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Implied Civil Liability Arising from Violation of the Rules of the National Association of Securities Dealers

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IMPLIED CIVIL LIABILITY ARISING FROM VIOLATION OF THE RULES OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS

The Securities Exchange Act of 1934[1] (the Act) was enacted by Congress in order "to protect the public and investors against malpractice in the securities and financial markets."[2] Its provisions were designed to eliminate undesirable practices in the trading of securities, to restore confidence in securities markets, and to protect the investing public.[3] As originally enacted, these purposes were to be achieved by imposing upon the Securities and Exchange Commission the responsibility of regulating the activities of broker-dealers who dealt in the over-the-counter markets and by charging various stock exchanges with the responsibility of regulating their members.[4]

When the task of direct regulation of all broker-dealers trading in the over-the-counter markets proved to be too burdensome for the SEC,[5] Congress responded by amending the Act in 1938.[6] The amendments provided that voluntary securities associations, comprised of broker-dealers who dealt in the over-the-counter markets, should be formed to carry the primary responsibility for regulating the activities of any broker-dealer who chose to associate with any such securities association.[7] Each association would be required to register with the

1. 15 U.S.C. § 78a *et seq.* (1970). See generally 2 CCH FED. SEC. L. REP. ¶¶ 20,001-26,992; E. GADSBY, THE FEDERAL EXCHANGE ACT OF 1934 (1966); W. MARTIN, THE SECURITIES MARKETS; A REPORT, WITH RECOMMENDATIONS (1971); E. MCCORMICK, UNDERSTANDING THE SECURITIES ACTS AND THE S.E.C. (1948); C. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 ANALYZED AND EXPLAINED (1934).

2. 2 U.S. CODE CONG. & AD. NEWS, 88th Cong., 2d Sess. 3016 (1964) [hereinafter cited as CONG. NEWS].

3. *Id.*

4. SPECIAL STUDY OF SECURITY MARKETS, REPORT OF THE SPECIAL STUDY OF SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 2, at 541 (1963) [hereinafter cited as SPECIAL STUDY].

5. *Id.* pt. 4, at 604.

6. Act of June 25, 1938, ch. 677, 52 Stat. 1070, *as amended*, 15 U.S.C. § 78o-3 (1970). For legislative history of these amendments, see S. REP. No. 1455 and H.R. REP. No. 2307, 75th Cong., 3d Sess. (1938).

7. *See* S. REP. No. 379, 88th Cong., 1st Sess. 14-15 (1963). *See generally* MacLean, *Broker's Liability for Violation of Exchange and NASD Rules*, 47 DENVER L.J. 63, 75 (1970) [hereinafter cited as MacLean]; Rediker, *Civil Liability of Broker-Dealers Under*

SEC, to organize in a prescribed manner, to adopt rules designed to meet certain standards, and to agree to discipline members who violate its rules.[8]

This self-regulatory scheme operated substantially without change until 1964.[9] The Act was then amended to allow the SEC to regulate broker-dealers who were neither members of a stock exchange nor members of the only voluntary association of securities dealers to be registered with the SEC, the National Association of Securities Dealers, Inc. (the NASD).[10] The purpose of this change was to preserve the voluntary nature of the NASD and, at the same time, to insure that all broker-dealers were subject to similar regulation.[11]

Furthermore, the SEC's power was expanded in response to a need for closer regulation of the NASD and its members.[12] It was given new administrative powers to censure, bar, or suspend an individual employee of a broker-dealer rather than just the firm itself.[13] The

SEC and NASD Suitability Rules, 22 ALA. L. REV. 15, 15-19 (1969) [hereinafter cited as Rediker].

8. Act of June 25, 1938, ch. 677, 52 Stat. 1070, *as amended*, 15 U.S.C. § 78o-3 (1970).

9. 2 CCH FED. SEC. L. REP. ¶ 25,592, at 18,576 (1972); SPECIAL STUDY, *supra* note 4, pt. 4, at 604-608; MacLean, *supra* note 7, at 65 n.13.

10. Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565, 570, 15 U.S.C. § 78o (b)(10) (1970). The SEC's jurisdiction over broker-dealers who are neither members of the NASD nor a stock exchange has been called "SECO" (*i.e.*, SEC regulated only). Thus the rules adopted by the SEC pursuant to this section have been referred to as the SECO rules.

11. Section 15(b)(10) (15 U.S.C. § 78o(b)(10) (1970)) is based in large part upon the requirements imposed upon a securities association by section 15A(b)(8) (15 U.S.C. § 78o-3(b)(8) (1970)) of the Exchange Act with respect to its membership and is necessary to insure that those brokers and dealers who choose not to belong to an association will be subject to regulation in those areas by the Commission. H.R. REP. NO. 1418, 88th Cong., 2d Sess. 24 (1964).

12. *See, e.g.*, SPECIAL STUDY, *supra* note 4, pt. 1, at 330 (recommendation 7).

13. Section 15(b)(7)-(10), 15 U.S.C. § 78o(b)(7)-(10) (1970). These sections provide:

> (7) The Commission may, after appropriate notice and opportunity for hearing, by order censure any person, or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer, if the Commission finds that such censure, barring, or suspension is in the public interest and that such person has committed or omitted any act or omission enumerated in clause (A), (D) or (E) of paragraph (5) of this subsection or has been convicted of any offense specified in clause (B) of said paragraph (5) within ten years of the commencement of the proceedings under this paragraph or is enjoined from any action, conduct, or practice specified in clause (C) of said paragraph (5). It shall be unlawful for any person as to whom such an order barring or suspending him from being associated with a broker or dealer is in effect, willfully to become, or to be, associated with a broker or dealer, without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him, without the consent of the Commission,

1964 Amendments further granted the SEC broader powers to alter or supplement NASD rules relating to organization, discipline, and eligibility for membership,[14] and the power to review and to set aside any actions by the NASD.[15]

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if such broker or dealer knew, or in the exercise of reasonable care, should have known, of such order.

(8) No broker or dealer registered under this section [section 15] shall, during any period when it is not a member of a securities association registered with the Commission under section 78o-3 [section 15A] of this title, effect any transaction in, or induce the purchase or sale of, any security (otherwise than on a national securities exchange) unless such broker or dealer and all natural persons associated with such broker or dealer meet such specified and appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable. The Commission shall establish such standards by rules and regulations, which may—

(A) appropriately classify brokers and dealers and persons associated with brokers and dealers (taking into account relevant matters, including types of business done and nature of securities sold).

(B) specify that all or any portion of such standards shall be applicable to any such class.

(C) require persons in any such class to pass examinations prescribed in accordance with such rules and regulations.

(D) provide that persons in any such class other than a broker or a dealer and partners, officers, and supervisory employees (which latter term may be defined by the Commission's rules and regulations and as so defined shall include branch managers of brokers or dealers) of brokers or dealers, may be qualified solely on the basis of compliance with such specified standards of training and such other qualifications as the Commission finds appropriate.

The Commission may prescribe by rules and regulations reasonable fees and charges to defray its costs in carrying out this paragraph, including, but not limited to, fees for any examination administered by it, or under its direction. The Commission may cooperate with securities associations registered under section 15A of this title and with national securities exchanges in administering examinations and may require brokers and dealers subject to this paragraph and persons associated with such brokers and dealers to pass examinations administered by or on behalf of any such association or exchange and to pay to such association or exchange reasonable fees or charges to defray the costs incurred by such association or exchange in administering such examinations.

(9) In addition to the fees and charges authorized by paragraph (8), each broker or dealer registered under this section [section 15] not a member of a securities association registered pursuant to section 78o-3 [section 15A] of this title shall pay to the Commission such reasonable fees and charges as may be necessary to defray the costs of additional regulatory duties required to be performed by the Commission because such broker or dealer is not a member of such a securities association. The Commission shall establish such fees and charges by rules and regulations.

(10) No broker or dealer subject to paragraph (8) of this subsection shall effect any transaction in, or induce the purchase or sale of, any security (otherwise than on a national securities exchange) in contravention of such rules and regulations as the Commission may prescribe designed to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market.

See Rediker, *supra* note 7, at 22-23, where it is concluded that the adoption of this amendment evinces a congressional intent to grant the SEC a voice at least equal to that of the NASD's in the formulation and application of ethical standards of conduct for broker-dealers.

14. Section 15A(j), 15 U.S.C. § 78o-3(k) (1970).

15. Section 15A(g) & (h), 15 U.S.C. § 78o-3(g) & (h) (1970).

Concomitant with the congressional trend of increased regulation of broker-dealers to make more effective the purposes of the Act is the judicial trend to grant additional rights of recovery to the public investor for breaches of the dictates of the Act and the rules promulgated thereunder. Although the Act fails specifically to grant a private cause of action to recover damages incurred when a person violates certain sections of the Act, the courts generally have not been hesitant to find that one does exist by implication.[16] In allowing an implied cause of action for violation of the proxy rules, the Supreme Court stated in its landmark opinion, *J.I. Case Co. v. Borak*,[17] that:

> While this language [section 14 of the Act] makes no specific reference to a private right of action, among its chief purposes is "the protection of investors," which certainly implies the availability of judicial relief where necessary to achieve that result.
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> . . . .
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> We, therefore, believe that under the circumstances here it is the *duty* of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.[18]

Judicial recognition of an implied civil remedy where necessary for the protection of public investors, coupled with the 1964 amendments which expanded effective control over the securities industry, raises an interesting question: Should a private right of action also exist for violation of the rules promulgated by the NASD[19] pursuant to the authority granted in section 15A(b)(8)[20] of the Act?

16. J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (granting a private cause of action to those injured by one who violated the requirements of section 14 of the Act); Tunstall v. Brotherhood of Locomotive Firemen & Engineermen, 323 U.S. 210, 213 (1944) (implied cause of action for brotherhood's violation of Railway Labor Act); Baird v. Franklin, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) (granting a private remedy against a stock exchange for failure to discipline its members as required by section 6(b) of the Act); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (implying a civil remedy for violation of section 10(b) and rule 10b-5 promulgated thereunder).

17. 377 U.S. 426 (1964). See generally Note, *Violation of Proxy Rules: Private Right of Action*, 50 CORNELL L.Q. 370 (1965); Note, *Civil Liability and Appropriate Remedies Under Section 14(a) of the Securities Exchange Act of 1934*, 59 NW. U.L. REV. 809 (1965); Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak*, 12 U.C.L.A.L. REV. 1150 (1965); 64 COLUM. L. REV. 1336 (1964); 78 HARV. L. REV. 296 (1964).

18. 377 U.S. at 432-33 (emphasis added).

19. CCH NASD MANUAL ¶¶ 2151-78 [hereinafter cited as MANUAL].

20. 15 U.S.C. § 78o-3(b)(8) (1970) provides:

> An applicant association shall not be registered as a national securities association unless it appears to the Commission that the rules of the association are

This Comment will argue that a broker-dealer should be subjected to liability for losses proximately caused by his negligent or fraudulent violations of a specific rule of the NASD enacted for the purpose of investor protection. Such a remedy would be consistent with the Act's purpose of protecting the investing public, with the congressional intent to provide effective enforcement of the provisions of the Act, and with the judicial resolve to make effective the purposes of congressional enactments.

1. NASD: THE NEED FOR EFFECTIVE ENFORCEMENT

Under present practice, the remedy of an investor who is harmed by a member firm's violation of NASD rules is to file a written complaint with one of the NASD's District Business Conduct Committees.[21] A copy of these allegations is forwarded to the member firm and the latter is given an opportunity to file a written reply.[22] Either party, or the committee itself, may request a hearing.[23] After due deliberations, the district committee is empowered to render a decision and affix a penalty.[24] These decisions may be appealed to the NASD's Board of Governors[25] and ultimately to the SEC.[26] While this procedure appears adequate to protect the public investor, there is one crucial omission. All of the permissible penalties—censure, fine, suspension, expulsion, revocation—while sufficient to punish the member firm or the individual broker, make no provision for awarding damages to the aggrieved investor.[27] As the *Report of Special Study of Securities Markets of the Securities and Exchange Commission* has emphasized:

> [A]lthough NASD staff and committee officials may offer a degree of assistance in the preparation of formal complaints and prosecution of the case, the responsibility for proceeding and carrying the case forward

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits, or unreasonable rates of commissions or other charges and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

21. NASD Code of Procedure § 4, MANUAL, *supra* note 19, ¶3004.

22. NASD Code of Procedure §§ 6-7, MANUAL, *supra* note 19, ¶3006.

23. NASD Code of Procedure § 8, MANUAL, *supra* note 19, ¶3008.

24. NASD Code of Procedure § 11, MANUAL, *supra* note 19, ¶3011.

25. NASD Code of Procedure § 15(a), MANUAL, *supra* note 19, ¶3014.

26. NASD Code of Procedure § 20, MANUAL, *supra* note 19, ¶3019.

27. Rule 1 of Article V of NASD Rules of Fair Practice, MANUAL, *supra* note 19, ¶2301.

> lies largely with the public complainant. Many potential complainants are unquestionably discouraged from going forward by the burdens involved in assuming that role, especially since this procedure will not result in restitution or other benefit to the complainant.[28]

With the public reluctant to utilize this form of private complaint, it seems clear that many abusive practices are not brought to the attention of the regulatory agency or association and, hence, go unpunished.[29] The SEC and NASD cannot possibly maintain adequate supervision of all the numerous transactions in which broker-dealers engage.[30] The *Borak* Court specifically cited this as a basis for implying a civil remedy for violations of the proxy rules: inability of the SEC to investigate adequately all of the statements made in the many proxy statements filed with the SEC each year.[31]

The *Borak* Court felt that, if an injured shareholder could secure reimbursement of losses which were caused by a false or misleading proxy statement, the shareholder would be more apt to police its accuracy.[32] With public awareness stimulated, those drafting proxy statements would tend to exercise a greater degree of care to insure accurate disclosures; hence, the congressional purpose of meaningful disclosures would be enhanced and strengthened.[33]

The congressional intent to regulate broker-dealer conduct in the over-the-counter markets would be equally strengthened and enhanced with the creation of a civil remedy to compensate injured investors. With the increased liability for violation of a rule and with the increased chance of a violation being reported to either the SEC or NASD, a broker-dealer may be less likely to engage in conduct which he knows, or should know, contravenes the rules of the NASD.

According to *Borak*, however, adequacy of existing remedies is only one test to be met before a civil remedy will be implied by the courts. Congressional intent in granting the enabling power to promulgate

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28. SPECIAL STUDY, *supra* note 4, pt. 4, at 664.

29. *Id.* pt. 1, at 328; Rediker, *supra* note 7, at 39. The *Special Study* frequently notes that many abusive practices go unpunished. "The adequacy of the substantive rules which delineate legal and ethical standards of selling in the industry are not always matched either by the techniques available to detect violations or the enforcement action applied after detection." SPECIAL STUDY, *supra* note 4, pt. 1, at 328.

30. During 1973, there were 4,053,200,000 transactions in the National Over-the-Counter securities market. THE DOW JONES INVESTORS HANDBOOK 67 (1974).

31. 377 U.S. at 432-33.

32. *Id.* at 432.

33. *Id.*

rules governing broker-dealer conduct must also be considered.[34] The congressional intent in *Borak* which justified implication of a private cause of action was the intention of Congress to protect the public. It can be argued that the same purpose motivated Congress in enacting section 15A of the Act. Section 15A(b)(8) of the Act provides, in part, that the rules of the association must be designed "to protect investors and the public interest,"[35] and Congress explicitly stated that one of its purposes was to provide protection to the investor and to the public.[36] Further, when Congress stated in enacting the 1964 amendments that its purpose was "[t]o extend to investors in certain over-the-counter securities the same protection now afforded to those in listed securities,"[37] by implication, it was declaring the purpose of existing regulation to be the protection of the public.

Although it is clear that the Act's purpose is investor protection, it is equally clear that neither statutory construction[38] nor legislative history[39] explicitly *supports* a civil cause of action. Thus, the broker-dealer concerned about the extent of his potential liability and the investor concerned about his legal rights to recoup any losses that he may sustain due to acts of a broker-dealer must turn to judicial responses to determine whether or not a private cause of action for breach of NASD rules has been added to the arsenal of weapons for the enforcement of such rules. Both the Second and Seventh Circuit Courts of Appeals have faced the question.[40]

II. THE SECOND CIRCUIT'S RESPONSE: THE IMPLICATION OF A CAUSE OF ACTION

The first and leading case to confront the issue of implied civil

34. *Id.*

35. 15 U.S.C. § 78o-3(b)(8) (1970). See note 20 *supra.*

36. CONG. NEWS, *supra* note 2, at 3013-14, 3016.

37. *Id.* at 3013.

38. *See* Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633, 635-42 (1966) [hereinafter cited as Lowenfels]; Rediker, *supra* note 7, at 31-34.

39. *See* Lowenfels, *supra* note 38, at 642. Lowenfels reaches this conclusion after having reviewed the Senate and House Reports, which dealt with the purpose and background of the Act and the floor debates regarding adoption of the Act. Since none of these sources made any mention of whether section 15A should be a basis for a private cause of action, a definitive conclusion as to the congressional intent on the question cannot be made.

40. Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir.), *cert. denied*, 397 U.S. 963 (1969); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

liability arising from violations of NASD rules is *Colonial Realty Corp. v. Bache & Co.*[41] In *Colonial*, the plaintiff sued for damages sustained when its broker sold certain of its equity securities to meet margin requirements, which exceeded those agreed upon between the broker and plaintiff, and in excess of those required by the stock exchange.[42] It contended that, since defendant had engaged in conduct which was not in accordance with just and equitable principles of trade and therefore in violation of section 1 of article III of the Rules of Fair Practice of the NASD,[43] the defendant should be liable for all damages proximately caused thereby.[44] The court, however, rejected plaintiff's assertion that a violation of a NASD rule *per se* is sufficient to constitute a cause of action.[45] Nevertheless, the court, in an opinion by Judge Friendly, did formulate a test to determine the circumstances under which a civil remedy under section 15A of the Act would be implied.[46]

The court's analysis was premised on the theory that the implication of a private right of action rests upon the duty of the courts to make effective the policy of a statute. This duty may be suggested in either one of two circumstances: (1) where there exists an "explicit statutory condemnation of certain conduct and a general grant of jurisdiction to enforce liabilities created by the statute, as in cases under section 10 and section 14 of the Act,"[47] or (2) where the existing remedies, judicial and administrative, are ineffective to achieve the pro-

41. 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

42. *Id.* at 179.

43. Article III, section 1 of the Rules of Fair Practice of the NASD provides: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." MANUAL, *supra* note 19, ¶ 2151. Plaintiffs also alleged that the defendant's behavior was in violation of article XIV of the constitution of the New York Stock Exchange which also prohibits conduct inconsistent with just and equitable principles of trade. The question of an implied cause of action for violations of the rules of the New York Stock Exchange is substantially the same for that of violations of the rules of the NASD. 358 F.2d at 181-82.

44. 358 F.2d at 180-81.

45. *Id.* at 182.

46. *Id.* See notes 6-15 *supra* and accompanying text.

47. 358 F.2d at 181. For discussion of the implication of a private remedy based upon section 10(b), see Klein, *Extension of a Private Remedy to Defrauded Securities Investors Under SEC Rule 10b-5*, 20 U. MIAMI L. REV. 81 (1965); Note, *Private Remedies Available Under Rule 10b-5*, 20 SW. L.J. 620 (1966); Note, *Civil Liability Under Section 10b and Rule 10b-5*, 74 YALE L.J. 658 (1965). For a discussion of the implication of a private remedy based upon section 14(a), see sources enumerated in note 17 *supra*.

tection intended by Congress.[48]

Proceeding to examine the nature of the NASD rule,[49] the court concluded that "whether the courts are to imply federal civil liability for violation of . . . dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis . . . ."[50] Indeed, it expressly rejected the contention that a violation of NASD rules is never actionable, stating:

> The court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.[51]

Thus, the *Colonial* court held that the plaintiff did not satisfy the requisite burden of proof because the rules alleged to have been violated were "something of a catch-all which . . . preserves power to discipline members for a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim."[52] Accordingly, in denying plaintiff's claim, it held that the general business conduct rule of the NASD[53] did not supply an adequate basis for the implication of a private remedy for investors.[54]

What emerges from *Colonial* is a case by case determination of the nature and place in the regulatory scheme of each specific rule, with the burden of proof being lightest where the rule in issue imposes a specific duty unknown at common law (*e.g.*, the duty to recommend securities which are suitable for a customer, which is now required of

48. 358 F.2d at 181.

49. *Id.* at 182.

50. *Id.*

51. *Id.* Other writers have suggested that the court formulated an additional test: that the rule must be one which amounts to a substitution for SEC regulation itself. See Rediker, *supra* note 7, at 49-50; Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 999 (1966). However, it does not appear that the court enumerated this as a condition precedent to implication of civil liability, but rather employed it as one indicator of the place the rule occupied in the statutory scheme.

52. 358 F.2d at 182. *See* Note, *Implying Civil Remedies from Federal Regulatory Statutes*, 77 HARV. L. REV. 285, 292 (1963).

53. See note 43 *supra*.

54. 358 F.2d at 183.

broker-dealers by NASD rule 2 of article III of the Rules of Fair Practice).[55] In determining the role the rule assumed in the statutory scheme, the court focused upon whether or not the rule was one which created a legal, as opposed to an ethical, standard.[56] Implicit in the court's holding is the conviction that voluntary dealer associations were to regulate conduct of associated members to a greater extent than they could or should be regulated under the law.[57] If the rule was one enacted for the purpose of prescribing a general level of behavior for broker-dealers to observe, only intradisciplinary sanctions should be employed in their enforcement.

The initial task in analyzing the nature of a rule, according to the *Colonial* court, is to ascertain whether or not the NASD rule was intended to impose a legal duty or merely a level of desired ethical behavior. The *Colonial* court, in answering that question, looked to the

55. This rule provides:

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

MANUAL, *supra* note 19, ¶ 2152.

56. 358 F.2d at 182.

57. There is much to support the contention that the NASD has in fact passed and enforced rules governing ethical behavior of broker-dealers in areas which Congress did not intend to grant the government power to regulate. When the Maloney Act (the amendments to the 1934 Act adopted in 1938) was before Congress, William O. Douglas, then Chairman of the SEC, stated that:

> By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone can effectively reach.

Address Before the Bond Club of Hartford, Connecticut, Jan. 7, 1938, *quoted in* SPECIAL STUDY, *supra* note 4, pt. 4, at 694-95. The Board of Governors of the NASD suggested the same distinction when it stated: "Sales efforts must . . . be undertaken only on a basis that can be judged as being within the ethical standards of the Association's rules . . . ." Policy of the Board of Governors, MANUAL, *supra* note 19, ¶ 2152. Several authors have argued that the legal-ethical distinction is a real one and that a breach of rules of an ethical nature should not per se give rise to civil liability.

> "Legal" requirements set forth a certain minimum standard of conduct, the failure to comply with which is (or is regarded as) punishable in civil or criminal as well as in administrative actions. "Ethical" responsibilities postulate a higher standard of conduct than their "legal" counterparts. The duty to comply with ethical dictates is largely voluntary and is (or is regarded as) punishable only through administrative actions.

Rediker, *supra* note 7, at 16; *see* MacLean, *supra* note 7, at 75. *But see* Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 721-22, 69 Cal. Rptr. 222, 234 (1968), where the court suggests that, while a legal-ethical characterization may exist, it should not bear on the analysis of civil liability arising from the rules of the NASD.

specificity of the rule (a rule of law must be specific in its proscription[58]), the form of the rule (a law is generally a condemnation of certain action rather than a command to act[59]), and whether or not the rule existed at common law (if the duty was already in existence at common law, sufficient redress for any damages would have been available in state courts, so Congress would not have granted jurisdiction to federal courts, which would rob state courts of their existing power over such claims and which would flood federal courts with common law claims[60]).

The validity of any ethical-legal dichotomy tends to lose some of its force when one considers the fact that Congress has granted the SEC power to enact rules regulating broker-dealers in the over-the-counter markets who are non-members of the NASD which are the same as or similar to the rules which the NASD has promulgated in the Rules of Fair Practice.[61] If Congress at one time did intend the scope of the voluntary securities dealers association to encompass areas beyond the reach of the government's power to regulate, it may have manifested a present intent to the contrary with the explicit grant of power to the SEC to regulate the same conduct of broker-dealers not associated with the NASD and with the grant of increased control over the formulation and enforcement of the rules of the NASD.

Nevertheless, even if such a distinction is valid, it does not seem to be a sufficient basis upon which to deny an injured investor a means by which to recoup the losses occasioned by the broker-dealer's actions. In *Twomey v. Mitchum, Jones & Templeton, Inc.*,[62] a California Court of Appeal, in holding that the NASD Rules of Fair Practice were admissible to establish a duty of a broker-dealer in proving negligence, argued that

58. 358 F.2d at 182.

59. *Id.*

60. *Id.* If an implied cause of action is created, federal courts would have exclusive jurisdiction over all such actions. 15 U.S.C. § 78aa (1970).

61. MANUAL, *supra* note 19, ¶ 2151.

62. 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968). In *Twomey*, defendant had allegedly entered into a fiduciary relationship with plaintiff and then proceeded to act as principal in many of the subsequent trading transactions for plaintiff's account without disclosing the conflicting interests. Defendant also allegedly purchased highly speculative securities for plaintiff when she was a widow in need of a steady, secure income. Plaintiff, in seeking to prove her allegation of negligent handling of her account, introduced rules 1 and 2 of the Rules of Fair Practice into evidence to establish the duty of a broker not to "churn" a customer's account and the duty to purchase securities which are suitable for a customer's investment objectives. *Id.* at 697-99, 69 Cal. Rptr. at 228-29.

> [i]t may be asserted that the proposed guidelines are merely ethical standards and should not be a predicate for civil liability. Good ethics should not be ignored by the law. It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions.[63]

Instead of focusing on the ethical-legal nature of a rule as the point upon which liability should turn, it would seem more consistent with the teachings of *Borak*, which *Colonial* purported to follow, and fairer to injured investors, for liability to turn on the congressional purpose of the Act and the adequacy of existing remedies to achieve that purpose. This is not to argue that all rules of the NASD were enacted for such purpose.[64] Both the rule-by-rule determination proposed by *Colonial*[65] and its test devised to make that determination by looking to the nature of the rule and its place in the regulatory scheme[66] should be employed. But the particular nature and role of the rule which *Colonial* established as a condition precedent to establishing liability must be abandoned. To be consistent with judicial precedent and congressional intent to enforce the Act effectively, the goal of the rule should be protection of the public and the role of the rule should be regulation of broker-dealer conduct toward that end.

III. THE SEVENTH CIRCUIT'S RESPONSE

Other courts which have considered the question of civil liability have followed the approach formulated in *Colonial*, but have departed from *Colonial*'s ethical-legal distinction when analyzing the nature of the rule in issue. The Seventh Circuit Court of Appeals, in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[67] was the first to consider the question after *Colonial*. Plaintiff, a trustee in bankruptcy for Dobich Securities, Inc., alleged that defendant knowingly allowed Dobich to open a cash account with fraudulently converted property of various customers of Dobich, that this practice was a vio-

63. *Id.* at 721-22, 69 Cal. Rptr. at 244.

64. One author has argued that the Rules of Fair Practice were enacted for the purpose of providing protection to the public and that the rules of the NASD termed the Uniform Practice Code were designed solely for purposes of internal housekeeping and, hence, should never give rise to a private cause of action. Lowenfels, *supra* note 38, at 650-54.

65. 358 F.2d at 182.

66. *Id.*

67. 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

lation of rule 405 of the New York Stock Exchange,[68] and that such violation should give rise to a cause of action for damages.[69]

The court, in determining whether or not a cause of action would lie for breach of rule 405, adopted the test formulated in *Colonial*[70] and then proceeded to supply its own determination of what the requisite nature of a rule should be before it can be privately actionable. "The touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct protection of investors.' "[71]

Thus it appears that *Colonial*'s requirement of an examination into the legal or ethical nature of a rule has been dropped entirely by the Seventh Circuit and the focus has been turned instead toward whether or not the rule was designed for the protection of the investors. Further, the *Colonial* requirement to consider the rule's specificity and existence at common law has been abandoned by the *Buttrey* court.

Buttrey, while seemingly relaxing the *Colonial* test, added an additional burden that the plaintiff must meet before the court would allow a cause of action for violation of any rule of an exchange or the NASD. In each case it must be established that the offending behavior of the broker-dealer constituted more than "mere errors of judgment."[72] It is uncertain exactly what level of conduct must be alleged, although

68. Rule 405 provides:

Every member organization is required through a general partner or an officer who is holding voting stock to:

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.

(2) Supervise diligently all accounts handled by registered representatives of the organization.

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer . . . . The member, general partner or officer . . . shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

CCH NEW YORK STOCK EXCHANGE MANUAL ¶ 2405.

69. The courts have treated the question of a private cause of action arising from stock exchange rules and one arising from NASD rules as substantially the same. *Buttrey*, although dealing with an implied cause of action based upon breach of exchange rules, has been relied upon in subsequent cases dealing with NASD rules. *See, e.g.*, Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir.), *cert. denied*, 397 U.S. 963 (1969).

70. 410 F.2d at 142.

71. *Id.*

72. *Id.* at 143.

the court indicated that strict liability would not be a basis for liability.[73] The court never reached the question of whether or not negligent violation of a rule would be sufficient since the plaintiff had alleged facts which were "tantamount to fraud."[74]

It would be consistent with the *Buttrey* holding and with the purposes of the Act to permit a cause of action to lie for negligent transgressions of the rules of NASD. If a rule is designed to protect the public,[75] if the actions of a broker-dealer were such that a prudent person in the same or similar circumstances could have reasonably foreseen that his actions would result in a breach of the rule, and if a member of the public were injured thereby, it is logical and fair to shift the loss from the investor to the broker-dealer who occasioned the loss. Further, to permit a cause of action to lie only if a broker-dealer's behavior reaches a level of fraud would render the court's efforts to imply a cause of action in this case meaningless since a cause of action already exists for fraudulent acts under sections 10(b)[76] and 15(c)[77] of the Act.

Although the Seventh Circuit has subsequently decided two additional cases, *Avern Trust v. Clarke*[78] and *SEC v. First Securities Co.*,[79]

73. *Id.* The requisite level of culpability required to impose liability was never reached by the *Colonial* court.

74. *Id.*

75. *See* text accompanying notes 35-36 *supra.*

76. Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. 78j(b) (1970). For commentaries dealing with the implication of a private cause of action arising from section 10(b), see note 47 *supra.*

77. Section 15(c)(1) provides:

> No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

15 U.S.C. § 78o(c)(1) (1970). This section was recognized as a basis for a civil cause of action in Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir.), *cert. denied*, 397 U.S. 963 (1969).

78. 415 F.2d 1238 (7th Cir.), *cert. denied*, 397 U.S. 963 (1969).

79. 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972).

which dealt with the issue of an implied cause of action, the question of the necessary level of offending behavior still remains unanswered. In *Avern*, the plaintiffs sued the defendant broker-dealer and his firm for damages in fraud and breach of a fiduciary relationship arising from a series of securities transactions which included making recommendations without adequate disclosure of the "inherent risks" and secretly dealing as a principal with the plaintiffs thereby maintaining an inherent conflict of interest.[80] The plaintiffs alleged that, since such behavior was in violation of sections 1, 2 and 18 of article III of the Rules of Fair Practice of the NASD,[81] they should be entitled to recoup the losses caused by defendant's purchases for plaintiffs' account.

The district court dismissed the claims based upon violation of the NASD rules, but the Seventh Circuit, relying on *Buttrey*, concluded that, although dismissal of such claims was erroneous as a matter of law,[82] it was not prejudicial since the "same claim" was incorporated under plaintiffs' allegation of violation of section 15(c) of the Act[83] (the antifraud provision for broker-dealers). The court cited *Buttrey* for the proposition that violation of rules promulgated by self-regulatory agencies can be a basis for civil liability if such rules are designed to protect the investing public.[84] The court did not discuss the second *Buttrey* requirement regarding the nature of the offending conduct of a broker-dealer; however, apparently implicit in the court's conclusion—that a cause of action for violation of a NASD rule is incorporated in a cause of action for fraud—is the requirement that the offending conduct be fraudulent. If negligent breach of a rule were sufficient, the court could not have claimed that a cause of action based on section 15(c) of the Act incorporated the same theory as one under the NASD rules.[85]

In *First Securities Co.*, Nay, the president and 92% owner of First

80. 415 F.2d at 1239.

81. Rule 1 of article III of the Rules of Fair Practice is set forth in note 43 *supra*. Rule 2 of article III of the Rules of Fair Practice is set forth in note 55 *supra*. Rule 18 of Article III of the Rules of Fair Practice provides:

> No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.

MANUAL, *supra* note 19, ¶ 2168.

82. 415 F.2d at 1242.

83. *Id.* See note 77 *supra* for text of section 15(c)(1).

84. 415 F.2d at 1242.

85. *Id.*

Securities, perpetrated a fraud on various customers of the firm by enticing them to invest money in an investment opportunity so confidential that even the investors could not be informed of its nature.[86] Nay guaranteed that the investment would produce a specified annual yield.[87] Each customer was to make the check payable to Nay personally and to mail any checks to him in an envelope marked "Confidential."[88] Nay then used the money to make personal investments and to repay personal debts.[89] He paid the promised yield from his personal funds to the extent that he could,[90] and he prevented his firm from discovering his fraud by forbidding any employee from opening his mail.[91] Later, Nay committed suicide, leaving a note which disclosed his scheme.[92] First Securities was sued by the defrauded investors for failure to adequately supervise Nay, which was in violation of rule 27 of article III of the NASD Rules of Fair Practice.[93]

Without engaging in incisive analysis, the court, citing *Avern* and *Buttrey*, concluded:

> We have no doubt that the enforcement of Nay's rule regarding the opening of mail is sufficient without more to constitute a violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public.[94]

The court dropped any reference to the test formulated in *Colonial* and simply employed the "investor protection" test formulated in *Buttrey*.[95] Again there was no mention of the nature of the violating conduct. This may have been for one of two reasons: the nature of the underlying acts for which First Securities was being held liable was fraudulent; or the court felt that violation of the rule 27 was fraud-

86. 463 F.2d at 984.
87. *Id.*
88. *Id.*
89. *Id.* at 983.
90. *Id.* at 984.
91. *Id.* at 985.
92. *Id.* at 983.
93. *Id.* at 988. Rule 27 of article III of the Rules of Fair Practice provides, in pertinent part, that:

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

MANUAL, *supra* note 18, ¶ 2177.
94. 463 F.2d at 988.
95. *Id.*

ulent *per se*. The court offered no guidance as to whether it relied on either ground in its omission of any express requirement of a level of culpability or whether the nature of the defendant's conduct is no longer relevant to the inquiry.

Only one district court case in the Seventh Circuit has dealt with the subject subsequent to *First Securities*. In *Rotstein v. Reynolds & Co.*,[96] the court held that securities sold without regard to the "suitability" of plaintiff's investment needs, in violation of rule 2 of article III of the Rules of Fair Practice, gave rise to "a viable theory of recovery."[97] However, the plaintiff's cause of action was dismissed because his allegations were insufficient to show that the stock was in fact unsuitable.[98] The court made no reference to a requirement of establishing the culpability of a defendant's behavior as required by *Buttrey*.

IV. APPLICATION OF THE STANDARDS

Thus far, there have been formulated two separate and inconsistent tests by which to determine whether or not a private federal remedy for damages will be implied for breach of the rules of the NASD. Although no other circuit court has yet considered the question, two district courts, one in the Ninth Circuit and one in the Fifth Circuit, have expressly confronted the question. Interestingly, the approach adopted by the courts was the incorporation of the standards of *Colonial* and *Buttrey*, producing a much stricter test than the one obtained under either of the cases alone.

In *Wells v. Blythe & Co.*,[99] the District Court for the Northern District of California was faced with the identical question presented in *Avern*: whether or not violation of rule 2, article III of the NASD Rules of Fair Practice gives rise to civil liability.[100] Plaintiffs alleged that the defendant broker-dealer's negligent failure to counsel them to sell their securities caused a $14,000 investment loss and that such practice was in violation of rule 2's prescriptions.[101] The court first applied the test formulated in *Colonial*,[102] asserting that the rule in question must play an integral part in the SEC's regulation and impose an explicit

96. 359 F. Supp. 109 (N.D. Ill. 1973).
97. *Id.* at 114.
98. *Id.*
99. 351 F. Supp. 999 (N.D. Cal. 1972).
100. See note 55 *supra* for text of rule 2 of article III.
101. 351 F. Supp. at 999.
102. *See* text accompanying notes 51-55 *supra*.

duty unknown to common law.[103] The court then turned to *Buttrey* to conclude that, since the plaintiffs did not allege facts tantamount to fraud,[104] no cause of action would be permitted.[105]

The District Court for the Southern District of Texas, in *Mercury Investment Co. v. A.G. Edwards & Sons*,[106] was also faced with the same question presented in *Avern*, violation of the NASD "suitability" rule.[107] The court, although explicitly setting out the *Colonial* requirement, concluded, in direct contrast with *Avern*, that the nature of the suitability rule was not such that it should give rise to civil liability.[108] The court held that the purpose of the Act was to prevent fraud, not merely negligent transgressions:

> Art. III, Sec. 2 of the N.A.S.D. rules seeks to regulate a much broader spectrum of broker activities than is envisioned by securities regulations. Thus a violation of this N.A.S.D. rule . . . *per se* does not give rise to federal civil liability under the Securities Act.[109]

Both *Wells* and *Mercury* adopted *Colonial's* approach, examining a rule's nature and place within the regulatory scheme. But rather than focusing on the ethical-legal nature of a rule in making that determination, the cases turned to the type of behavior sought to be regulated. Each interpreted *Buttrey* as requiring the rule to be of a nature designed to regulate fraudulent practices.[110] The *Buttrey* holding, however, is not so narrow, and, in fact, it is not clear whether negligent behavior would satisfy the *Buttrey* requirement.[111] Subsequent cases by the same court seem to have dropped such a requirement altogether and determined, as did *Buttrey*, that whether or not a rule was enacted for the purpose of protection of the public is the touchstone in determining if a rule should be a basis for a private action.[112]

This combination of the requirements of *Buttrey* and *Colonial* effectively prevents implication of a private remedy arising from viola-

103. 351 F. Supp. at 1000-01.
104. *Id.* at 1002.
105. *Id.* at 1001-02.
106. 295 F. Supp. 1160 (S.D. Tex. 1969).
107. See note 55 *supra* for text of the "suitability" rule.
108. 295 F. Supp. at 1163.
109. *Id.*; *see* Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 430-31 (N.D. Cal. 1968).
110. 295 F. Supp. at 1163; 351 F. Supp. at 1002.
111. *See* text accompanying notes 73-75 *supra.*
112. SEC v. First Securities Co., 463 F.2d 981, 988 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972); Rotstein v. Reynolds & Co., 359 F. Supp. 109 (N.D. Ill. 1973).

tion of a rule of the NASD to be relied upon by an injured investor as a viable means of recovery. With the requirement that the rule be of a nature to prevent fraudulent practices, there is no advantage in alleging breach of an NASD rule as a cause of action. If a plaintiff can successfully allege conduct amounting to fraud, he need not carry the additional burden of establishing the specificity of a rule and its absence at common law, but rather he need only allege violations of section 10(b) or section 15(c) of the Act.[113] It is the plaintiff, injured by negligent behavior of a broker-dealer which is in violation of rules set down by the broker-dealer's own association, who is denied satisfaction of his claim in federal court.

CONCLUSION

It is clear that much conflict and confusion still surround the very important question of whether or not a cause of action for civil damages will lie for a breach of the rules of the NASD. No definitive approach to answer this question has yet been formulated by the courts. The Second Circuit has determined that each rule should be examined to determine whether the rule was intended to have imposed a legal duty upon the broker-dealer or merely to have established a desired level of behavior.[114] If the rule was of a nature intended to impose legal obligations upon a broker-dealer, breach of the rule may give rise to civil damages.[115] The Seventh Circuit, on the other hand, has focused on whether or not the rule was enacted for the protection of the public.[116] If such is found to be the purpose of the rule, then violation of it may properly give rise to a civil cause of action.[117] Since the two tests are quite different and would produce different results for plaintiffs similarly situated, the divergence should be resolved. As a plaintiff's legal rights should not turn upon the forum in which the suit is brought, there is a pressing need for the Supreme Court to review the question and formulate a single test for the circuits to apply.

Not only does confusion still surround the test to be employed, but the degree of culpability which must be proved to impose liability remains equally unclear. The Seventh Circuit has explicitly rejected

113. See notes 76-77 *supra* and accompanying text.
114. See notes 41-61 *supra* and accompanying text.
115. See notes 41-66 *supra* and accompanying text.
116. See notes 67-95 *supra* and accompanying text.
117. See notes 67-98, 112 *supra* and accompanying text.

strict liability for breach of the rules of the NASD,[118] but has not settled whether an action will lie for a negligent breach; while a district court in California and one in Texas have required the defendant's actions to be tantamount to fraud.[119] A private action based on NASD rules should lie for negligent breaches thereof in order to broaden the substantive scope of investor protection, to further the means and adequacy of enforcing the purposes of the Act, and to have the one who occasioned a loss bear the responsibility.

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118. See text accompanying note 73 *supra.*
119. See notes 99-112 *supra* and accompanying text.