitability grounds for unrecommended customer purchases. Part II concludes with an examination in this altered context of the conventional wisdom that suitability liability necessarily depends on the recommendation of a securities purchase, concluding that the "order clerk" shibboleth does not explain why broker-dealers are relieved of liability for unrecommended transactions in a context of private adjudication and online order execution.

Part III develops an affirmative theory of broker-dealer liability for suitability claims on unrecommended transactions, arguing that the well-established common law duty imposed on an agent to provide information relevant to the agency relationship to his or her principal justifies imposition on brokers-dealers of a "duty to warn" inexperienced and unsophisticated customers when their trades are inconsistent with their investment objectives or other aspects of their personal financial situation of which their broker-dealer is aware. Part III also argues that, unlike common law

32. Munarriz, *supra* note 7.

33. See generally Steven K. McGinnis, *Ten Deadly Sins: It's Easy To Make These Mistakes, Which Can Spell the End of Your Career*, FIN. PLAN., Feb. 2004, at 79 (noting that current NASD arbitration claims based on violation of the suitability obligation are more than three times their level in 2000).

agents, broker-dealers should not be permitted to contract out of this duty, because of the general statutory policy of the securities laws against waiver of rights under such laws, and specific policies promoting investor protection and market efficiency that would be frustrated by allowing broker-dealers to contract out of such duties. Finally, Part III suggests that agency law may support imposition on broker-dealers of a limited “duty to rescue” such customers when they persist in financially destructive or otherwise irrational trading that entails no reasonable prospect of investment profits and has already resulted in large losses. Part IV concludes with the suggestion that, in light of the increasing importance of self-directed investment to future retirement income and the likelihood that self-directed investing has become a permanent fixture of individual investing, a general broker-dealer duty to warn of the unsuitability of unrecommended purchases is sound policy.

II. THE ORIGINS AND EVOLUTION OF BROKER-DEALER LIABILITY ON SUITABILITY GROUNDS

A. Suitability Obligations for Recommended Purchases of Securities

“Suitability” refers to the obligation of a full service broker to recommend to a customer only securities that match the customer’s financial needs and goals. This obligation has two dimensions, “customer-specific” or “know your customer” suitability, which focuses on the financial objectives, needs, and other circumstances of the particular customer; and “reasonable basis” or “know your security” suitability, which focuses on the characteristics of the recommended security.³⁴

1. “Customer-Specific” Suitability

Customer-specific suitability imposes on broker-dealers the obligation to recommend to a customer only those securities that are appropriate to the customer’s financial status, tax situation, investment objectives, financial sophistication, and general personal circumstances.³⁵ For example, a broker-dealer would probably violate its customer-specific suitability obligation by recommending purchase of a non-dividend-paying growth stock with a high price-to-earnings multiple to a customer whose investment goals are current

34. See Lowenfels & Bromberg, *supra* note 17, at 1557.

35. Unger, *supra* note 17, at 25.

income and preservation of capital;³⁶ by recommending high-risk, illiquid, or complex securities to inexperienced or unsophisticated customers who do not understand the risks of such investments;³⁷ or by recommending securities transactions that leave even an experienced and sophisticated customer under-diversified and over-exposed to a risk of substantial loss from the failure of a single company or the decline or under-performance of a single market sector.³⁸

The customer-specific suitability obligation would not be a meaningful constraint on broker-dealer conduct unless it entailed an affirmative obligation on the broker to obtain information about the customer sufficient to enable an informed judgment about the suitability of any particular security for the customer.³⁹ Although the broker industry generally has resisted regulatory pressure to make explicit the precise inquiries that

36. *E.g.*, *In re Dartt*, 48 S.E.C. 693, Exch. Act Rel. No. 34-24198 (Mar. 10, 1987), available at 1987 SEC LEXIS 2396 (upholding result of NASD disciplinary proceeding which sanctioned broker for recommending speculative securities to retired investor who wished to follow a conservative trading strategy and who was dependent on income from her investments); see also 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, *BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW* § 9.01, at 9-4 (Rel. No. 8 Dec. 2000):

A young, single person with few assets may be suitable for a highly speculative investment. At that stage of life, the individual is better able to take risks and to recover from investment losses, without endangering needed retirement funds or the security of dependents. In contrast, a wealthy person may be unsuitable for some investments, for example, a wealthy widow or endowed orphan whose life-style is endangered by large speculative investments recommended by a broker.

Id.; F. Harris Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFF. L. REV. 435, 438 & n.23 (1977) (arguing that customer-specific suitability is violated when a broker-dealer recommends new issues and speculative securities to a person whose goal is long term growth or preservation of capital and income production); George Schieren et al., *Suitability and Institutions*, 905 PRAC. L. INST. / CORP. 699, 705 ("The typical [suitability] case . . . involves the sale of a security (usually a low-priced, speculative security or standardized option) to a retail customer whose investment objective is safety and/or income.").

37. *E.g.*, *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222 (Ct. App. 1968) (upholding breach of fiduciary duty claim against broker who invested savings of financially unsophisticated widow in highly speculative securities); see also Nichols, *supra* note 36, at 437 n.21 (suggesting that a broker may recommend speculative issues to an unsophisticated investor only "after carefully explaining all of the risks to the customer" in a way that the customer can understand them).

38. Dan Brecher & Jeffrey S. Rosen, *Securities Arbitration of Customer Claims Alleging Unsuitability, Improper Markups/Markdowns or Breach of Fiduciary Duties*, 950 PRAC. L. INST. / CORP. 469, 478-79; see also Nichols, *supra* note 36, at 437 ("Is the total portfolio properly diversified so that each security balances some risks taken or avoided in the customer's other securities or assets?").

39. See NORMAN POSER, *BROKER-DEALER LAW AND REGULATION* § 3.03[A], at 3-80 (Supp. 2001).

brokers must make of their customers, it is well established that broker-dealers have an affirmative obligation to collect information about their customers sufficient to support a judgment about customer-specific suitability; in other words, a broker cannot mitigate or avoid its customer-specific suitability obligation by keeping itself purposefully ignorant of the customer's situation.⁴⁰

2. "Reasonable-Basis" Suitability

The second dimension of a broker-dealer's suitability obligation, known as "reasonable-basis" suitability, requires that broker-dealers have a reasonable belief that the securities they recommend are suitable *for somebody*. Reasonable-basis suitability is violated when a broker recommends a security that no rational person would purchase—that is, which "is unsuitable for any investor, regardless of his wealth, willingness to bear risk, age, or other individual characteristics."⁴¹ For example, a broker-dealer would probably violate its reasonable-basis suitability obligation by recommending securities of a thinly traded shell corporation with no operations, earnings, or assets, or by recommending securities that purport to guarantee an unreasonably high rate of return.⁴²

Reasonable-basis suitability focuses on the security recommended, rather than on the customer to whom it is recommended. In contrast to judgments about customer-specific suitability, judgments of reasonable-basis suitability are necessarily independent of a particular customer's financial or other personal circumstances. Whereas customer-specific suitability requires that broker-dealers investigate the situation of customers to whom they make recommendations, regardless of the character of the recommendation, reasonable-basis suitability requires that brokers investigate the securities they recommend, regardless of the situation of the customers to whom such securities are recommended.

40. NASD MANUAL, *supra* note 12, Conduct Rule 2310(b) (requiring that broker-dealer must make reasonable efforts to acquire information about financial and tax status, investment objectives, and other relevant information before making a recommendation to a non-institutional customer); *e.g.*, *Erdos v. SEC*, 742 F.2d 507, 508 (9th Cir. 1984) (holding that the broker-dealer's NASD suitability obligation "is not limited to situations where comprehensive financial information about the customer is known to the dealer," but also includes the obligation to gather such information where it is not known); *Twomey*, 69 Cal. Rptr. at 242 (holding that broker-dealer's failure to inform itself of the "essential facts as to plaintiff's financial situation and needs" did not relieve it of liability for purchase of unsuitable securities in the customer's account when the broker-dealer's recommendations "were for all practical purposes the controlling factor in the transactions").

41. Unger, *supra* note 17, at 25; *see also id.* at 28.

42. *See Nichols*, *supra* note 36, at 437; *Brecher & Rosen*, *supra* note 38, at 478–79.

B. Suitability as a Fiduciary Duty

The Commission has relied on four sources of law to justify the imposition on broker-dealers of the suitability obligation as a fiduciary duty: the common law of agency, from which derives the agency theory; the general law of fiduciaries, from which it developed the "special circumstances" theory; and the common law doctrine of "holding out" and federal statutes authorizing the Commission to regulate broker-dealers, from which sprang the "shingle" theory.

1. The Agency Theory

As Professor Loss once observed, much of the doctrine on which the Commission relies to define the duties of broker-dealers to their customers is "nothing more than good old-fashioned agency law."⁴³ An agency relationship is a "fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control," with "consent by the other so to act."⁴⁴ It is well established that stockbrokers are agents of the customers for whom they execute trades.⁴⁵ This was the rule at common law, and by the early twentieth century there was a well-developed line of agency cases defining the rights and duties of full service brokers and their customers in terms of agency law.⁴⁶ The 1934 Act itself defines "broker" in straightforward agency terms, as "any person engaged in the business of effecting transactions for the account of others."⁴⁷

"An agent is a fiduciary with respect to matters [falling] within the scope of [the] agency" relationship,⁴⁸ meaning that the agent is under a duty to act for the benefit of the principal with respect to such matters, even at cost to

43. Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 517 (1948).

44. RESTATEMENT (SECOND) OF AGENCY § 1 (1958); *see also* *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 752 (Ct. App. 1989) ("Any agent is also a fiduciary, whose obligation of diligent and faithful service is the same as that of a trustee.").

45. *E.g.*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990); *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*, 794 F.2d 198, 200 (5th Cir. 1986); *Duffy*, 264 Cal. Rptr. at 749; *see, e.g.*, Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61, 71-72 (1990); Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 67, 75-76 (1997).

46. *See* Weiss, *supra* note 45, at 67; Note, *Conflicting Duties of Brokerage Firms*, 88 HARV. L. REV. 396, 397 (1974).

47. Securities Exchange Act of 1934 § 3(4) [hereinafter 1934 Act].

48. RESTATEMENT (SECOND) OF AGENCY, *supra* note 44, § 13.

itself.⁴⁹ As agent and fiduciary for the customer, the broker owes the customer duties of both care and loyalty that it generally would not owe in an arm's-length transaction.⁵⁰

Agents have long been held to owe a specific duty to give or to provide material information to the principal about the matter entrusted to the agent.⁵¹ This duty obligates the agent to communicate to the principal any relevant information in the agent's possession of which the agent knows or should know that the principal is not aware, but of which the principal would want to be informed.⁵² The provision of such information enables the principal to maintain the principal's rightful control of the agent and the purpose of the agency, by revising or rescinding earlier instructions, issuing additional instructions, changing the focus of the agency, or terminating it altogether.⁵³

49. *Id.* § 13 cmt. a; *see also id.* § 39.

50. *E.g., id.* § 379 (An agent owes to the principal the duty "to act with standard care and with the skill which is standard in the locality for the kind of work" the agent is retained to perform); *id.* § 387 ("An agent [owes to the principal the duty] to act solely for the benefit of the principal in all matters connected with his agency.").

51. *See, e.g.,* 2 FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY § 538, at 375 (1889) ("It is the duty of the agent to give his principal reasonable and timely notice of every fact coming to his knowledge in reference to his agency, and which it may be material for the principal to know in order for the protection or preservation of his interests.") (citing *Hegenmyer v. Marks*, 37 Minn. 6 (1887); *Devall v. Burbridge*, 4 Watts & Serg. 305 (Pa. 1842); *Arrott v. Brown*, 6 Whart. 9 (Pa. 1840); *Harvey v. Turner*, 4 Rawle 223 (Pa. 1833); *Moore v. Thompson*, 9 Phila. Co. 164; 5 Am. St. Rep. 808).

52. RESTATEMENT (SECOND) OF AGENCY, *supra* note 44, § 381 ("Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person."); *e.g.,* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990) ("A broker is an agent who . . . has a duty to give his principal information which is relevant to the affairs entrusted to him of which he has notice.") (citations omitted); *accord* RESTATEMENT (THIRD) OF AGENCY § 8.11 (Coun. Dr. No. 6, Sept. 30, 2004):

An agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know when

(1) the facts are material to the agent's duties to the principal or the agent knows or has reason to know that the principal would wish to have them;

(2) the agent knows or has reason to know that the principal would wish to have the facts; and

(3) the facts can be provided to the principal without violating a duty owed by the agent to another person.

Id.

53. RESTATEMENT (THIRD) OF AGENCY, *supra* note 52, § 8.11 cmt. b:

An agent's duty to provide information to the principal facilitates the principal's exercise of control over the agent. Within a relationship of agency, an agent assents to act subject to the principal's control. A principal may exercise control by providing the agent with interim instructions

The suitability obligation fits comfortably within the agent's fiduciary duty to provide relevant information to the principal. The suitability obligation requires that a broker-dealer make customer-specific disclosures to a customer that may deter the customer's purchase of a security, and to decline to sell certain securities altogether on reasonable-basis grounds, even though such actions cost the broker-dealer commission income and may result in loss of the customer. That securities recommended by a broker-dealer are either not suitable for the customer or not suitable for any investor falls within the scope of the customer's relationship with the broker-dealer. Indeed, in the case of full service broker-dealers, it is precisely to obtain the broker's expertise in purchasing securities that a customer opens a full service account. It is, therefore, reasonable for the full service customer to assume that any securities recommended to the customer for purchase by a broker are suitable given the customer's needs and goals. It is self-evident, of course, that a reasonable full service customer would want to know about the unsuitability of any recommended transaction. Consequently, a full service customer may assume without more that any recommended security is suitable to his or her financial situation.

The common law of agency provides a coherent justification for imposition of the suitability obligation with respect to recommended transactions in which the broker-dealer acts as a "broker," or a "person engaged in the business of effecting transactions in securities for the account of others."⁵⁴ When acting as a broker, a broker-dealer takes a buy order from a customer into the market and purchases the designated securities for the customer from an exchange specialist or an over-the-counter market-maker. In such situations, the broker is the agent of the customer and consequently owes fiduciary duties of care and loyalty to the customer as to matters within the scope of the agency relationship, including the duty to advise a customer whenever a recommended transaction is not suitable.

Broker-dealers may, however, act as "dealers" as well as brokers in executing recommended orders. Under the securities laws, a "dealer" is

directing action that the agent may properly take on the principal's behalf. Information that the agent provides to the principal may enable the principal to reconsider a course of action that the principal has previously decided upon, leading the principal to revise or rescind prior instructions given to the agent and thereby enabling the principal to shape how the agent's actions may affect the principal's legal relations with third parties in light of developments reported by the agent.

Id. (internal cross-references omitted).

54. 1934 Act § 3(a)(4)(A).

“any person engaged in the business of buying and selling securities for such person’s own account”⁵⁵ When acting as a dealer, a broker-dealer fills the customer’s order from its own inventory of the security. Although the transaction usually looks the same to the customer regardless of the capacity in which the broker-dealer acts, the broker-dealer is clearly the agent of the customer—and owes fiduciary duties—when acting as a broker, whereas it acts as a principal—and, as such, owes only ordinary duties of care—when acting as a dealer.⁵⁶ The Commission’s development of the special circumstances and shingle theories as justifications for the fiduciary character of the suitability obligation can be understood as an effort to ensure that the obligation applies with the same fiduciary force whether a broker-dealer acts as broker/agent or dealer/principal in filling a recommended order.⁵⁷

2. The “Special Circumstances” Theory

Fiduciary law does not constitute its own legal category, like tort or agency law, but refers to the wide range of situations in which rules have been fashioned—primarily by courts acting in equity—to impose duties on persons acting in particular situations that exceed those required by the common law duty of ordinary care.⁵⁸ The recognition of a fiduciary duty usually depends on the context of a particular relationship.⁵⁹ For example, a fiduciary relationship is often found in situations in which one person is placed in a position of vulnerability with respect to another person because

55. *Id.* § 3(a)(5)(A).

56. Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493, 1563–68; *see also* Ramirez, *supra* note 22, at 551–52:

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. . . . 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. The logical upshot of this distinction is that dealers generally did not owe fiduciary duties.

Id. (footnotes omitted); Weiss, *supra* note 45, at 67:

Under common law, . . . 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.

Id.

57. *See* Ramirez, *supra* note 22, at 552.

58. Weiss, *supra* note 45, at 67, 70.

59. *See id.* at 68–69.

of reasonable, extraordinary reliance on the other person, when the other person is aware of and consents to such reliance.⁶⁰

The Securities and Exchange Commission has recognized that the relationship between a full service broker-dealer and its customers may be marked by vulnerability of customers with respect to the broker-dealer, and thus should be characterized as fiduciary even when the broker-dealer is not formally acting as an agent. In *Arleen W. Hughes*, for example, the Commission determined that Hughes, a securities dealer, was a fiduciary because she affirmatively and successfully put herself in a "position of trust and confidence" with respect to her customers, resulting in their following her recommendations in virtually every instance.⁶¹ The Commission went on to observe that "[t]he very function of furnishing investment counsel on a fee basis—learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities—cultivates a confidential and intimate relationship," thereby imposing on the broker-dealer the duty "to act in the best interests" of its customers by making only such recommendations as serve their interests.⁶²

60. See, e.g., Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 797 (1983) (arguing that the basic problem posed by fiduciary relationships is "abuse of delegated power"); J. C. Shepherd, *Towards a Unified Concept of Fiduciary Relationships*, 97 LAW Q. REV. 51, 58, 61, 75 (1981) (cataloguing and criticizing various theories accounting for imposition of fiduciary duties, including "where one person reposes trust or confidence or reliance in another," and "wherever there is established an inequality of footing between the parties," and synthesizing a general principle that imposes fiduciary duties "whenever any person receives a power of any type on condition that he also receive with it a duty to utilise that power in the best interests of another, and the recipient of the power uses that power"); Weiss, *supra* note 45, at 69 ("The catalyst is the defendant's knowledge of the plaintiff's reliance. Inequality of bargaining power and the vulnerability of the putative beneficiary are important considerations in finding a fiduciary relationship.") (footnotes omitted).

61. *Arleen W. Hughes*, 27 S.E.C. 629 (1948), Grounds for Revocation or Suspension, Exch. Act Rel. No. 34-4048 (Feb. 18, 1948), available at 1948 WL 29537, at *1, *4, *7. Although Hughes performed investment advisory as well as broker-dealer services for her customers, the Commission emphasized that its determination did not rest on the fact that Hughes acted as an investment adviser:

Our determination that registrant is a fiduciary with respect to her customers and is obligated to make the indicated disclosures does not stem merely from the fact that she renders investment advice, a common practice of over-the-counter firms generally. Our conclusion rests on the fact that registrant has created a relationship of trust and confidence with her clients by holding herself out as performing confidential advisory services for a fee, and has represented that she would act solely in the best interests of her clients and that she would make only such recommendations as would serve their interests. And, in fact, the record clearly demonstrates that registrant's clients reposed complete trust and confidence in her

Id. at *7.

62. *Id.* at *4.

The Commission emphasized, however, that fiduciary obligations do not automatically follow when a broker-dealer incidentally renders investment advice in providing broker-dealer services, but apply “only in situations where a broker-dealer has cultivated a position of trust and confidence” with the customer.⁶³

The special circumstances theory, then, provides that broker-dealers owe fiduciary duties to a customer whenever they create a relationship of trust and confidence in their dealings with that customer.⁶⁴ The theory is aptly summarized by Professor Loss, who suggested that the relation of broker-dealer to customer is often created by the broker-dealer’s solicitation of the customer to purchase a security, in the course of which the broker-dealer—or “salesman,” in Loss’s terminology—

will almost inevitably render some advice as an incident to his selling activities, and who may go further to the point where he instills in the customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels—and the salesman knows the customer feels—that the salesman is acting in the customer’s interest. When you have gotten to that point, you have nothing resembling an arm’s-length principal transaction regardless of the form of the confirmation. You have what is in effect and in law a fiduciary relationship.⁶⁵

The suitability obligation belongs on the list of fiduciary duties that a broker-dealer owes to the customer in such a circumstance. The position of trust and confidence that the broker-dealer often occupies makes it overwhelmingly likely that the customer will accept the broker-dealer’s recommendation. The broker-dealer is thus under a duty to make a reasonable investigation of any security he or she recommends, and under the further duty to make a reasonable judgment that the recommended security is consistent with the customer’s investment objectives and his or her general circumstances.

Since dealers are not agents, agency theory cannot account for a broker-dealer’s suitability obligation when he or she acts as dealer in filling a customer order for a recommended security. The special circumstances theory fills this gap in the agency theory, without which the question whether a broker-dealer owes fiduciary duties would depend on the fortuitous circumstance of whether it fills a customer order in the market or

63. *Id.* at *7; see also Loss, *supra* note 43, at 520 (distinguishing the duties of a dealer “who is effecting an ordinary principal transaction” from those of a dealer “occupying a special fiduciary position”).

64. See Schieren et al., *supra* note 36, at 708.

65. Loss, *supra* note 43, at 529.

from its own inventory.⁶⁶ Under the special circumstances theory, a broker-dealer owes fiduciary duties to its customer even when acting as dealer and principal in a customer transaction, so long as the broker-dealer/customer relationship is one of trust and confidence.⁶⁷ The broker-dealer in *Arleen W. Hughes*, for example, was found to owe a fiduciary duty to her clients even though she had acted as a dealer in the disputed transactions.⁶⁸

Unfortunately, the special circumstances theory creates a problem as serious as the one it solves. The special circumstances theory does not impose fiduciary duties on the broker-dealer as a matter of law, as agency law does with respect to the broker-dealer when acting as “broker,” but only when the circumstances of the particular relationship seem to demand it.⁶⁹ Whether a broker-dealer is a fiduciary with respect to any particular customer is a question of fact—namely, whether the particular relationship at issue was one of “trust and confidence” such that the customer consistently relied on the broker’s recommendations and thus was vulnerable to an unassumed and unreasonable risk of loss because such

66. Poser, *supra* note 56, at 1568:

[T]he choice of function . . . cannot be (and was never intended to be) a means by which a broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction. . . . What is decisive in the end is that the facts disclose an “agency” relationship in the most basic and unmistakable sense of both the common law and securities law.

Id. (quoting *Opper v. Hancock Secs. Corp.*, 250 F. Supp. 668, 675 (S.D.N.Y. 1966)).

67. See Weiss, *supra* note 45, at 93–94; see also Quinn, *supra* note 45, at 79 n.111 (“The trust and confidence theory is properly invoked in the absence of an explicit creation of an agency relationship.”).

68. See *Arleen W. Hughes*, 1948 WL 29537, at *3–*4.

69. E.g., *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974) (“The mere existence of a broker-customer relationship is not proof of its fiduciary character, but on a disputed record the issue remains [a question] of fact.”); *Avern Trust v. Clarke*, 415 F.2d 1238, 1239–40 (7th Cir. 1969); see also THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 14.15[2], at 829–30 (4th ed. 2002):

The majority view of the cases applying state common law is that a blanket fiduciary relationship between broker-dealer and client does not arise as a matter of law, but that additional facts can suffice to create a fiduciary duty. Chief among these factors which may create a fiduciary relationship is “a reposing of faith, confidence and trust,” often evidenced by a broker-dealer having either prior authorization to trade for the client’s account on a discretionary basis, or de facto control of the account.

Id.; Weiss, *supra* note 45, at 108 (“A fiduciary relationship will be found if the firm gained the trust and confidence of its customer. No fiduciary relation exists per se, but once the broker induces the customer to place his trust and confidence in the firm, a fiduciary relationship is said to exist.”).

recommendations were unsuitable.⁷⁰ This proposition leaves the question whether a fiduciary relationship exists between broker-dealer and customer to the notorious vagaries of case-by-case analysis.

Under the fiduciary theory, once the broker-dealer/customer relationship is characterized as one of trust and confidence, in which the customer relies on the superior knowledge and skill of the broker in purchasing and selling securities, the broker-dealer is held to the standards of a fiduciary, which includes the obligation to recommend to the customer only suitable securities.

3. The “Shingle” Theory

First articulated by Professor Loss, the “shingle” theory of broker-dealer liability holds that merely by identifying themselves as brokers and dealers in securities—by “hanging out a shingle”—broker-dealers impliedly represent that they will deal fairly with the public.⁷¹ The theory has both regulatory and common law foundations.

The 1934 Act provides that no broker or dealer may effect or solicit securities transactions unless he or she is a member of a “registered securities association” or a registered “national securities exchange.”⁷² The largest and most important national securities exchanges are the New York

70. Benson, *supra* note 4, at 403 (“The majority view in the common law states that a fiduciary relationship between broker and client does not arise as a matter of law, but that additional facts and circumstances can create a fiduciary duty.”) (citations omitted); Poser, *supra* note 56, at 1565:

New York law is clear that a fiduciary relationship exists from the assumption of control and responsibility and is founded upon trust reposed by one party in the integrity and fidelity of another. No fiduciary relationship exists . . . [where] the two parties were acting and contracting at arm’s length. . . . At base, the existence of a fiduciary relationship [under the trust and confidence theory] is a factual question. “New York courts typically focus on whether one person has reposed trust or confidence in another who thereby gains a resulting superiority or influence over the first.”

Id. (quoting *Beneficial Commerce Corp. v. Murray Glick Datsun, Inc.*, 601 F. Supp. 770, 772 (S.D.N.Y. 1985)); *Lehman Bros. Commercial Corp. v. Minmetals Int’l Non-Ferrous Metals Trading Co.*, No. 94 Civ. 8301 JFK, 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000)).

71. Loss, *supra* note 43, at 518; *accord HAZEN*, *supra* note 69, at § 14.15[3], 831 (“[B]y hanging up a shingle, the broker implicitly represents that he or she will conduct business in an equitable and professional manner.”).

72. Broker-dealers who are members of a registered national exchange but not a registered national securities association are authorized to effect or solicit “transactions solely on that exchange.” 1934 Act § 15(b)(1)(B). The Commission is authorized to exempt broker-dealers from the prohibition from trading on unregistered exchanges when the transaction volume of the exchange is sufficiently low that registration is not required to protect the public interest. *Id.* § 5(2).

and American Stock Exchanges; the National Association of Securities Dealers, Inc., or NASD, is the only registered national securities association. The exchanges and the NASD are collectively referred to as “self-regulatory organizations” or “SROs.” All SROs are statutorily required to adopt rules, subject to Commission approval, designed “to promote just and equitable principles of trade.”⁷³ A substantial portion of the Commission’s regulation of securities, securities markets, and market participants is overseen and implemented in the first instance by SROs.⁷⁴

Among the most important of the rules adopted in accordance with this statutory mandate is the suitability obligation. The suitability obligation is expressly imposed on members of the NASD by one of its “rules of fair practice.”⁷⁵ The so-called “know your customer” rules adopted by the exchanges are comparable,⁷⁶ although their origin and history are different.⁷⁷

73. *Id.* § 6(b)(5) (“An exchange shall not be registered as a national securities exchange unless the Commission determines that . . . [t]he rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . and, in general, to protect investors and the public interest”); *id.* § 15A(b)(6) (same with respect to registration of an “association of brokers and dealers” as a “national securities association”); *see also* Ramirez, *supra* note 22, at 540, 542:

[T]he 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.” The NYSE constitution contains similar language articulating essentially the same goals.

Id. (quoting NASD MANUAL, *supra* note 12, at 1011 ¶¶ (1), (3)–(4); discussing NYSE MANUAL, *supra* note 12, at 1021 ¶ 2).

74. HAZEN, *supra* note 69, § 14.1[3], at 750–55.

75. *See* NASD MANUAL, *supra* note 12, Conduct Rule 2310.

76. *See* NYSE MANUAL, *supra* note 12, Rule 405; AMEX MANUAL, *supra* note 12, Rule 411.

77. Although there is general agreement that the exchanges’ “know-your-customer” rules were originally adopted to protect broker-dealers and the securities markets from customers who are financially unable to settle their trades, most commentators agree that these rules are now understood by the exchanges to encompass a suitability obligation owed by member firms to their customers. *See, e.g.,* 23A MARKHAM & HAZEN, *supra* note 36, §9.01, at 9-3 (noting that the NYSE has interpreted its “know your customer” rule in a manner similar to the NASD’s understanding of Rule 2310); Lowenfels & Bromberg, *supra* note 17, at 1571 (The NYSE know-your-customer rule “was originally designed to protect member firms against irresponsible customers, [but] has recently evolved to include suitability obligations running from the broker to its customer.”); Miller & Popper, *supra* note 19, at 7:

The original ‘know-your-customer’ rules were [designed] by exchanges to insure that customers were able to pay for their purchases. Thus, these rules commonly require a broker to obtain credit and other relevant information before taking on a new customer. These requirements evolved into a mechanism to protect customers, by insuring that they did not engage in transactions for which they were financially unsuited.

The NASD and exchange rules require that a recommendation made by a member to a non-institutional investor be supported by a reasonable belief that the recommended security is "suitable" for the customer based on information obtained by the broker about the customer's financial and tax status and investment objectives.⁷⁸

A broker-dealer's failure to observe NASD or exchange suitability rules is held by the Commission to constitute a violation of the broker's statutory obligation to deal justly and equitably with its customers.⁷⁹ Indeed, the Commission and the courts consider it a form of fraud for a broker-dealer intentionally or recklessly to fail to satisfy its suitability obligations after impliedly representing such fair dealing by holding itself out as a broker-dealer.⁸⁰

Id.; compare Stuart D. Root, *Suitability—the Sophisticated Investor—and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 295–96:

While the NYSE has no explicit "suitability" rule, the expanded application of the Exchange's "know your customer" rule may operate as an effective surrogate. Although originally designed to assure that customers would be responsible in honoring their obligations, a NYSE inspection program initiated in 1962 was viewed as imposing "an obligation on exchange members to prevent their salesman from recommending unsuitable securities to their customers."

Id. (quoting SEC, REPORT OF SPECIAL STUDY OF THE SECURITIES MARKETS, H.R.Doc. No. 95, 88th Cong., 1st Sess., at 316 (1961)) (footnotes omitted), with Black & Gross, *supra* note 6, at 493 (arguing that "[w]hile the literal language [of the NYSE know-your-customer rule] could support an intent to protect customers, the rule's purpose is to primarily protect the firm from irresponsible customers who may not honor their commitments on placed orders").

78. See NASD MANUAL, *supra* note 12, Conduct Rule 2310(a)–(b); NYSE MANUAL, *supra* note 12, Rule 405, at 3696 (requiring that every member of the Exchange use "due diligence" to obtain the "essential facts" about to every customer and every order); see also HAZEN, *supra* note 69, § 14.1[3][c][2], at 76 (characterizing Rule 2310 as "[a]mong the most important" of the NASD Rules of Fair Practice).

For a time, the Commission imposed the suitability obligation directly on broker-dealers who did not belong to an SRO and were consequently regulated directly by the Commission itself. See 1934 Act Rule 15b10-3 ("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."), *rescinded*, SECO Programs, Exchange Act Release No. 20409 [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶83,457, at 86,415 (Nov. 22, 1983). Rule 15b10-3 was rescinded upon statutory enactment of the requirement that all broker-dealers belong to an SRO, which eliminated authority for the Commission to regulate directly broker-dealers who are not members of SROs. *Id.*

79. See Black & Gross, *supra* note 21, at 1006; Lowenfels & Bromberg, *supra* note 17, at 1566–67.

80. See Nichols, *supra* note 36, at 444 (citing *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944)).

The statutory foundation for the shingle theory is reinforced by the common law doctrine of "holding out." This doctrine provides that one who represents himself or herself as possessing expert knowledge and skill is held to the higher standard of care consistent with the representation.⁸¹ The doctrine applies to any person who provides services to others in the practice of a profession or a skilled trade.⁸² By holding themselves out as experts in securities and securities markets, and thereby inducing their customers to rely on their recommendations, broker-dealers are held to a fiduciary standard of care with respect to the recommendations they make to their customers.⁸³ As the recommendation of an expert, therefore, a broker-dealer's recommendation to a customer that he or she purchase a security carries with it the implied representation that the security meets the customer's "particular needs and investment objectives."⁸⁴

Because the bases for liability under the shingle theory are the broker-dealer's failure to adhere to the fiduciary standard of care implied by "just and equitable principles of trade" (under the 1934 Act) and its implied representation of expertise in dealing with securities and securities markets (under the doctrine of holding out), it is irrelevant whether the broker-dealer is acting as broker or dealer—i.e., whether the broker-dealer is an agent or a principal at common law. Under the shingle theory, a broker-dealer impliedly represents to the public that it will deal professionally and fairly with its customers as soon as it goes into business, regardless of whether those dealings are in an agency relationship as broker or a principal relationship as dealer.⁸⁵

81. *E.g.*, RESTATEMENT (SECOND) OF TORTS § 299A (1965) ("Unless he represents that he has greater or less skill or knowledge, one 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 in good standing in similar communities.").

82. *Id.* § 299A cmt. b.

83. 23A MARKHAM & HAZEN, *supra* note 36, § 9.01, at 9-2; Gerald L. Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233, 239-40 (1966).

84. 23A MARKHAM & HAZEN, *supra* note 36, § 9.01, at 9-2 to -3; *accord* HAZEN, *supra* note 69, § 14.15[3], at 832 ("It has long been established that since the broker occupies a special position of trust and confidence with regard to his or her customer, any recommendation of a security carries with it an implicit representation that the broker has an adequate basis for the recommendation."); Schieren et al., *supra* note 36, at 743 ("Under the shingle theory, a broker-dealer implicitly represents that a customer will be dealt with fairly and in accordance with the standards in the industry. . . . Among these implied representations is that the securities a broker-dealer recommends meet the customer's financial situation and needs.") (footnotes omitted).

85. *See* Weiss, *supra* note 45, at 67, 88-89; *see also* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1275 (1995) ("The shingle theory is not based upon the law of agency because a broker-dealer may act as either agent or principal.").

The shingle theory is founded upon the premise that “the Commission has the authority pursuant to the regulatory scheme enacted by the securities laws to protect investors by insisting on standards of conduct from broker-dealers higher than [those] found in the common law.”⁸⁶ In *Charles Hughes*, for example, the Commission held that a dealer could not sell securities to its customer at an excessive, undisclosed markup—that is, at a price unrelated to the market for such securities—even though transactions between dealers and their customers are arm’s-length, principal-to-principal transactions lacking any formal agency character, and despite the further fact that there were no special circumstances creating a fiduciary relationship.⁸⁷

The shingle theory appears to avoid the uncertainty of case-by-case analysis that inheres in the special circumstances theory, because the shingle theory provides that broker-dealers owe special duties to their customers simply by virtue of being licensed in the securities industry.⁸⁸ Regrettably, while the fact that broker-dealers owe special duties under the shingle theory is normally not in dispute, the content of those duties creates nearly as much uncertainty as the special circumstances theory. One commentator, for example, has observed that in establishing the nature of the implied representation of fair dealing established by the shingle theory, opinions rely heavily on “language implying fiduciary responsibilities, including equitable concepts of unequal relationship, trust and confidence, and full disclosure.”⁸⁹ Indeed, one is hardly surprised to find that the courts and the Commission have specified the meaning of elastic statutory terms like “just” and “equitable,” and broad concepts like “professionalism”—the sources of legal authority for the shingle theory—by recourse to concepts of justice and equity set forth in the common law and as equitable principles—the sources of legal authority for the special circumstances theory. Accordingly, the shingle theory and the special circumstances theory are

86. Quinn, *supra* note 45, at 80; *see also id.* at 74–75 (arguing that a broker-dealer is “under a special duty not to take advantage of its customers”).

87. Charles Hughes & Co., 13 S.E.C. 676, 681–82 (1943), *aff’d*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944). Other SEC decisions developing the shingle theory include *In re Duker & Duker*, 6 S.E.C. 386 (1939); *Jansen & Co.*, 6 S.E.C. 391 (1939); *In re Hope*, 7 S.E.C. 1082 (1940); and *Allender Co.*, 9 S.E.C. 1043 (1941).

88. Karmel, *supra* note 85, at 1296.

89. Weiss, *supra* note 45, at 89. Ms. Weiss observes that common elements in all shingle theory cases are “findings that the broker-dealer induced the trust and confidence of the investor” and subsequently abused that trust and confidence—precisely the elements of the special circumstances theory. *Id.* (footnote omitted).

often referred to as a single theory; some commentators argue that they have essentially merged.⁹⁰

Under the “shingle theory,” the mere act of “hanging out a shingle” identifying oneself as a broker and dealer in securities is held to impliedly represent that the broker-dealer will deal “fairly and equitably” with the customer, which includes recommending only securities transactions that are suitable for the customer. A fiduciary relationship between broker-dealer and customer is an obvious and, indeed, unavoidable consequence of the agency and special circumstances theories, under each of which the broker-dealer owes fiduciary duties by definition. A fiduciary relationship is also a consequence of the shingle theory, although perhaps a less obvious one. The shingle theory provides a legal justification for the Commission and the SROs to make administrative judgments about duties owed by broker-dealers to customers on the basis of justice and equity. The fiduciary concept is an equitable one, both historically and substantively. It is present in virtually every area of law to mitigate harsh consequences that otherwise would ensue when a person is made vulnerable by his or her reasonable reliance on the superior knowledge, skill, or position of the person on the other side of the transaction. Accordingly, when the Commission or the SROs impose suitability obligations on the basis of fairness and equity under the shingle theory, thereby preventing the broker-dealer from exploiting its superior knowledge and skill in securities and securities markets at the customer’s expense, they are doing nothing so much as recognizing that the broker-dealer is the customer’s fiduciary.

C. The Relaxation of Constraints on Suitability Claims

1. The Eclipse of Law by Equity

The courts are virtually unanimous that no private right of action exists for violation of NASD or exchange rules, including those that impose the suitability obligation.⁹¹ As a result, most suitability claims were initially brought as Rule 10b-5 actions.⁹² False express claims by a full service

90. Quinn, *supra* note 45, at 78–79; *see also* Karmel, *supra* note 85, at 1278 (observing that there is a “lack of theoretical clarity between the shingle theory and a fiduciary duty theory”); Quinn, *supra* note 45, at 76 (noting that the shingle theory is often conflated with the special circumstances theory).

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

92. *See* Benson, *supra* note 4, at 406; Black & Gross, *supra* note 21, at 1023–25; Ramirez, *supra* note 22, at 549.

broker that a security is suitable for a customer fall within the Rule as material misrepresentations in connection with the purchase of a security; the failure to disclose unsuitability in connection with a recommendation constitutes a material omission whose disclosure is necessary to make the recommendation not misleading.⁹³

The rise of the independent suitability claim coincided with the fall of the Rule 10b-5 private action.⁹⁴ Beginning in the late 1970s, the Supreme Court began to impose new limits on implied federal private rights of action generally,⁹⁵ and private actions under Rule 10b-5 in particular.⁹⁶ Especially significant in this regard were the Court's determinations that 10b-5 liability requires pleading and proof of scienter, or an intention to defraud, as well as reasonable reliance on a defendant's false or misleading statement, as part of the plaintiff's *prima facie* case.⁹⁷ Most suitability claims involve judgments by the broker-dealer that might be wrong, but are rarely obviously so. If the broker-dealer has exercised some diligence with respect to the recommendation—that is, has elicited some information from the customer or performed some investigation of the security—it is difficult for

93. *E.g.*, *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599–600 (2d Cir. 1978); *see O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 897 (10th Cir. 1992):

Some courts examining a § 10(b), Rule 10b-5 unsuitability claim have analyzed it simply as a misrepresentation or failure to disclose a material fact. In such a case, the broker has omitted telling the investor the recommendation is unsuitable for the investor's interests. The court may then use traditional laws concerning omission to examine the claim.

Id. (citations omitted).

94. *See Root, supra* note 77, at 309–16.

95. *See, e.g.*, *California v. Sierra Club*, 451 U.S. 287 (1981); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11 (1979); *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979).

96. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 233–37 (1980) (holding that trading on the basis of nonpublic market information does not violate Rule 10b-5 in the absence of fiduciary duty owed by trader to owner of information); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472–80 (1977) (holding that Rule 10b-5 action requires proof of deception or manipulation); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that Rule 10b-5 action requires proof of scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731–32 (1975) (holding that plaintiff must have been a purchaser or seller of securities to have standing to bring Rule 10b-5 action).

97. *Black & Gross, supra* note 21, at 1010; *Root, supra* note 77, at 315–18. The lower federal courts have uniformly construed “scienter” to include reckless as well as intentional misrepresentations. *E.g.*, *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267–68 (2d Cir. 1996); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568–69 (9th Cir. 1990); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 43–46 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039–40, 1044–47 (7th Cir. 1977).

the plaintiff to prove fault greater than negligence.⁹⁸ Moreover, if the broker-dealer formally disclosed to the customer the risk of unsuitable investments made on the customer's behalf, or otherwise advised the customer of such risk, the customer might not be able to prove reliance.⁹⁹ Accordingly, suitability claims were generally pled under Rule 10b-5 as "add-on" counts in situations involving egregious broker-dealer conduct constituting virtually per se fraud, such as churning a discretionary account, ignoring customer orders in a nondiscretionary account, or converting or otherwise mishandling account funds.¹⁰⁰ Stand-alone suitability actions, in which breach of the suitability obligation is the core of the action, were unusual, and customer recovery on such actions rarer still.¹⁰¹

In the late 1980s, the broker-dealer industry achieved a long sought-after goal when the Supreme Court upheld the enforceability, under the 1933 and 1934 Acts, of contractual provisions mandating arbitration of claims by customers against broker-dealers.¹⁰² In the wake of these decisions, most broker-dealers in the United States added mandatory arbitration to their standard form customer contracts, and the exchanges and the NASD created arbitration forums to deal with customer claims under such provisions.¹⁰³ As a consequence, virtually all customer disputes with broker-dealers are now arbitrated rather than litigated, and reported decisions relating to suitability have vanished since the early 1990s, when the last private pre-arbitration actions were adjudicated.¹⁰⁴

98. See, e.g., *O'Connor*, 965 F.2d at 899-900 (finding no scienter because broker-dealer had investigated the unsuitable securities and was able to give reasons for their purchase notwithstanding their apparent lack of suitability for the customer).

99. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1028-29 (2d Cir. 1993); *O'Connor*, 965 F.2d at 896.

100. See, e.g., *Mundheim*, *supra* note 11, at 470 ("In every case in which suitability concepts have been articulated there have also been fraud grounds for disposing of the case."); J. Michael Rediker, *Civil Liability of Broker-Dealers Under SEC and NASD Suitability Rules*, 22 ALA. L. REV. 15, 25 (1969) (noting that "[t]he NASD rarely invokes the suitability rule alone" in disciplinary actions, usually invoking it in combination with violations of "net capital or bookkeeping rules, or where the broker-dealer's conduct has been so willful or grossly violative of the ethical rules as to amount to fraud in the legal sense"); Root, *supra* note 77, at 315 (noting the frequent coincidence of suitability and churning claims).

101. See Root, *supra* note 77, at 318-19.

102. See *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 482-84 (1989) (holding arbitration provision valid and enforceable under the 1933 Act); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 234-40 (1987) (arriving at the same result under the 1934 Act).

103. Black & Gross, *supra* note 21, at 992; Karmel, *supra* note 85, at 1293-94.

104. See Black & Gross, *supra* note 21, at 992-93. Decisions relating to suitability that have been reported in the last ten years have generally involved consideration of the suitability obligation as part of judicial review of a Commission disciplinary proceeding. *Id.* at 993.

Industry-sponsored arbitration is widely thought to be systematically biased in favor of the industry,¹⁰⁵ which is probably why broker-dealers so strongly supported it. Nevertheless, broker-dealers frequently complain that arbitrators ignore established legal principles in adjudicating disputes between customers and broker-dealers, especially in suitability cases.¹⁰⁶ There is little doubt that many suitability claims on which damages have been awarded against a broker-dealer would not have satisfied the stringent pleading requirements of Rule 10b-5 in a judicial proceeding.¹⁰⁷ Nevertheless, it is rare that such awards are overturned. A party seeking to vacate an award on legal grounds must show that the arbitrators “manifestly disregarded” the law.¹⁰⁸ Courts have held that this requires proof that the arbitrators knew and understood the law, and then consciously misapplied it in the case before them.¹⁰⁹ In the absence of an opinion explaining the legal basis for their decision, which arbitrators rarely render, satisfying this standard of review is virtually impossible.¹¹⁰

Some commentators have pointed out that because arbitration is an alternative method of dispute resolution, it is entirely proper for arbitrators to weigh the equities of a dispute apart from and even in contradiction to the standards of legal liability.¹¹¹ After the change from judicial to private adjudication, equitable considerations which had theretofore been formally excluded from judicial proceedings by the pleading constraints of Rule 10b-5, such as compliance with industry ethics, became relevant as bases for

105. See *supra* note 27 and accompanying text.

106. See Black & Gross, *supra* note 21, at 992. Such complaints are more than a little ironic, given how hard broker-dealers themselves worked to establish mandatory arbitration.

107. See, e.g., Lowenfels & Bromberg, *supra* note 17, at 1584–85 (noting that the basis for suitability claims has shifted from fraud under the Rule 10b-5, “to a nebulous quasi-legal, quasi-ethical test for breaches of standards of duty and care under SRO rules which does not require scienter or recklessness”).

108. Black & Gross, *supra* note 21, at 1033–35.

109. See *id.* at 1033–34.

110. See *id.* at 1034.

111. See *id.* at 1029 (“Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.”) (citing SECURITIES INDUSTRIAL CONFERENCE ON ARBITRATION, THE ARBITRATOR’S MANUAL, *preface* (2001), available at http://www.nasdar.com/sica_manual.asp) (internal quotations omitted); Lowenfels & Bromberg, *supra* note 17, at 1567 (“[A]n approach of equitable fairness rather than strict legal doctrine drives . . . arbitration panels . . .”). But see Black & Gross, *supra* note 21, at 1004 (conceding “that arbitration generally is considered to be an equitable forum,” but nonetheless arguing that “arbitrators *should consider* applicable statutory and common law”) (quoting SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. 31 (1996)).

deciding suitability claims in arbitration.¹¹² In other words, arbitrators who consider ethics and equity in awarding judgments are not ignoring the proper bases of decision, since those bases were expanded beyond the strict bounds of Rule 10b-5 liability by the switch to private adjudication. As a consequence, the probability that damages might be awarded on a suitability claim, heretofore substantially depressed by the strict pleading and proof requirements of Rule 10b-5, were substantially and properly increased by the balancing of equities and insulation from judicial review that characterize arbitration.¹¹³

2. The Removal of the Account Executive from the Order-Execution Process

Prior to the advent of online trading, a customer who wished to purchase securities was required to communicate his or her trades to the account executive or “registered representative” responsible for servicing the account.¹¹⁴ “Registered representatives” are licensed securities professionals subject to regulation and discipline by the NASD and the exchanges.¹¹⁵ The gradual “professionalization” of the broker-dealer industry, with its concomitant institution of increasingly demanding professional standards of care, is widely credited with having resulted in substantial protection of investors.¹¹⁶ Full service customers who had determined on their own to purchase an unrecommended and unsuitable security were often talked out of ill-advised trades by their account executives, though full service broker-dealers insist that they are not liable on suitability grounds for unrecommended purchases.¹¹⁷ Moreover, it has been suggested that both full

112. See Black & Gross, *supra* note 21, at 1039 (“In many ways, it is counter-intuitive that the brokers fought so hard to get investors’ claims out of the courts and into arbitration, since customers’ complaints are frequently stronger on the equities—hardship and betrayal—while the brokers’ defenses are stronger on the law.”); *cf.* Rediker, *supra* note 100, at 16 (noting the tension between broker-dealer standards of conduct that the industry considers “purely ethical,” but “which the SEC and the federal courts have increasingly tended to consider *legal*”).

113. See, e.g., Lowenfels & Bromberg, *supra* note 17, at 1572 (observing that the SEC’s practice of “cross-citing” NASD suitability standards in NYSE disciplinary actions, and the NYSE’s position that Rule 405, its “know your customer” rule, applies regardless of whether the broker-dealer makes a recommendation, “appears to give securities industry arbitration panels a certain latitude to apply Rule 405 to discount and ‘do-it-yourself online’ brokers in cases where customers allege unsuitable transactions even in the absence of a recommendation by the broker”).

114. See *supra* note 73 and accompanying text.

115. See *supra* note 73 and accompanying text.

116. See *supra* notes 11 and accompanying text.

117. See *supra* notes 13–15, 18–26 and accompanying text.

service and discount customers are deterred from frequent “in-and-out” trading by having to communicate their trades to a live person, even when that person has no suitability obligation and, therefore, no obligation to communicate his or her view about the wisdom of such frequent trading.¹¹⁸

The informal deterrent to irrational trading imposed by customer interaction with an account executive is entirely absent in online trading.¹¹⁹ Online trading, moreover, tends to exacerbate the negative trading consequences of inexperience and lack of sophistication. The interactive quality of online order execution, for example, gives customers the illusion of control and an unfounded confidence in their ability to navigate the risks of securities investments.¹²⁰ Discount and online advertising often attempt to preserve this illusion of investor expertise and control,¹²¹ especially during advancing markets when generally rising stock prices mask or mitigate investor errors.¹²² Studies have also shown that many tasks performed online become habit-forming, and in some people may rise to the level of addiction, leaving the user unable to resist repeating the tasks.¹²³ This is

118. See *supra* note 6 and accompanying text.

119. See Buckman, *supra* note 18; Grundfest, *supra* note 11, at 105; cf. Schieren et al., *supra* note 36, at 709 (“A finding that there exists no ‘longstanding business or personal relationship’ or that there has been little or no direct contact between the broker-dealer and the customer tends to mitigate against a determination that a broker-dealer has a duty to disclose [unsuitability].”) (footnotes omitted).

120. Barnett, *supra* note 1, at 1109–10 (“A recent study explains that online investors tend to be overconfident in their trading ability due, in part, to an illusion of knowledge and control. As a result, online investors tend to be overly self-attributive of their successes, especially in light of the market’s recent prosperity.”) (footnotes omitted).

121. See David Futrelle, *Martha, the Market and You*, MONEY, at 28 (Apr. 1, 2004), available at 2004 WL 55037707; Vickers & Weiss, *supra* note 6, at 2; see also Johnson, *supra* note 30, at 2 (suggesting that the “real appeal of online trading is rooted deeply in [American] values: Do it yourself. Don’t trust the powers that be. Take control over your own life. Enjoy the successful moments as they come along. And most of all, work toward the American dream of a better life.”).

122. See *supra* notes 7–9 and accompanying text.

123. The concept of Internet addiction was first suggested as a psychological disorder by Kimberly S. Young, Internet Addiction: The Emergence of a New Clinical Disorder (paper presented at the 104th Ann. Meeting of Am. Psych. Ass’n, Toronto, Canada, Aug. 11, 1996) (cited in Kimberly S. Young, *Internet Addiction: Symptoms, Evaluation, and Treatment* in 17 INNOVATIONS IN CLINICAL PRACTICE: A SOURCE BOOK *passim* (L. VandeCreek & T. Jackson eds., 1999)). See also Mark Griffiths, *Internet Addiction: Does It Really Exist?*, in PSYCHOLOGY AND THE INTERNET 61, 73 (Jayne Gackenbach ed., 1998) (concluding that although “[e]xcessive use of the Internet may not be problematic in most cases,” the “limited case study evidence does seem to suggest that for some individuals, excessive Internet Usage is a real addiction and of genuine concern”); Young, *supra*, at 19 (describing negative consequences, symptoms, and treatment of “pathological Internet use”); David N. Greenfield, *Virtual Addiction: Sometimes New Technology Can Create New Problems* (n.d.) (unpublished manuscript, on file with author) (concluding on the basis of a self-reporting survey of 18,000 people that the “combination of

particularly true of stock-trading, banking, and other online financial tasks.¹²⁴ All of these factors combine to create a significant risk in online trading, not present in full service or old-fashioned discount trading, that

available *stimulating content, ease of access, convenience, low cost, visual stimulation, autonomy, and anonymity* all contribute to a highly psychoactive experience” that may be addictive; and reporting further that Internet access exacerbates “well-established forms of compulsive consumer behavior such as gambling, shopping, stock trading, and compulsive sexual behavior”); Paul M. Mastrangelo & Karen K. Daniels, Internet Addiction at Work: Not as Sexy as You Think (n.d.) (unpublished paper presented at 73rd Annual Meeting of the Eastern Psych. Ass’n, Boston, MA) (reporting that “compulsive computer use was positively correlated with personal task-oriented misuse of work computers . . . , such as playing computer games, browsing the web, building non-job related web sites, downloading files and music, and trading stocks”).

124. Greenfield, *supra* note 123:

[T]he lack of any social context to purchasing removes any last vestige of judgment or restraint [in online shopping, stock trading, and auctioning]. . . . Money seems less real, and the Net affords a financial transaction that is devoid of human contact. It seems probable that it is that . . . human contact (even if by telephone) that contributes to increased judgement and better control of impulses.

Id.; see Rosen, *supra* note 4, at H6 (“[W]ith Internet chat rooms creating even more hype, people with poor impulse control can lose money even faster. After all, it’s just a few mouse clicks from chat room to trade, with no one to toss out a caveat or suggest an alternative.”); cf. Adam Joinson, *Causes and Implications of Disinhibited Behavior*, in *PSYCHOLOGY AND THE INTERNET* 43, 56 (Jayne Gackenbach ed., 1998) (concluding that the general “disinhibit[ing]” effect that computer-mediated communication exerts may result, *inter alia*, in users purchasing more items online than they would purchase “‘in real life,’ possibly because of concerns about others’ judgments”).

Although there is a widespread public perception that the largest category of compulsive Internet use involves online pornography, surveys show that finance and investment sites tend to be the most addictive. See, e.g., Mastrangelo & Daniels, *supra* note 123, at 5 (reporting that “the behaviors most similar to gambling that correlated with compulsive computer use . . . were stock trading, . . . stock research, . . . and visiting money-making sites”); Press Release, Nielsen/NetRatings (Feb. 27, 2002) at http://direct.www.nielsen-netratings.com/pr/pr_020227.pdf:

[F]inancial Web sites took the No. 1 spot as the most addictive online destination at-home and at-work [during January 2002]. . . .

Financial Web sites outscore every other category in depth of usage, including the popular search engines, portals and online communities. . . . Financial Web sites attract serious and engaged consumers who go beyond casual Internet activity, logging more than 21 minutes of online activity per surfer in January.

The addictive nature of financial Web sites tempts surfers to spend increasing amounts of time online, promoting familiarity, brand recognition and a sense of trust, which is critical in the realm of finance

Id. (quoting Internet analyst Patrick Thomas).

unknowledgeable investors will engage in overconfident and irrational patterns of repetitive trading that have little chance of being profitable.¹²⁵

The elimination of the account executive as a buffer or stop between unknowledgeable customers and the market, combined with the intoxicating quality of online interaction, has made it more likely that unknowledgeable customers will purchase unsuitable securities in unrecommended transactions, and less likely that they will receive any comment, warning, or other intervention from the broker-dealers who supervise their accounts. It was inevitable that an equitable forum like arbitration, even an industry-sponsored one, would respond to this situation.

D. The "Order Clerk" Shibboleth

The image of the "order clerk" has been present in securities law literature from the earliest suggestion of the suitability obligation. The image is attached to the proposition that a broker owes no suitability obligation when it merely executes an unsolicited purchase order. The phrase has an old-fashioned resonance, evoking the mental picture of an accountant-looking fellow in sleeve garters and eye-shade who sits behind a caged counter, meticulously accepting purchase and sell orders like a racetrack cashier taking bets. Usually unaccompanied by analysis, as if its meaning and applicability were self-evident, the image of the order clerk is commonly deployed by courts, regulators, commentators, and industry representatives in support of the conclusion that broker-dealers do not and, indeed, cannot owe suitability obligations to their customers for unrecommended purchases.¹²⁶

125. Barnett, *supra* note 1, at 1100, 1109–10 ("Online investors . . . typically execute trades more often than investors who use traditional 'offline' brokers. . . . [O]nce investors go online, they tend to 'trade more actively, more speculatively and less profitably.'") (quoting Brad M. Barber & Terrance Odean, *Online Investors: Do the Slow Die First?*, at 24 (Dec. 1999) (draft version), available at <http://www.gsm.ucdavis.edu/~odean/papers/Online/Online.html>).

126. See *Chee v. Marine Midland Bank, N.A.*, [1990–1991 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 95,806, at *2 (E.D.N.Y. Jan. 29, 1991) (holding that customer could not maintain suitability claim against discount firm for option trading because, *inter alia*, firm had not recommended any of the transactions); NASD, NOTICE NO. 01-23, ONLINE SUITABILITY (Mar. 19, 2001), at 2001 WL 278614 (National/Federal) at *2 & n.7, *3 (explaining that Rule 2310 applies only when a broker recommends a security, and does not apply "when a member acts merely as an order-taker"); Benson, *supra* note 4, at 411 ("Most online broker-dealers oppose rules mandating suitability review in this context because they claim that they serve as mere order-takers and the relationship with the customer is highly impersonal."); Black & Gross, *supra* note 6, at 487 ("Where the broker acts merely as an order-taker for the customer who manages his own portfolio, the broker assumes no responsibility for assuring that the investment, either singly or as a component of the customer's portfolio, is suitable for the customer."); Fishman, *supra* note 83, at 240 (explaining that "boiler room" brokers who sell

Though usually credited to Professor Loss, the image of the “order clerk” was first employed by Dean Mundheim, whose analysis Loss subsequently summarized in the next edition of his treatise.¹²⁷ Mundheim used the expression to illustrate one end of a continuum of customer reliance on broker-dealer expertise: “When the broker-dealer recommends securities to an inexperienced customer, reliance is usually present. On the other hand, when the broker-dealer simply serves as an order clerk, there is usually no reliance.”¹²⁸ Mundheim supplied an analysis to accompany the image of the order clerk, though the analysis is cited far less than the image. Mundheim observed that, as a means of encouraging investors to rely “on the superior skill of the broker-dealer community” when they purchase securities, brokers have traditionally emphasized both the “intricate” nature of securities and securities transactions and the “special skills” of brokers in dealing with these complexities.¹²⁹ It is thus entirely appropriate, Mundheim argued, that the law recognize both the obligation of brokers to recommend suitable securities to their customers, and an accompanying presumption that customers rely on their brokers’ recommendations “in all but the order clerk situation.”¹³⁰ In fact, “the only time when the broker-dealer should be relieved of this responsibility,” in other words, “is when his *only* relationship with the customer is that of an order clerk.”¹³¹

As Dean Mundheim employed it, then, the “order clerk” paradigm is a default category that absolves the broker of his suitability obligation and reverses the presumption of customer reliance when—and only when—the

securities to customers with whom they have no ongoing relationship have recently been subjected to the suitability rule); Lowenfels & Bromberg, *supra* note 17, at 1561 (noting that the Commission’s penny stock suitability standards promulgated under the 1934 Act “distinguished between brokers as mere order takers or engaged only in general advertising on the one hand and brokers directly recommending the purchase of a specific security to an investor on the other hand”); Root, *supra* note 77, at 328 (“[W]hen the parties agree that the broker will be a mere order taker and executioner, the scope of the duty owed is limited to fulfilling the functions undertaken in a professional manner.”); Schieren et al., *supra* note 36, at 753 (“In general, the courts (to the extent they have addressed the issue), the SEC and the SROs impose a suitability obligation on a broker-dealer only in the context of a ‘recommendation.’ Suitability concerns do not appear to arise when a broker-dealer acts merely as an order taker.”); UNGER, *supra* note 17, at 28 (reporting that securities industry participants in round table discussion on online services agreed that suitability obligations do not attach “when firms provide pure order entry and execution services”); Weiss, *supra* note 45, at 98 (“The broker-dealer is relieved entirely [of suitability obligations] only when his relation to the customer is that solely of an order clerk.”).

127. See LOSS, *supra* note 23, at 3726–27 (citing and quoting Mundheim, *supra* note 11, at 449).

128. Mundheim, *supra* note 11, at 450.

129. *Id.*

130. *Id.*

131. *Id.* at 472–73 (emphasis added).

broker's participation in a securities transaction amounts to nothing more than passive reception of the customer's order: "If a customer calls a broker-dealer and tells him to buy 100 shares of XYZ stock, the broker-dealer should be able to do so without attempting to determine whether that security is suitable for the customer."¹³²

Unlike others who employ the order clerk image, Mundheim himself did not believe that brokers could absolve themselves of suitability obligations by simply not recommending securities. In Mundheim's view, factors such as the nature of the broker-customer relationship and the broker's subjective awareness of the customer's financial situation could by themselves trigger a suitability obligation, even in the absence of a recommendation:

[I]f the broker-dealer has had a prior relationship with the customer going beyond that of serving as an order clerk, and if on the basis of information which he knows or should know about the customer's risk threshold he determines or should determine that the security is unsuitable, he should be required to inform his customer that he thinks the security is unsuitable.¹³³

A full service broker, of course, will nearly always have a prior relationship with the customer that entails far more than simply accepting unsolicited orders for unrecommended securities. The only reason to open a full service account, after all, is to obtain services, including purchase recommendations, beyond mere order execution. Although it would be unfair to make a full service broker-dealer the insurer of even its recommended investments, let alone unrecommended ones, there is also something wrong with a full service broker-dealer that silently collects its commissions while its unsophisticated customer commits financial suicide by purchasing securities that the broker-dealer knows are not suitable for the customer.¹³⁴ That the full service broker-dealer did not recommend the suicidal purchases hardly establishes that the customer received the just and equitable treatment to which he or she is entitled under the shingle theory.

132. *Id.* at 473.

133. *Id.*

134. *Id.* at 465–66 (observing that the equities of the situation in which a full service broker remains silent about the obvious unsuitability of self-directed trades by an unsophisticated customer and profits from that silence by collecting commissions on the unsuitable trades are likely to compel courts to search for ways to protect the customer); Letter from Frank G. Zarb, NASD Chairman & CEO, to NASD Members (Feb. 4, 1999) ("While the old suitability notion may be difficult to apply in the face of today's technology, our firms still need to be certain they are maintaining an environment that does not encourage investors who have little experience, background or financial wherewithal to engage in high risk activity."), *reprinted in* Caruso, *supra* note 3, at 275.

A consideration of the equities counsels in favor of imposition of a duty to warn even on discount brokers. Advertising by discount firms frequently emphasizes easy profits, and rarely emphasizes risk.¹³⁵ Discount advertising also typically targets middle- and lower-middle-class investors with little knowledge of or experience with direct securities investing,¹³⁶ and who are often unable to sustain substantial losses in their portfolios. Additionally, bulk commission discounts and commission-free trading promotions to encourage the opening of discount accounts encourage unprofitable frequent

135. See, e.g., Benson, *supra* note 4, at 395 (describing discount ad in which a tow truck driver is portrayed as having earned enough money through online trading to purchase his own tropical island country); Johnson, *supra* note 30 (describing a full service ad in which a couple imagines purchasing palatial mansions “with manicured gardens and fountains” with stock trading profits); Petruno, *supra* note 7, at 4–5 (describing online brokerage ad in which two female jogging pals rush home from a run so that one of them can check a stock price, sell the stock, and make a profit); see Barnett, *supra* note 1, at 1111–12 (observing that “[o]nline brokers’ television and print advertisements assert that online trading is easy, convenient and profitable,” “encourage a get rich quick mentality,” and imply that “just using an online broker and trading frequently will result in profits”); Black & Gross, *supra* note 6, at 486 (asserting that “large infusions of funds into the securities markets” during the last decade have come from “investors who ha[ve] never previously traded in securities, many of whom were lured into the market by the ‘get rich quick’ advertising of many discount brokers”); Sara Hansard, *Hey Stuart! You’re Outta Line!: Traditional Brokers File FTC Complaint over Online Ads*, INVESTMENT NEWS, Dec. 13, 1999, at 1 (characterizing online brokerage ads as promoting that “online investing can lead to easy riches and that stockbrokers are price gougers who provide inferior service”), available at 1999 WL 11754397; Vickers & Weiss, *supra* note 6, at *2 (characterizing the dominant Wall Street advertising message during the late 1990s as “Wall Street can make you rich—and fast”); Sam Zuckerman, *E-Trade’s Marketing Probed*, S.F. CHRON., Aug. 24, 2000, at B1 (reporting government and industry criticisms of online advertising implying that “trading on the Internet was a fast and easy way to get rich”), available at 2000 WL 6489863; see also Fried, *supra* note 10, at *3 (observing that instead of emphasizing “allocation strategies that will help investors meet their long-term goals,” mutual funds market themselves ““based on recent performance””) (quoting Don Phillips, managing director of *Morningstar*).

136. See, e.g., Barnett, *supra* note 1, at 1107, 1110 (observing that online broker advertising “appear[s] to target . . . average American[s]” who lack understanding of how securities markets work); Black & Gross, *supra* note 6, at 486 (observing that during the last decade many persons lacking knowledge about or experience with securities markets have invested in securities as the result of discount advertising); Schulz, *supra* note 4, at *10 (“Obviously, the marketing by Internet firms has been directed at the masses, and there is nothing in their system to distinguish between the novice or the sophisticated investor.”); Johnson, *supra* note 30 (describing online brokerage ad starring the infamous “Stuart, a guy with a pierced nose and red, green and blond hair,” the subtext of which is that trading requires little or no education or experience, “[b]ecause if Stuart can trade . . . dude, anyone can trade”); McDowell, *supra* note 27 (describing Ameritrade ad which portrays an immigrant adult education class whose members “can barely understand English, but at the first reference to Wall Street, they are fluent, knowledgeable and on the cutting edge”).

trading.¹³⁷ Together, these characteristics of discount self-promotion have created a continuing regulatory concern that online discounters are enticing unsophisticated investors into online trading and encouraging (without formally recommending) investments that are not suitable for such investors.¹³⁸ The risk that discounters are subtly misleading investors into unsuitable purchases is compounded by the complexities of securities and securities markets, whose workings are usually beyond the general knowledge of the average person, even though they are well understood by the discount broker-dealers encouraging such purchases.¹³⁹

Given the mutual understanding between discount brokers and their customers that the former will not make purchase recommendations to the latter, it seems even more unfair to force the discount broker to assume the risk of losses from customer purchases than it would be to impose that risk on full service brokers. And yet again, here as there, there is something odd about allowing discount brokers to encourage for profit the purchase of unsuitable securities by unsophisticated customers, without incurring any responsibilities for the losses that are almost certain to follow. It is neither just nor equitable for a discount broker to encourage irrational financial behavior in its customers, and then to avoid liability for the consequences of the very behavior it encouraged, on the technical ground that it failed formally to recommend the purchase of specific securities.¹⁴⁰

137. *E.g.*, Email from TD Waterhouse, to author (Sept. 3, 2003) (offering free trades for a month upon opening a trading account); see Barnett, *supra* note 1, at 1107 (observing that “online broker[-dealer] advertising encourages frequent trading”); Hansard, *supra* note 135, at 1 (noting that online brokerage ads encourage investors to “engage in a hyper level of activity in their accounts”).

138. Barnett, *supra* note 1, at 1091–92; Benson, *supra* note 4, at 401 (“The [1963] Special Study used terms such as ‘speculative impulses’ and ‘gambling instincts’ in its characterization of the appeal of certain securities advertisements and considered securities purchases in this manner unsuitable.”).

As the Special Study of the Securities Markets recognized in 1963, research reports provided by broker-dealers often serve to stimulate the average investor. Consequently, investors exhibit “gambling instincts” and enter into unsuitable investments. Online brokerage firms appeal to investors because they provide investment information over the Internet in a simplistic and tantalizing manner, but often do not disclose the inherent risks involved. This characteristic leads many unsophisticated investors to make investment decisions unsuitable to their financial status and goals.

Id. at 411 (citations omitted).

139. See Mundheim, *supra* note 11, at 450; see also Karmel, *supra* note 85, at 1275 (“[I]n dealing with customers, the broker-dealer necessarily has superior knowledge about certain matters.”).

140. *Cf.* Barnett, *supra* note 1, at 1121 (“In light of online brokers’ advertising, Web pages, and the personalized information they provide to their often unsophisticated customers,

III. AN AGENCY THEORY OF BROKER-DEALER LIABILITY: A DUTY TO WARN THAT AN UNRECOMMENDED PURCHASE IS UNSUITABLE

Common law principles of agency and general equitable considerations under the shingle theory require that a broker-dealer not be summarily relieved of its suitability obligation to a customer simply because the broker-dealer did not recommend the security purchased by the customer, especially when the broker-dealer knows or should know that the customer is not knowledgeable about securities and securities markets. When a broker-dealer knows or should know that an unrecommended trade by an inexperienced or unsophisticated customer is not suitable for the customer, the agency theory and the shingle theory together justify imposing on the broker-dealer a duty to warn the customer of the unsuitability of the trade before executing the order.¹⁴¹ The broker-dealer may know that the unrecommended trade is unsuitable because of customer-specific information in its possession, or because the security is obviously unsound, and thus lacks reasonable-basis suitability. The broker-dealer may relieve itself of this duty by qualifying the customer as a sophisticated investor, similar to the way investors are qualified to purchase unregistered private offerings and to engage in high-risk trading strategies such as day-trading and margin, options, and penny-stock trading. The investor- and market-protection policies that underlie the securities laws, however, should prevent broker-dealers from contracting out of this duty with respect to unsophisticated customers, even when the customer is willing to allow it.

A. Unrecommended Purchases and the Agent's Duty To Provide Relevant Information

The broker-dealer's duty to warn is not only justified by notions of justice and equity, but also by the legal standards of agency law. A broker-dealer that recommends the purchase of securities that the broker-dealer knows or ought to know are unsuitable for a customer has a duty to disclose this fact to the customer. Even if special circumstances do not exist that would justify characterizing the particular broker-dealer/customer relationship as a fiduciary relationship, the duty to make this disclosure is encompassed by the well-established common law duty of an agent to

regulators should require suitability checks for unsophisticated customers entering trades online.").

141. A duty on the part of broker-dealers to warn customers of the unsuitability of unrecommended trades was first suggested by Professor Grundfest. See Grundfest, *supra* note 11, at 106.

provide material information to the principal that is relevant to the agency relationship.¹⁴² A customer who opens an account with a broker-dealer for the purpose of purchasing securities recommended by the broker-dealer is entitled to assume without further investigation that any securities recommended are both generally sound investments (reasonable-basis suitability) and appropriate to the customer's investment goals and financial circumstances generally (customer-specific suitability).¹⁴³ The unsuitability of any security recommended by the broker-dealer is thus a fact that is material to the agency relationship and of which the broker-dealer should know that the customer would want to be informed.¹⁴⁴ It is also clear that the just and equitable treatment of customers demanded by the shingle theory requires that the broker-dealer disclose the unsuitability of any recommended security.¹⁴⁵ Accordingly, the broker-dealer owes this disclosure irrespective of whether it is acting as a "broker" or a "dealer" within the meaning of the 1934 Act.¹⁴⁶

When a broker-dealer recommends a security, it is necessarily charged with knowledge of its characteristics, and thus with the further knowledge of its suitability or lack thereof for the customer. Knowledge of unsuitability is neither logically nor practically dependent on the broker-dealer's making a recommendation, however. The information that full service firms are required to obtain from new customers puts them in the position of knowing, or being properly charged with knowing, that a customer's unsolicited order of securities lacks customer-specific suitability; in many cases discounters are also in possession of sufficient knowledge about the customer's financial situation to make the same judgment. Moreover, both full service and discount broker-dealers will often know when their customers make unsolicited orders of securities that lack reasonable-basis suitability. When the broker-dealer possesses such knowledge, it owes a duty to warn its customers that the purchase of a security is unsuitable, even though it has not recommended or otherwise solicited the purchase.

142. See *supra* notes 51–56 and accompanying text.

143. See *supra* text following note 53.

144. See *supra* note 54 and accompanying and following text.

145. See *supra* notes 79–85 and accompanying text.

146. See *supra* note 85 and accompanying text.

1. Unrecommended Securities Lacking Customer-Specific Suitability

Because it entails the judgment that a security is not suitable for purchase by a particular customer, customer-specific suitability requires knowledge of the customer's investment goals and his or her general financial situation. Full service brokers always have this information. Because full service broker-dealers anticipate recommending the purchase of particular securities, and because the NASD suitability rule and the exchange know-your-customer rules require broker-dealers affirmatively to acquire information on which to base judgments of suitability regarding such recommendations, opening a full service account always entails the customer's communication in writing of his or her investment objectives and tolerance for risk, as well as detailed disclosure of income, assets, education, employment, age, marital status, dependents, and prior investment experience.¹⁴⁷ Based on this information, the full service broker-dealer will approve the account for certain kinds of trading or investment in certain kinds of securities. For example, an account as to which a middle-income wage earner has specified "growth" may be approved for purchase of exchange-traded equities, but not for trading on margin, in options, or in OTC securities. Similarly, an account as to which an owner retired on a fixed income has specified "preservation of capital" as the investment goal may be approved for low-risk securities, such as U.S. Treasury bonds and high-grade corporate bonds, and not for any equities at all. Thus, when a full service broker receives an unsolicited purchase order for a security, it is always already in possession of the information necessary to make a customer-specific judgment about the suitability of the security even though it did not recommend it.

Courts and commentators sometimes appeal to the distinction between general and specific agents to justify relieving full service brokers of their customer-specific suitability obligation with respect to unrecommended securities.¹⁴⁸ "A general agent is one authorized to conduct a series of

147. *E.g.*, MERRILL LYNCH, *CMA Account Application*, at <https://www.fs.ml.com/accounts/DirectEn/openaccountdirect.asp> (last visited Feb. 13, 2005); MORGAN STANLEY, *Individual Investor Account Application*, at <http://www.morganstanleyindividual.com/customerservice/contactme/default.asp?> (last visited Feb. 13, 2005); see Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1329 (2002) (observing that customers opening full service accounts typically disclose their financial status, investment objectives, risk tolerance, and prior investment experience).

148. *See, e.g.*, *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952–53 (E.D. Mich. 1978); *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107, 111–14 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972); David M. Minnick, *Breach*

transactions,” whereas a special agent is only “authorized to conduct a single transaction, or a series of transactions” that do not entail continuity of service.¹⁴⁹ A general agency endures continuously until terminated, whereas a special agency relationship is presumed to start and stop with each unrelated transaction.¹⁵⁰ Since the fiduciary duties owed by an agent depend on the duration as well as the scope of the agency, special agents do not owe continuous fiduciary duties to their principals.

The distinction between general and special agents is often used to argue that the broker-dealer’s fiduciary duties with respect to unrecommended transactions arise upon receipt of the unsolicited order and terminate upon the order’s fulfillment, thereby relieving the broker of any obligation to warn the customer of the unsuitability of the securities to be purchased by the order.¹⁵¹ The conclusion is something of a non sequitur, however; the characterization of a broker-dealer as a special agent with respect to unrecommended purchases goes to the commencement and the termination of the broker-dealer’s fiduciary duties, not to the substantive obligations implied by such duties when they are in effect. Even on the assumption that the broker-dealer has no obligation to collect information about a customer

of Fiduciary Duty in Securities Arbitration, 53 J. MO. B. 210, 211–12; Weiss, *supra* note 45, at 108–10.

149. Weiss, *supra* note 45, at 72.

150. *Id.* at 67.

151. *See, e.g., De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002):

It is uncontested that a broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis. The broker’s duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer’s investments.

Id.; *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 567 (9th Cir. 1985) (“Normally the agency relationship created by a non-discretionary account arises when the client places an order and terminates when the transaction ordered is complete. The stockbroker assumes no continuing obligation to advise his clients of information that affects their securities.”) (citation omitted); *Leib*, 461 F. Supp. at 952, 953 (referring to a nondiscretionary account, where “a stockbroker has a limited duty to serve his customer’s financial interest within the framework of a single transaction only,” and “the broker’s responsibility to his customer ceases when the transaction is complete”); *Robinson*, 337 F. Supp. at 111 (finding that the agency relationship between a broker-dealer and its customer with respect to a nondiscretionary account “commences when the order is placed and ends when the transaction is complete. . . . The affair entrusted to a broker who is to buy or sell through an exchange is to execute the order, not to discuss its wisdom”); *see also* Weiss, *supra* note 45, at 108–09 (“[A] broker acting only as a broker would be an agent for each separate trade without any interest beyond his commission. He would be obliged to execute his customer’s orders faithfully, but not to volunteer advice.”) (citations omitted).

account in between transactions—which is by no means clear¹⁵²—the broker-dealer is nonetheless obligated to act on the information when the special agency is in effect.¹⁵³ Even if a full service broker-dealer's agency obligation with respect to unrecommended transactions does not commence until the unsolicited order is received, once such an order is received and the special agency commences, the broker-dealer possesses all of the information required to judge the suitability of the purchase. In other words, in the conceptual space between receipt of an unsolicited purchase order and execution of such an order, a full service broker is possessed of information—the suitability or unsuitability of the unrecommended security—that is material to the agency relationship and of which the broker-dealer knows or should know that the customer would want to be informed. A broker-dealer should not be permitted to act as if it does not know customer-specific information that renders the unsolicited order unsuitable when, in fact, it does.¹⁵⁴ Thus, whether the full service broker is characterized as a general or a special agent, the common law duty to give material information imposes on the broker-dealer the duty to warn its customers of the unsuitability of any unsolicited order to purchase an unrecommended security.¹⁵⁵

The same analysis applies to discount brokers, the only difference being whether such broker-dealers are generally in possession of customer-specific information sufficient to judge the suitability of the unsolicited orders it receives. Usually they are.¹⁵⁶ Many discount firms require the same kinds of detailed disclosures required by full service firms, and most obtain sufficient information to enable a judgment about the suitability of

152. Industry practice among many full service and discount brokers is to monitor trading patterns in investment accounts for suitability. See Black & Gross, *supra* note 6, at 504–05; Engle & McCoy, *supra* note 147, at 1329; Unger, *supra* note 13, at *2; see, e.g., McCann, *supra* note 25, at E1 (reporting that claimant in *Lee v. First Securities Investment Corp.* received letter from discount broker inquiring whether her frequent trading was consistent with her investment objectives and her general intentions regarding her account).

153. See RESTATEMENT (THIRD) OF AGENCY, *supra* note 53, § 8.11 cmt. c (“[E]ven a relationship confined to a single transaction may impose a duty on the agent to furnish information to the principal.”).

154. See Root, *supra* note 77, at 330 n.131 (“A broker, informed of a customer's investment objectives and informed of the security's characteristics, has a duty to warn of any unsuitability of which it is aware. This flows either from the Rules of Fair Trade or principles of agency, or both.”) (citing RESTATEMENT (SECOND) OF AGENCY, *supra* note 55, § 381).

155. Weiss, *supra* note 45, at 67.

156. See Schulz, *supra* note 4, at *8 (observing that “[e]very customer who opens an Internet trading account is asked to provide information about his net worth, trading history, and investment goals,” and arguing that firms are required to do this “so that firms can fulfill a suitability duty”).

unrecommended purchases by their customers.¹⁵⁷ In addition, many discounters monitor customer suitability and trading patterns for their own purposes, such as preventing customer defaults in settling transactions, and reducing exposure on suitability grounds.¹⁵⁸

2. Unrecommended Securities Lacking Reasonable-Basis Suitability

Since reasonable-basis suitability is a judgment about the general soundness of a security, and not its appropriateness for any particular customer, it requires knowledge of the characteristics of the security and the business and finances of the issuer, rather than any customer-specific information. Most broker-dealers do not track securities that lack reasonable-basis suitability, and it would be both expensive and unfair to require them to do so in order to provide suitability warnings on unrecommended transactions. Conceptually, this tracking would require investigation of literally every security in the world, a clearly impossible task.

Nevertheless, there are several kinds of reasonable-basis suitability warnings that would reasonably fall within the duty to give information. Many securities lack reasonable-basis suitability on their face; these fall into the well-known fraud category, "If it sounds too good to be true, it is." A broker-dealer need not do any investigation at all to recognize the reasonable-basis unsuitability of, say, a debt security that offers twenty-five

157. The discount industry practice varies. For example, the largest American discount firm, Charles Schwab & Co., asks new customers to indicate their age, marital status, number of dependents, "investment knowledge" and "investment experience" (none, limited, good, extensive), federal income tax bracket, annual income, and liquid net worth, and to characterize the "overall investment objective of account" (capital preservation, income, growth, speculation). It then goes on to ask detailed questions about the customer's preferred approach to managing investments, ownership of or interest in various types of securities and retirement assets, the number of trades the customer have made during the past year, and the percent of the customer's "investable assets" expected to be held in the Schwab account. See CHARLES SCHWAB & CO., *Schwab One Account Application*, at http://q1.schwab.com/pdfs/schwab_one_app_with_margin.pdf (last visited Feb. 13, 2005). Online discounter Ameritrade requires less information, but still asks for marital status, date of birth, employment status, employer and occupation, income, net worth, and liquid net worth. See AMERITRADE, *Account Application*, at <https://www.ameritrade.com/cgi-bin/apps/IndividualApServlet> (last visited Feb. 4, 2005). However, online deep-discounter TD Waterhouse, the country's second-largest discount firm, asks for only date of birth, and employer and occupation, plus preferences with respect to margin, options, and day-trading. See TD WATERHOUSE, *Account Application*, at <https://www2.tdwaterhouse.com/oao-web/apps/BBE8A585-C86C-4F5A-BDB2-B4343DFC47FA/public/leadCapture.jsp?PlatformType=A> (last visited Feb. 13, 2005).

158. See note 152 *supra*.

percent annual interest on purportedly secured principal, or publicly traded shares of a shell corporation with no income, assets, or operations. The licensing and training procedures to which all broker-dealers and their registered representatives are subject include education in such facially unsuitable securities.

B. Unrecommended Purchases and the Agent's Duty of Loyalty

The broker-dealer's duty to warn a customer that an unrecommended purchase is unsuitable is strengthened by the fact that broker-dealers face a conflict of interest with respect to such customer purchases. Since broker-dealers are generally compensated by commissions payable on a per-transaction basis, customers who trade frequently generate more revenue for broker-dealers than those who buy and hold their investments. As a result, broker-dealers who execute unsolicited orders for unrecommended securities which they know are unsuitable for the customer are subject to a conflict of interest between their duty to give material information to the customer about the agency relationship, which may result in cancellation of the order and loss of revenue, and their duty of loyalty to the customer, which requires them as fiduciaries to act in the customer's best interests.¹⁵⁹ With respect to an unrecommended purchase, in other words, broker-dealers will often know both that the purchase is not suitable for the customer, and that a warning of unsuitability is likely to deter the customer from the purchase, thereby eliminating the commission income that the broker-dealer would otherwise earn from executing the order. Broker-dealers are thus subject to a genuine conflict of interest when they execute an unsolicited trade for a customer in an unrecommended security which they know to be unsuitable for the customer.¹⁶⁰ Dean Mundheim suggested that this conflict

159. See, e.g., Fishman, *supra* note 83, 246-47 ("[N]otwithstanding the industry's long promotion of an image of professionalism, the primary emphasis of the securities business is on selling securities. In reality, registered representatives are salesmen, and clients are customers.") (citations omitted); Mundheim, *supra* note 11, at 447 (noting "the conflict [in the broker-customer relationship] between the desire for professionalism and the demands of a business the primary purpose of which is the sale of securities"); Rediker, *supra* note 100, at 15 (observing that "the demands of operating a profitable business may easily conflict with the broker-dealer's 'professional' duty to place his customers' interests above his own"); Vickers & Weiss, *supra* note 6, at 7 (explaining that in the past, "[i]nvestor-relations departments used to handle routine shareholder requests and dealings with analysts, [but 'n]ow, investment-relations people are supposed to dress their stock up and sell it—like it's a washing machine or a pizza") (quoting Matthew J. Greco, editor of *Investor Relations Business*).

160. E.g., RESTATEMENT (THIRD) OF AGENCY, *supra* note 53, § 8.11 cmt. d (detailing examples in which agent is bound to provide information even when doing so would jeopardize the agent's interest in the transaction, including loss of commissions); *id.* ("When an agent has

of interest is the principal source of broker-dealer hostility to the suitability obligation in general, and to application of the obligation to unrecommended purchase orders in particular.¹⁶¹

The conflict of interest between a broker-dealer's duty to provide information and its duty to act in the customer's interests should be waivable. Broker-dealers are, after all, entitled to be compensated for the services they provide. But such waivers should be effective only after full disclosure of the conflict, which must include disclosure of the unsuitability of the transaction which generates the conflict.¹⁶²

C. The Role of Customer Sophistication

Customer sophistication is a well established means of protecting customers under the securities laws. Under the 1933 Act, for example, an offering of securities is exempt from the Act's onerous filing and registration requirements if the securities are not offered or sold to the public.¹⁶³ The Supreme Court has held that the applicability of this exemption "should turn on whether the particular class of persons affected need the protection of the [1933] Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"¹⁶⁴ "Fending for oneself" in a securities transaction refers to the power and ability of an investor to obtain, understand, and evaluate information about the issuer and the securities being issued.¹⁶⁵ The Commission has taken the position that individual purchasers of privately offered securities must have either (1) investment knowledge and experience sufficient to enable such purchasers to evaluate the merits and

an interest in a matter that diverges from the principal's interest, the likelihood that the agent will fulfill the duty to furnish material information to the principal may be lessened if the agent's [sic] believes that furnishing the information may jeopardize achieving the agent's divergent interest."); see Fishman, *supra* note 83, at 247; see also Root, *supra* note 77, at 298–99 (observing that the "essential problems in the suitability area" stem from the fact that "[a]ccount executives in the trading departments of most brokerage houses stand in a classic conflict of interest position with respect to their customers") (quoting O'Hara, *The Elusive Concept of Control in Churning Claims under the Federal Securities and Commodities Law*, 21 SECS. L. REV. 281 (1981)).

161. See Mundheim, *supra* note 11, at 477.

162. Cf. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng*, 901 F.2d 1124, 1128 (D.C. Cir. 1990) (noting that an agent's duty to disclosed relevant information to the principle "is enhanced where . . . the agent has developed an interest inconsistent with that of the principal").

163. Securities Act of 1933 § 4(2) [hereinafter 1933 Act] (exempting from registration "transactions by an issuer not involving any public offering").

164. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (quoting 1933 Act, § 4(2)).

165. See *id.* at 125.

risks of investing in the securities; or (2) income or assets sufficient to enable them to bear the financial risk of loss of an investment in the securities.¹⁶⁶ Moreover, discount and full service broker-dealers are already subject to special customer qualification and disclosure requirements with respect to day-trading,¹⁶⁷ margin trading,¹⁶⁸ options trading,¹⁶⁹ and trading in so-called “micro-cap” or “penny” stocks.¹⁷⁰

I am not suggesting that investors in ordinary equities be required to show the kind of experience, sophistication, and wealth that is now required

166. *E.g.*, 1933 Act Rule 501(a), 17 C.F.R. § 230.501(a) (West 2005) (defining “accredited investor” as, *inter alia*, a person with a net worth of \$1 million or with income exceeding \$200,000 during each of the last two years); *id.* Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (West 2005) (restricting the number of purchasers (other than accredited investors) in a nonpublic offering to thirty-five persons who have “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment”).

167. *See, e.g.*, NASD Manual, *supra* note 12, Conduct Rule 2360(b) (requiring that brokers who open a day-trading account “have reasonable grounds for believing that the day-trading strategy is appropriate for the customer,” and “exercise reasonable diligence to ascertain the essential facts relative to the customer,” including his or her financial situation, tax status, prior investment and trading experience, and investment objectives); *id.* Conduct Rule 2361(a) (requiring that broker-dealers disclose the risks of day-trading to customers intending to use their accounts to engage in day-trading strategies).

168. *See* 1934 Act Rule 15c2-5, 17 C.F.R. § 240.15c2-5 (West 2005) (requiring that, with respect to any application for a margin trading account, the broker-dealer (1) deliver written disclosure “setting forth the exact nature and extent of” the customer’s obligations on margin loans, the “risks and disadvantages” of margin trading, and all related charges and commissions; and (2) “[o]btains from [the customer] information concerning his financial situation and needs, [and] reasonably determines that the entire transaction, including the [margin] loan arrangement, is suitable for such person”).

169. *See, e.g.*, Chicago Board Options Exchange Rule 9.7(a), (f) (requiring that broker-dealers ascertain the suitability of customers for uncovered options trading, and requiring further that broker-dealers develop specific criteria for approval of uncovered options trading accounts), *available at* <http://cchwallstreet.com/ChicagoBoardOptionsExchangeCBOE/CBOERules/CBOERules—ChaptersI-XXVII/CHAPTERIXDoingBusinesswiththePublicRules9.1-9.25/163200013E.asp>; *id.*, Rule 9.15(a) (requiring that any customer approved for uncovered options trading receive a disclosure document and prospectus containing the “special written description of the risks inherent in writing uncovered short option transactions” mandated by Rule 9.7(f)(5)) (quoting Rule 9.7(f)(5)), *available at* <http://cchwallstreet.com/ChicagoBoardOptionsExchangeCBOE/CBOERules/CBOERules—ChaptersI-XXVII/CHAPTERIXDoingBusinesswiththePublicRules9.1-9.25/163200013E.asp>.

170. *See* 1934 Act Rule 15g-2, 17 C.F.R. § 240.15g-2 (West 2005) (requiring written disclosure of risks of trading penny stocks as set forth by the Commission in Schedule 15(g)); 1934 Act Rule 15g-9(b), 17 C.F.R. § 240.15g-9(b) (West 2005) (requiring that a broker obtain as condition precedent to approval of an account for penny stock trading (1) “information concerning the person’s financial situation, investment experience, and investment objectives”; and (2) “[r]easonably determine, based on [such information], that transactions in penny stocks are suitable for [that] person”).

of investors in private offerings;¹⁷¹ this would effectively close off the equity markets to most middle- and working-class Americans. Rather, I am arguing that broker-dealers who execute purchase orders for unrecommended securities on behalf of unsophisticated investors be required to warn such investors when they know or should know that the securities such investors propose to purchase are not suitable, given their investment goals, tolerance for risk, and financial situation.¹⁷² Broker-dealers who wish to relieve themselves of the duty to warn of unsuitability, however, may do so by qualifying their customers for investment sophistication.

It is neither difficult nor expensive for broker-dealers to undertake the suitability review and disclosure required by a duty to warn of unsuitability. Suitability review software that analyzes whether a specific trade is appropriate for a particular customer already exists.¹⁷³ Indeed, some industry representatives believe that computer technology makes suitability review easier, more reliable, and less expensive in the online context than in the face-to-face context.¹⁷⁴ Such software enables broker-dealers comprehensively to track customer trades and to compare them against the customer's declared investment goals, income, and net worth, as well as against the configuration of securities that already appear in the customer's portfolio. Broker-dealers can construct their order execution websites so that a pop-up warning appears whenever an online customer attempts to purchase an unrecommended security that is not suitable for his or her

171. Cf. Barnett, *supra* note 1, at 1121 (“[R]egulators should require suitability checks for unsophisticated customers entering trades online. A suitability check or suitability review is when an online broker monitors the trades customers place online and stops the execution of any trades that are unsuitable for a customer’s financial situation.”) (citations omitted).

172. See *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 750 (Ct. App. 1989).

[W]here an apparently unsophisticated investor expresses a desire to engage in speculative investments with the objective of making large profits, the stockbroker cannot simply carry out the customer’s wishes. Rather, the stockbroker has a *fiduciary duty* (1) to ascertain that the investor understands the investment risks in light of his or her *actual* financial situation; (2) to inform the customer that *no* speculative investments are suitable if the customer persists in wanting to engage in such speculative transactions without the stockbroker’s being persuaded that the customer is able to bear the financial risks involved; and (3) to refrain completely from *soliciting* the customer’s purchase of any speculative securities which the stockbroker considers beyond the customer’s risk threshold.

Id. (emphasis in original) (summarizing the holding of *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222 (Ct. App. 1968)). But see Black & Gross, *supra* note 6, at 499–504 (arguing that there is little support in the case law and literature for a broker-dealer duty to warn unsophisticated investors of unsuitable trades).

173. See Barnett, *supra* note 1, at 1122; Engel & McCoy, *supra* note 147, at 1329.

174. Barnett, *supra* note 1, at 1122–23.

financial situation. Pop-up warnings could easily be linked to more comprehensive explanations of the warning triggered, and to a default suggestion to contact a registered representative if further questions remain. For example, an unsophisticated discount investor with preservation-of-capital goals who attempts to purchase speculative securities would receive an initial pop-up warning that the securities he or she proposes to purchase are highly volatile and entail a risk of loss of the entire investment; more detailed information explaining the terms of the warning could be linked to the warning itself, along with contact information if the investor wishes to speak with an account representative.

Of course, it would always be open to broker-dealers to relieve themselves altogether of their suitability obligations with respect to unrecommended purchase orders by qualifying account holders as sophisticated investors—that is, as possessing a basic understanding of the information about securities markets and investing on which suitability judgments are made, particularly the effect that risk plays in the pricing of securities, and the role played by portfolio diversification in reducing risk. As in other areas of the securities laws, sophisticated investors—who by definition are able to fend for themselves—may be left to their own devices in choosing investments. It is the unsophisticated investor who poses a danger to his or her own well-being, as well as that of the securities markets, and who thus requires the protection of the suitability warning for unrecommended purchases.

D. Paternalism, Investor Protection, and Contracting Out of the Duty To Warn

The most obvious argument against a broker-dealer duty to warn of unsuitability is anti-paternalism. The duty to warn, in essence, prevents otherwise competent investors from waiving the protection of the suitability requirement. The impossibility of waiving the duty to warn thus departs from the agency law in which the duty is rooted, which has long permitted principals and agents to agree to narrow or to eliminate altogether the agent's duty to communicate to the principal information relevant to the agency relationship.¹⁷⁵

175. See RESTATEMENT (SECOND) OF AGENCY, *supra* note 44, § 381 (providing that the agent is subject to the duty to disclose relevant information to the principal, “[u]nless otherwise agreed”); RESTATEMENT (FIRST) OF AGENCY, § 381 (1933) (same). The progressive drafts of the *Restatement (Third) of Agency* included the same language until the most recent draft, which eliminated the express provision for contrary agreement while continuing to imply that contractual waiver of the duty to disclose relevant information is possible. See RESTATEMENT

This argument ignores that the securities laws are rooted in paternalism. From their inception, the securities laws were oriented towards the protection of public investors from misrepresentations, market manipulation, high pressure sales tactics, and other unfair and inequitable practices by corporate insiders and market professionals.¹⁷⁶ The factual premises of securities regulation include the facts that securities and securities markets are sufficiently complex, and information about their operation sufficiently asymmetric, that government regulation to protect public investors, including restrictions on investor choice, is fully justified.¹⁷⁷ In this, the paternalistic profile of the securities laws mirrors that of other consumer-protection laws regulating the sale of "intricate merchandise,"¹⁷⁸ such as cash-value life insurance and sub-prime mortgage loans.¹⁷⁹

The paternalism of the securities laws is also reflected in anti-waiver provisions contained in both the 1933 and 1934 Acts.¹⁸⁰ Recognizing that the investor protection goals of the Acts would be easily frustrated by contractual waiver provisions, especially as to unsophisticated public investors who lack power to renegotiate the provisions of the form contracts typically used to formalize the broker-dealer/customer relationship, Congress provided that contractual waivers of rights under the Acts are

(THIRD) OF AGENCY, *supra* note 52, § 8.11 (stating unqualifiedly that "[a]n agent has a duty to use reasonable effort to provide the principal with facts that the agent knows, has reason to know, or should know"), *with* cmt. b (suggesting that the agent is relieved of liability when the principal manifests a "lack of interest in receiving some or all information from the agent").

176. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 27–30 (Aspen Law & Business 3d ed. 1998); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1133–35.

177. See Robert Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337, 351:

[T]he Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers.

Id. (quoting *Wilko v. Swan*, 346 U.S. 427, 435 (1953)).

178. *Cf. Mundheim*, *supra* note 11, at 450 (observing that the broker-dealer industry has encouraged the public to rely on its "superior skill" in transactions involving "such intricate merchandise as securities").

179. See *Engel & McCoy*, *supra* note 147, at 1317–37 (comparing suitability requirements in the securities, insurance, and sub-prime mortgage lending markets).

180. 1933 Act, § 14 ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."); 1934 Act, § 29(a) (same with respect to the 1934 Act and rules, and regulations thereunder).

void, and courts have generally ruled that contractual waiver, merger, no-reliance, and other clauses restricting rights and remedies under the securities laws are unenforceable.¹⁸¹

The antiwaiver provisions of the securities laws properly cast doubt on the power of broker-dealers to negotiate away the duty to warn. As an aspect of the just and equitable treatment of customers mandated by the 1934 Act under the shingle theory, the duty to warn against unsuitability in unrecommended purchases of securities is subject to this statutory prohibition against waivers. Any agreements between broker-dealers and their unsophisticated customers relieving broker-dealers of the duty to warn of unsuitable transactions should thus be treated as unenforceable.

E. A Duty To Rescue?

I have argued that broker-dealers have a duty to warn their unsophisticated customers when such customers propose to engage in unsuitable transactions. While it is reasonable to expect that many unsophisticated investors will be deterred from unwise trading by suitability warnings, it is unrealistic to expect that warnings will deter all such investors from purchasing unsuitable securities. Even scrupulous enforcement of the duty to warn will not keep all unsophisticated investors from entering into unsuitable transactions; to the contrary, it is likely that a significant number of unsophisticated customers will insist on broker-dealer execution of unsuitable transactions even after being clearly and unmistakably warned of their unsuitability.

The question arises, then, whether the broker-dealer must refuse to execute an unsuitable order for an unsophisticated investor, even after properly warning the customer of unsuitability. In other words, does the broker-dealer have a duty to *rescue* its unsophisticated customer from unsuitable transactions, or is its duty merely to *warn* of unsuitability? There is scant support for the proposition that a broker-dealer has an obligation to stop a customer from financially destructive trading practices or patterns.¹⁸² A duty to rescue would come perilously close to the anachronistic merit regulation that still animates some state securities statutes, under which a regulatory body determines whether an issue of securities is simply too risky and speculative for state residents to purchase, regardless of their wealth or sophistication. By contrast, the federal securities laws reject merit regulation outright, and have long been premised on the disclosure of

181. See Prentice, *supra* note 177, at 350–52.

182. Black & Gross, *supra* note 6, at 505–06.

material facts relating to securities, rather than their intrinsic financial merit.¹⁸³ Despite occasional suggestions to the contrary, “protecting a customer from his or her own greed” is fundamentally at odds with the disclosure orientation of the federal securities laws. Allowing a broker-dealer to execute an unsuitable customer order after the customer has been properly advised of such unsuitability is consistent with the disclosure orientation of the federal securities laws, and generally ought to be permitted. In other words, a broker-dealer should generally not be legally required to refuse to execute unsuitable transactions when, after being warned of unsuitability, a customer insists that the order be executed anyway.¹⁸⁴

In a small number of cases, irrational trading may be evidence of diminished capacity sufficient to enable a customer to avoid otherwise enforceable contracts.¹⁸⁵ Accordingly, an important exception to the general absence of any broker-dealer duty to rescue clients who insist on engaging in unsuitable transactions is triggered by diminished customer capacity. This provision is obvious with respect to minors, those suffering from classic mental disabilities, and those temporarily incapacitated by alcohol or drugs. Whether broker-dealers would have a duty to rescue because of a customer’s diminished capacity caused by Internet addiction or risk or gambling compulsion would likely become an important issue with respect to the duty to warn.

183. See 1 LOSS & SELIGMAN, *supra* note 176, at 169–222 (describing the intense debate between advocates of merit regulation and those of disclosure regulation that surrounded the drafting and enactment of the 1933 Act).

184. Cf. Black & Gross, *supra* note 6, at 499, 508 (considering, but ultimately rejecting, the proposition that a broker-dealer may have an obligation to protect its customers from “economic suicide,” by refusing to “execute transactions that, in his professional judgment, are too risky for the customer”).

Brokers should be more professional, competent and ethical. They are not strictly liable, however, for an investor’s ‘fiscal hari-kari.’ It would indeed be ‘outrageous’ to impose a duty to rescue and ‘save’ a self-directed trader—even a compulsive gambler—from himself. Ultimately, brokers’ ethical responsibilities to aid their customers in making sound investment decisions should not transcend the law and transform into a legal duty to stop the customer from engaging in economic suicide.

Id. at 526–27 (citations and quotations omitted).

185. See *id.* at 506–07 (suggesting that irrational trading may be evidence that the customer suffers from an “addictive personality,” and thus lacks the “requisite mental capacity to enter into contracts”); see also *supra* notes 123–124 and accompanying text.

IV. CONCLUSION

Many people may depend financially on a customer besides himself or herself, and are financially harmed by the customer's unsuitable trading. In an era in which the social safety net is being stretched thinner and thinner—particularly in case of retirement benefits—the government has a legitimate interest in preventing excessive, “last-resort” dependence on government services and benefits. Therefore, a general broker-dealer duty to warn customers of the unsuitability of unrecommended securities purchases that they propose to make, and a limited broker-dealer duty to rescue from such purchases customers who suffer from diminished capacity, are not only the consequence of the well-established fiduciary duties imposed by agency and securities law, but sound public policy.