THE BUSINESS LAWYER

Section of Business Law • American Bar Association
University of Maryland School of Law

ARTICLES

Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in *Bank of America v. 203 North LaSalle Street Partnership*
G. Eric Brunstad, Jr. and Mike Sigal

Suitability in Securities Transactions
Lewis D. Lowenfels and Alan R. Bromberg

The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk
Richard A. Booth

Consumer Bankruptcy Filers and Pre-Petition Consumer Credit Counseling: Is Congress Trying to Place the Fox in Charge of the Henhouse?
Howard B. Hoffman

Letters of Credit, Voidable Preferences, and the "Independence" Principle
David Gray Carlson and William H. Widen

The Default Provisions of Revised Article 9 of the Uniform Commercial Code: Part II
Timothy R. Zinnecker

SURVEY

Uniform Commercial Code

Suitability in Securities Transactions

*By Lewis D. Lowenfels and Alan R. Bromberg**

INTRODUCTION

One of the most important doctrines under the federal securities laws which has endured in various guises and manifestations since the enactment of those statutes is the suitability doctrine. The suitability doctrine, always somewhat nebulous and amorphous with respect to its content and parameters, may be broadly defined as a duty on the part of the broker to recommend to a customer only those securities which are suitable to the investment objectives and peculiar needs of that particular customer.[1] The suitability doctrine entails the matching of two elements: (i) the investment objectives, peculiar needs, and other investments of the particular customer with (ii) the characteristics of the security which is being recommended.

In an Avoidance and Prevention Advisory (Advisory) distributed to its member firms in May 1998, the National Association of Securities Dealers, Inc. (NASD) disclosed that unsuitability claims account for ninety-five percent of filings under NASD members' errors and omissions insurance policies.[2] "Because they are the most common yet most ambiguous of all client accusations," the Advisory said, " 'unsuitability' claims can often create significant problems for your firm. This is because what constitutes a viable unsuitability claim is open to debate."[3]

*Lewis D. Lowenfels, A.B., Harvard University, LL.B., Harvard University, is a partner in the New York law firm of Tolins & Lowenfels; Public Governor of the American Stock Exchange 1993-1996; adjunct professor of law, Seton Hall University School of Law; co-author with Alan R. Bromberg of *Bromberg and Lowenfels on Securities Fraud and Commodities Fraud* (2d ed. 1999), a six-volume treatise published by West Group.

Alan R. Bromberg, A.B., Harvard University, J.D., Yale University, is a University, Distinguished Professor of Law, Southern Methodist University; of counsel, Jenkens & Gilchrist, a Professional Corporation; co-author with Lewis D. Lowenfels of *Bromberg and Lowenfels on Securities Fraud and Commodities Fraud* (2d ed. 1999), a six-volume treatise published by West Group.

1. *See, e.g.*, Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527, 529 (1998).
2. *Zarb Urges Broker Dealers to 'Be on Guard' About Suitability*, 30 Sec. Reg. & L. Rep. (BNA) No. 22, at 810 (May 29, 1998).
3. *Id.*

The fact that unsuitability claims are the most common and yet the most ambiguous of all customer claims is not the only reason why these claims are creating significant problems for brokers and their firms. There are other reasons as well. Following the dictates of the U.S. Supreme Court in the landmark decisions of *Shearson/American Express, Inc. v. McMahon*,[4] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[5] the principal forum where customer damage claims for unsuitability are heard has shifted within the last decade from the courts to arbitration, primarily the arbitration tribunals provided by the NASD. Additionally, the specific provisions relied upon by customers pursuing unsuitability claims in these arbitration forums have shifted within this past decade from the anti-fraud provisions of the federal securities laws, primarily section 10(b)[6] and Rule 10b-5[7] of the Exchange Act, which mandate a legal standard of intent to defraud or recklessness, to the unsuitability rules of the self-regulatory organizations (SROs), primarily NASD Rule 2310,[8] which embody a comparatively nebulous, quasi-legal, quasi-ethical standard of due care and fair dealing between brokers and customers. This shift in forum and in governing standards has eased meaningfully the customer's path to recovery and consequently has increased the customer's leverage to compel a significant settlement.

The use of the suitability rules of the SROs by customers as the basis for the recovery of damages in private actions against brokers and their firms has been of great concern to the brokerage industry for many years. Indeed, it has been this concern that has in great part fueled the industry's and the NASD's consistent opposition to any expansion of customer rights under the NASD's suitability rule.

In this Article the authors will analyze the suitability doctrine. First, the suitability rules promulgated by the SROs and the disciplinary actions initiated under these rules will be examined. Second, the authors will examine U.S. Securities and Exchange Commission (SEC) initiatives with respect to the suitability doctrine. Finally, private damage actions for unsuitability under both federal and state law and in arbitration will be examined.

THE SUITABILITY RULES OF THE SROS

Most of the SROs in the securities industry have adopted rules embodying the suitability doctrine in one form or another. Indeed, the genesis of the suitability doctrine is rooted more in the ethical guidelines of the

4. 482 U.S. 220 (1987).
5. 490 U.S. 477 (1989).
6. Securities Exchange Act of 1934 (Exchange Act) § 10(b), 15 U.S.C. § 78j(b) (1994).
7. 17 C.F.R. § 240.10b-5 (1998).
8. NASD Conduct Rule 2310, NASD Manual (CCH) ¶ 2310, at 4261-65 (Apr. 1997).

SROs than in legal precedents under the federal securities laws. In this section, the authors analyze and compare the suitability rules of the various SROs with particular attention to the suitability rule promulgated by the NASD.

THE NASD SUITABILITY RULE

The NASD's suitability doctrine is embodied primarily in NASD Rule 2310, entitled Recommendations to Customers (Suitability), of the NASD's Conduct Rules and in three loosely organized subdivisions of Interpretive Material that have been published by the NASD under Rule 2310: (i) IM-2310-1, entitled Possible Application of SEC Rules 15g-1 through 15g-9; (ii) IM-2310-2, entitled Fair Dealing with Customers; and (iii) IM-2310-3, entitled Suitability Obligations to Institutional Customers.[9]

The NASD takes the position that these subdivisions of Interpretive Material are part of the rule itself and, as such, have the same status and importance as any other part of the rule. This position would seem to be correct because interpretations of NASD rules fall within the Exchange Act's definition of rules.[10] Moreover, the SEC is required to publish all proposed NASD rules for comment before approving them;[11] and while IM-2310-1 is merely a cross-reference to the SEC penny stock rules,[12] and IM-2310-2 is a grandfathered provision from Article III, section 2 of the NASD's old Rules of Fair Practice, the SEC published IM-2310-3 for comment and IM-2310-3 was the subject of relatively widespread attention, analysis, and substantial revision before its final adoption. On the other hand, it is interesting to note that the 1996 *NASD Manual* contains the following definition of the letters "IM" which precede each of the three numbered subdivisions of Interpretive Material enumerated above: "IM stands for Interpretive Material of the Rules of the Association *that has not been converted to Rule form*, including interpretations, resolutions, explanations, policies and guidelines. The IM number includes the number of the Rule or Rule Series which the material interprets."[13]

Determining whether or not the Interpretive Material is part of the rule itself is not merely an academic exercise because, as discussed below, if the Interpretive Material is part of the rule itself then it establishes rights and liabilities which may determine whether private damages are awarded or not awarded to customers by arbitration tribunals.[14]

9. *Id.* ¶¶ IM-2310-1 to IM-2310-3, at 4263-65.
10. Exchange Act § 3(a)(27), 15 U.S.C. § 78c(a)(27).
11. Exchange Act § 19(b), 15 U.S.C. § 78s(b).
12. *Compare* Possible Application of SEC Rules 15g-1 through 15g-9, NASD Manual (CCH) ¶ IM-2310-1, at 4261, *with* 17 C.F.R. §§ 240.15g-1 to -6 (1999) *and id.* § 240.15g-7 (1998).
13. Guide to the Manual, NASD Manual (CCH), at 21 (May 1996) (emphasis added).
14. *See infra* notes 182-207 and accompanying text.

The various provisions of Rule 2310 have been adopted in stages over the years following the enactment of the federal securities laws and have evidenced a clear trend toward increasing the protections afforded to the investing public.

NASD Rule 2310(a)—Recommendations to Customers

In 1938 the NASD adopted Article III, section 2 of its old Rules of Fair Practice, currently Rule 2310(a), which reads as follows:

> (a) 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.[15]

Rule 2310(a) is limited by its express terms to recommendations.[16] Moreover, as discussed below, the majority of the authorities are consistent in the position that the suitability obligation is imposed on a broker-dealer only in the context of a recommendation.[17] The definition of a "recommendation" within the context of Rule 2310(a), however, raises difficult questions of interpretation, as is clear from the following series of NASD releases.

In Notice to Members 96-32 issued May 9, 1996, which addressed suitability practices when dealing in speculative securities, the NASD reminded its members that the Rules of Fair Practice require "a careful review of the appropriateness of transactions in low-priced, speculative securities, *whether solicited or unsolicited*."[18] Four months later, in response to protests from discount brokers, the NASD purported to "clarify" the above reference to "unsolicited transactions" by issuing Notice to Members 96-60:

> A member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member. It would not apply, therefore, to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member (See SEC Release No. 34-27160, August 22, 1989). However, a broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as "solicited" or "unsolicited." In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.[19]

This "clarification" only provoked further protest and controversy primarily from the Bond Market Trade Association, a group with interests somewhat different from the interests of the discount brokers, which urged that "the act of providing market observations, forecasts about the general direction of interest rates, descriptive or objective statements concerning debt securities or the credit markets or price quotations should not constitute making a 'recommendation.' "[20] The NASD responded with a further Clarification of Notice 96-60 which appeared to represent its final and rather unhelpful word with respect to the matter: "[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances, which . . . [Notice 96-60] was not intended to define."[21] Perhaps the NASD's successive "clarifications" serve only to emphasize the impossibility of establishing a single interpretation of a crucial rule for a disparate membership dealing with a wide variety of securities.

One of the most useful sources for guidance in interpreting the term "recommendation" within the context of Rule 2310(a) is contained in the SEC releases proposing and adopting the penny stock rules. In Exchange Act Release No. 27,160, the Commission 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.

> [T]he NASD and other suitability rules have long applied only to "recommended" transactions . . . . [T]he [Penny Stock Suitability Rule being adopted] would not apply to situations in which a broker-dealer functioned solely as an order taker and executed transactions for persons who on their own initiative decided to purchase a [penny stock] without a recommendation from the broker-dealer. Nor would the Rule apply to general advertisements not involving a direct recommendation to the individual. The Rule would apply, however, to

15. NASD Conduct Rule 2310(a), NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).

16. *See, e.g.*, Parsons v. Hornblower & Weeks-Hemphill, Noyes, 447 F. Supp. 482, 495 (M.D.N.C. 1977) (finding that NASD Conduct Rule 2310(a) requires suitability determinations only with recommendations), *aff'd*, 571 F.2d 203 (4th Cir. 1978).

17. *See* George A. Schieren et al., *Suitability and Institutions, in* SECURITIES LITIGATION 1995, at 699, 752-61 (PLI Corp. Law & Practice Course Handbook Series No. B4-7112, 1995).

18. NASD Notice to Members 96-32, May 1996, *available in* LEXIS, 1996 NASD LEXIS 51 (emphasis added).

19. NASD Notice to Members 96-60, Sept. 1996, *available in* LEXIS, 1996 NASD LEXIS 76.

20. *For Suitability Issue, NASDR Definition of 'Recommendation' Overbroad, PSA Says*, 28 Sec. Reg. & L. Rep. (BNA) No. 48, at 1517 (Dec. 13, 1996).

21. NASD Clarification of Notice to Members 96-60, Mar. 1997, *available in* <http://www.nasdr.com/pdftext/9703fyi.pdf>.

> situations where the broker-dealer recommends to an investor the purchase of a specific [penny stock], whether through direct telephone communication with the customer or through sending promotional material through the mail.
>
> While in some contexts determining whether a transaction was recommended may raise close questions, the Commission understands that in practice most [penny stocks] are "sold, not bought," and in most cases the determination will not be difficult. In particular, in most situations in which the broker-dealer brings a specific [penny stock] to the attention of the customer, a subsequent purchase of the security will involve an implicit or explicit recommendation by the broker-dealer. For example, if several different customers dealing with a registered representative purchased the same security within a short period of time and without communicating with each other, it would be strong evidence that the registered representative had recommended the security.
>
> Some commenters believed that the Proposed [Penny Stock Suitability] Rule should apply to investor responses to general advertisements by a broker-dealer, one noting that general advertisements could serve the same purpose as cold calls by laying the groundwork for subsequent high pressure sales tactics. The Commission notes, however, that these high pressure sales tactics generally would involve a recommendation after the customer calls for information in response to a general advertisement, and therefore any resulting transactions would be covered by the Rule.[22]

A general mailing by a brokerage firm of a research report to all of its customers should generally not be seen as a recommendation.[23] On the other hand, a research report directed to a limited number of customers carrying a notation from the customer's registered representative to "take a careful look at the enclosed" might be a recommendation. If the relationship between the registered representative and the customer is long-term and the customer has a history of invariably following his or her registered representative's suggestions, this weighs toward a recommendation. Conversely, if the same customer has a practice of making his or her own investment decisions and only accepting a relatively small percentage of the registered representative's suggestions, this militates against finding a recommendation. The sophistication or lack thereof of the customer is important as is the speculative or non-speculative nature of the securities involved. Also relevent in this determination is whether the brokerage firm holds itself out to the public as full-service and charges full commissions or advertises itself as a discount operation and publicly rejects any intention to dispense investment advice. The various factual permutations are obviously crucial and virtually limitless.

22. Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Release No. 27,160 [1989-1990 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,440, at 80,416 (Aug. 22, 1989).

23. *See* Adoption of Rules under Section 15(b)(10) of the Securities Exchange Act, Exchange Act Release No. 8135 [1966-1967 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,390 (Aug. 9, 1967) (noting that distribution of research is not itself tantamount to a recommendation).

NASD Rule 2310(b)—Brokers' Duty of Inquiry

On January 1, 1991, the NASD added new subsection (b) to its old Rules of Fair Practice, currently Rule 2310(b) and applicable only to non-institutional customers. Rule 2310(b) reads as follows:

> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>
> (1) the customer's financial status;
>
> (2) the customer's tax status;
>
> (3) the customer's investment objectives; and
>
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[24]

The adoption of Rule 2310(b) resolved a nagging problem; Rule 2310(a) standing alone did not impose a duty of inquiry upon a broker. It permitted reasonable grounds for determining suitability to be based upon "the facts, *if any*, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[25] Indeed, the NASD advised its membership in 1964 that "no affirmative obligation to ascertain a customer's resources and needs was imposed upon a salesman."[26]

The SEC, however, never concurred in this NASD position. In a leading boiler-room case, *Gerald M. Greenberg*,[27] the defendant objected to a finding that he violated the NASD's suitability rule on the grounds that he did not have any information concerning the financial condition and holdings of his customers and therefore was under no obligation to see that the security recommended was suitable for such customers. The SEC rejected this argument and refused to read the words "if any" in the NASD's suitability rule as permitting a broker-dealer to avoid making inquiry about the financial situation and needs of his or her customers. The SEC held in *Greenberg* that a broker-dealer had a duty of inquiry and could not recom-

24. NASD Conduct Rule 2310(b), NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).

25. Suitability Obligations to Institutional Customers, NASD Manual (CCH) ¶ IM-2310-3, at 4264 (emphasis added).

26. NASD, 1964 Report to Members 8.

27. 40 S.E.C. 133 (1960).

mend a security without at least "attempt[ing] to obtain information concerning the customer's other security holdings, his financial situation, and his needs so as to be in a position to judge the suitability of the recommendation."[28]

The NASD countered quickly, and in an action involving a large member firm of the New York Stock Exchange (NYSE), disavowed the duty of inquiry and limited the application of the suitability rule to situations in which a broker-dealer had actual knowledge of facts indicating unsuitability that it disregarded.[29]

Again, the SEC refused to acquiesce. The SEC initiated its own disciplinary action against the same broker-dealer, and based on transactions involving the same stock and utilizing Exchange Act section 10(b) and Rule 10b-5, the SEC found "glaring examples" of unsuitable recommendations to customers including a thirteen-year-old boy, an aged widow, and other persons of modest means who sought safety, dividends, and long-term growth.[30]

The controversy between the two regulators ultimately ended in 1991 with the adoption of Rule 2310(b) which made the duty of inquiry explicit.[31] As regards current informational requirements, in addition to the information specifically required by Rule 2310(b), NASD Rule 3110[32] requires the broker to maintain customer account information which may differ depending upon whether the account is institutional or non-institutional, discretionary or non-discretionary. Moreover, currently the large broker-dealer firms usually have different and detailed account information requirements for, *inter alia*, margin accounts, retirement accounts, trust accounts, option accounts, commodities accounts, and futures accounts with numerous sub-categories within each of these classifications. The industry has come a long way from the days when the SEC adopted its own (since repealed) suitability rule and listed the following informational requirements:

> [a] broker or dealer . . . [is] expected to make reasonable inquiry concerning the customer's investment objectives, and his financial situation and needs. Information concerning financial situation and needs would ordinarily include information concerning the customer's marital status, the number and age of his dependents, his earnings, the amount of his savings and life insurance, and his security holdings and other assets.[33]

28. *Id.* at 138.

29. *See* Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 457-58 (1965).

30. *In re* Shearson, Hammill & Co., Exchange Act Release No. 7743 [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,306, at 82,525 (Nov. 12, 1965).

31. NASD Conduct Rule 2310(b), NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).

32. NASD Conduct Rule 3110, NASD Manual (CCH) ¶ 3110, at 4891-92 (Nov. 1998).

The essence of the suitability doctrine, however, has remained the same: matching the investment objectives, peculiar needs, and other investments of the particular customer with the characteristics of the security which is being recommended.

NASD Rule 2310(c)—Definition of Institutional Customer

Rule 2310(b) discussed above applies only to non-institutional customers. Rule 2310(c) defines the term "non-institutional customer."[34] The last sub-paragraph of Rule 2310 inserted before the Interpretive Material states: "(c) For purposes of this Rule, the term 'non-institutional customer' shall mean a customer that does not qualify as an 'institutional account' under Rule 3110(c)(4)."[35] Customers which qualify as "institutional accounts" under Rule 3110(c)(4) include the following:

> (4) For purposes of this Rule and Rule 2310 the term "institutional account" shall mean the account of:
>
> (A) a bank, savings and loan association, insurance company, or registered investment company;
>
> (B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); or
>
> (C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.[36]

Subsection (c) of Rule 2310 was adopted in 1996 in conjunction with the adoption of IM-2310-3, both of which defined brokers' suitability obligations to institutional customers.[37] The result was the adoption of two mutually conflicting definitions of the term "institutional customer" within the same Rule 2310. On the one hand, the NASD codified a relatively narrow definition of institutional customer for purposes of Rule 2310(b) (generally speaking, any entity with total assets of $50 million or

33. Adoption of Rules Under Section 15(b)(10) of the Securities Exchange Act, Exchange Act Release No. 8135 [1966-1967 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,890 (Aug. 9, 1967).

34. NASD Conduct Rule 2310(c), NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).

35. *Id.*

36. NASD Conduct Rule 3110(c)(4), NASD Manual (CCH) ¶ 3110, at 4891-92 (Nov. 1998).

37. NASD Conduct Rule 2310(c), NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997); Suitability Obligations to Institutional Customers, NASD Manual (CCH) ¶ IM-2310-3, at 4263-65.

more)[38] while at the same time adopting a more expansive definition of "institutional customer" for purposes of IM-2310-3 (any entity other than a natural person, but "more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management").[39] In theory, at least, the conflicting definitions expand the number of retail customers benefiting from Rule 2310(b) while concomitantly expanding the number of institutional customers benefiting from IM-2310-3.

NASD Rule 2310: IM-2310-1—Possible Application of SEC Penny Stock Rules

IM-2310-1 in its entirety is an alert to NASD members that, generally speaking, "any transaction which involves a non-Nasdaq, non-exchange equity security trading for less than five dollars per share may be subject to the provisions of SEC Rules 15g-1 through 15g-9, and those Rules should be reviewed to determine if an executed customer suitability agreement is required."[40] SEC Rules 15g-1 through 15g-9[41] are the draconian "penny stock rules" which, among other things, impose additional, highly stringent suitability requirements with respect to transactions in "penny stocks."

NASD Rule 2310: IM-2310-2—Fair Dealing with Customers

The essence of IM-2310-2 is an admonition, based upon the "ethical" standards of NASD rules, that brokers have a fundamental responsibility to deal fairly with their customers. IM-2310-2 enumerates in individual subparagraphs the following practices as having been found by SRO disciplinary panels to clearly violate this responsibility for fair dealing: (a) recommending speculative low-priced securities particularly in high pressure telephone sales campaigns without attempting to obtain suitability information from the customers; (b) churning; (c) trading in mutual funds particularly on a short-term basis; (d) fraudulent activity including establishment of fictitious accounts, excessive or unauthorized trading in customer accounts, unauthorized use or borrowing of customer funds or securities, forgery, non-disclosure or misstatement of material facts, and manipulations; and (e) recommending or effectuating purchases beyond the customer's financial capability.[42] Finally, IM-2310-2 emphasizes brokers' obligations for fair dealing with customers with regard to derivative or new financial products.[43]

38. NASD Conduct Rule 3110(c)(4)(C), NASD Manual (CCH) ¶ 3110, at 4892 (Nov. 1998).
39. Suitability Obligations to Institutional Customers, NASD Manual (CCH) ¶ IM-2310-3, at 4265 (Apr. 1997).
40. Possible Application of SEC Rules 15g-1 through 15g-9, NASD Manual (CCH) ¶ IM-2310-1, at 4261.
41. 17 C.F.R. §§ 240.15g-1 to -9 (1998).
42. Fair Dealing with Customers, NASD Manual (CCH) ¶ IM-2310-2, at 4261-62.

The history with respect to IM-2310-2 is particularly interesting because in some ways it represents a prototype of the entire NASD experience with the suitability doctrine. With the exception of subparagraph (e) dealing with derivatives, IM-2310-2 was originally adopted in 1964 as a Policy Statement of the NASD Board of Governors under old Article III, section 2 of the NASD's former Rules of Fair Practice and has now been grandfathered verbatim into NASD Rule 2310.[44] This Policy Statement was originally adopted grudgingly by the NASD in response to pressure from the SEC and the Special Study emanating from the *Greenberg* controversy described above.[45] As a result, IM-2310-2, which has retained its original wording, standing alone carefully avoids mentioning the word "suitability" and limits the broker's duty of inquiry with respect to customer suitability to situations where "speculative low-priced" securities are being recommended to customers.[46]

Over the past thirty-five years, however, IM-2310-2 has undergone a striking transformation, evolving from a carefully hedged and limited interpretation of suitability in one subparagraph to a sweeping, broad-based standard contained in its other subparagraphs. Indeed, today IM-2310-2 by its terms stands as a broad ethical standard "with particular emphasis on the requirement to deal fairly with the public."[47] The present problem for the industry is that this broad ethical standard embodying a laundry list of unacceptable activities has become in effect a quasi-legal standard which forms the basis for the award of private damages to customers against brokers in arbitration.[48] In practical reality—in part because securities industry arbitration panels normally do not render reasoned decisions in writing, in part because an approach of equitable fairness rather than strict legal doctrine drives these arbitration panels, and in part because there is no effective right of appeal from the decisions of arbitration panels—the exposure of the industry to private damages for violations of NASD suitability rules has expanded in exponential fashion.

NASD Rule 2310: IM-2310-3—Suitability Obligations to Institutional Customers

In 1996 the NASD adopted certain suitability "guidelines" designed to "be utilized to determine whether a member has fulfilled its suitability

43. *Id.* at 4263.
44. *See* Recommendations to Customers, NASD Manual (CCH), Art. III, Sec. 2, ¶ 2152, at 2041 (July 1992).
45. *See supra* notes 27-33 and accompanying text.
46. *See* Recommending Speculative Low-Priced Securities, NASD Manual (CCH) ¶ IM-2310-2(b)(1), at 4261.
47. Fair Dealing with Customers, NASD Manual (CCH) ¶ IM-2310-2(a)(1), at 4261.
48. *See infra* notes 182-207 and accompanying text.

obligations with respect to a specific institutional customer transaction."[49] According to the NASD, these "guidelines" were adopted as a result of broadened authority granted to the NASD in 1993 by amendments to the Government Securities Act.[50] A more likely scenario, however, is that these "guidelines" were adopted to establish a safe harbor for brokerage firms facing private lawsuits and arbitrations from institutional customers burned by investments in complex and risky derivative securities in the early 1990s. In any event, these "guidelines" were extended to apply to all debt and equity securities, excluding municipals, and to all "institutional investors" defined as "any entity other than a natural person . . . [but] more appropriately applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management."[51]

IM-2310-3 states: "The two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are [(i)] the customer's capability to evaluate investment risk independently and [(ii)] the extent to which the customer is exercising independent judgment in evaluating a member's recommendation."[52]

As regards the first "most important" consideration, a "customer's capability to evaluate investment risk independently," IM-2310-3 elaborates:

> A member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.[53]

IM-2310-3 then lists certain "considerations" that "could" be relevant to a determination of the particular institutional customer's capability to evaluate investment risk independently:

> A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:
>
> - the use of one or more consultants, investment advisers or bank trust departments;
> - the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;
> - the customer's ability to understand the economic features of the security involved;
> - [t]he customer's ability to independently evaluate how market developments would affect the security; and
> - the complexity of the security or securities involved.[54]

As regards the second "most important" consideration, customer exercise of "independent judgment in evaluating a member's recommendation," IM-2310-3 elaborates: "A member may conclude that a customer is exercising independent judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations."[55]

IM-2310-3 then lists certain "considerations" which "could" be relevant to a determination that a customer is making an independent investment decision with respect to a particular recommendation:

> A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and the customer. Relevant considerations could include:
>
> - any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;

49. *Exhibit: Relating to Municipalities, in* DERIVATIVES 1996: AVOIDING THE RISK AND MANAGING THE LITIGATION, at 172 (PLI Corp. Law & Practice Course Handbook Series No. B4-7137, 1996).

50. *Id.* at 169.

51. *See supra* notes 38-39 and accompanying text.

52. Considerations Regarding the Scope of Members' Obligations to Institutional Customers, NASD Manual (CCH) ¶ IM-2310-3, at 4264.

53. *Id.*

54. *Id.* at 4264-65.

55. *Id.* at 4264.

- the presence or absence of a pattern of acceptance of the member's recommendations;
- the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.[56]

IM-2310-3 states that where the broker-dealer has reasonable grounds to conclude that the two "most important" considerations set out above—customer's capability to evaluate investment risk independently and customer's exercise of independent judgment in evaluating member's recommendation—have been satisfied, "then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled."[57] If the customer has delegated decisionmaking authority to an agent, such as an investment advisor or a bank trust department, this suitability "interpretation" must be applied to the agent.

The above description of IM-2310-3 is an attempt to present a comparatively clear summary of a very convoluted and confusing "rule." One of the reasons for this confusion is that, as suggested above, IM-2310-3 was originally prepared as a safe harbor to protect brokers facing damage actions from disgruntled institutional investors, but was subsequently diluted and obfuscated by successive changes.[58] The result is a somewhat nebulous "rule" that by its express terms merely provides "guidelines" for members to determine suitability for specific institutional customer transactions on a case-by-case basis. That being said, at the same time it must be recognized that the rule clearly does not create a safe harbor for brokers, clearly places the responsibility for making a suitability determination on the broker-dealer not on the institutional customer, and in contra-distinction to the definition of institutional customer contained in Rule 2310(c) and discussed above, is clear in its potential application to a broad range of institutional customers.[59]

56. *Id.* at 4265.
57. *Id.* at 4264.
58. *See supra* notes 37-39 and accompanying text.
59. *See* NASD Notice to Members 94-62, Aug. 1994, *available in* LEXIS, 1994 NASD LEXIS 65; *Proposed Suitability Interpretation Could Harm Markets, Markey Warns NASD*, 26 Sec. Reg. & L. Rep. (BNA) No. 40, at 1366 (Oct. 14, 1994); NASD Notice to Members 95-21, Apr. 1995, *available in* LEXIS, 1995 NASD LEXIS 41; *NASD Issues Rule Proposal on Members' Suitability Obligations*, 27 Sec. Reg. & L. Rep. (BNA) No. 16, at 594 (Apr. 21, 1995) (amended version of Suitability Proposal "merely provides guidelines" and "is not intended to create a safe harbor").

NEW YORK STOCK EXCHANGE (NYSE) RULE 405

The NYSE does not have a suitability rule *per se.* It does, however, have a "know your customer" or "due diligence" Rule 405[60] that was originally designed to protect member firms against irresponsible customers and which has recently evolved to include suitability obligations running from the broker to its customer. Rule 405 states in essence that every member must "[u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization . . . ."[61] In addition, the person authorized to approve the opening of the account must be personally informed "as to the essential facts relative to the customer and to the nature of the proposed account" prior to giving his approval.[62]

The NYSE does not define further the "essential facts," except with respect to approving a customer's account for options transactions.[63] Here the NYSE requires its members to seek to obtain from options customers, who are natural persons, a compendium of suitability information, including investment objectives, employment status, estimated annual income, estimated net worth, estimated liquid net worth, marital status, age, and investment experience.[64] Since an existing customer can decide to execute an options transaction at any time, many NYSE member firms use the above compendium as an informal checklist for all accounts.

The burden, however, clearly remains upon NYSE member firms to define what are the "essential facts" with respect to each individual account. The NYSE staff examiners orally and informally define "essential facts" as any information which affects the customer's ability to accept risk. Since there is no written, formal standard, however, the NYSE staff examiners retain substantial power to decide, after the fact (using 20-20 hindsight), that certain information was "essential" and therefore required, but was not obtained.

There are a number of important distinctions between NYSE Rule 405 and NASD Rule 2310. First, NYSE Rule 405 by its terms applies to "every customer, every order, every cash or margin account";[65] it is not limited to "recommendations" as is NASD Rule 2310.[66] Second, NYSE Rule 405 requires its members "to use due diligence to learn the *essential* facts relative to *every customer*";[67] except as described above with respect to options transactions, Rule 405 does not further define "essential facts" as does NASD

60. NYSE Rule 405(1), 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994).
61. *Id.*
62. *Id.* at 3697.
63. *See* NYSE Rule 721(b), 2 N.Y.S.E. Guide (CCH) ¶ 2721.10, at 4558 (Dec. 1995).
64. *See id.*
65. NYSE Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994).
66. NASD Conduct Rule 2310, NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).
67. NYSE Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (emphasis added).

Rule 2310(b), nor does Rule 405 distinguish between institutional and non-institutional customers as does NASD Rule 2310(b)-(c) and IM-2310-3.[68] Third, in contrast to the NASD, the NYSE sanctions members that it holds responsible in connection with unsuitable investments under the comparatively generalized NYSE Rule 476(a), which prohibits conduct that is "inconsistent with just and equitable principles of trade,"[69] rather than under the more specific "know your customer" Rule 405.[70] Indeed, SEC opinions on appeal from NYSE disciplinary panel decisions addressing suitability usually do not even mention NYSE Rule 405 and instead rest upon NYSE Rule 476(a) and cross-cite decisions applying the NASD suitability rule as authorities for its opinions affirming findings of unsuitability under NYSE rules.[71] This cross-citing of authorities by the SEC raises interesting questions as to the possible use of NASD suitability rules and the cases decided thereunder as controlling authorities in private damage actions initiated by customers against NYSE members in an NYSE arbitration forum.[72] Finally, NYSE Rule 405, which is not confined to recommendations, can create a dilemma for discount and "do-it-yourself online" brokers who customarily function as mere order takers and avoid making recommendations. The NYSE takes the position that "[e]xchange rules do not make a distinction between 'discount' firms and firms that conduct business on other than a discount basis."[73] This position 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.[74]

OPTIONS SUITABILITY RULES

Trading in options can be quite risky and highly complex. As a result, the SROs have developed special suitability requirements for options trading. The suitability rule of the Chicago Board Options Exchange (CBOE), the originator of trading in listed options, states:

68. *Id.*; NASD Conduct Rule 2310(b)-(c), NASD Manual (CCH) ¶ 2310, at 4261; Suitability Obligations to Institutional Customers, NASD Manual (CCH) ¶ IM-2310-3, at 4263 (Apr. 1997).

69. NYSE Rule 476, 2 N.Y.S.E. Guide (CCH) ¶ 2476(a), at 4057 (Aug. 1996).

70. NYSE Rule 405, N.Y.S.E. Guide (CCH) ¶ 2405, at 3696.

71. *In re* Rangen, Exchange Act Release No. 38,486, 64 S.E.C. Docket 731, 732 n.1, 737 n.11 (Apr. 8, 1997); *see also infra* notes 103-11 and accompanying text.

72. *See infra* notes 106-11 and accompanying text.

73. *See* Letter from Donald Siemer, NYSE Director, to Thomas C. Prescott, Jr., Securities Consultant, Page & Bacek (Dec. 22, 1989) (discussing Rule & Interpretive Standards) (on file with *The Business Lawyer*, University of Maryland School of Law).

74. *See generally* Rebecca Buckman, *Discount and Online Brokers Worry About Investor Cases*, WALL ST. J., Nov. 25, 1998, at C1.

> Every member, Registered Options Principal or Registered Representative who recommends to a customer the purchase or sale (writing) of any option contract shall have reasonable grounds for believing that the recommendation is not unsuitable for such customer on the basis of the information furnished by such customer after reasonable inquiry as to his investment objectives, financial situation and needs, and any other information known by such member, Registered Options Principal or Registered Representative.
>
> No member, Registered Options Principal or Registered Representative shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing at the time of making the recommendation that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.[75]

The requirement of a "recommendation" and the "reasonable inquiry" requirement are similar to NASD Rule 2310[76] and the "not unsuitable" language, while worded in the form of a double negative, appears indistinguishable in practical effect from the affirmative wording contained in NASD Rule 2310.

The CBOE, however, has a number of additional requirements which cumulatively impose a strict regulatory framework with respect to suitability in options trading. First, as seen in the second paragraph of Rule 9.9 quoted above, there is a special emphasis upon customer capability to evaluate risks and customer financial ability to bear risks in connection with recommended positions in options contracts. Second, CBOE Rule 9.7[77] imposes the following suitability requirements upon members with respect to options trading: specific due diligence requirements to learn enumerated essential information with respect to each customer's investment objectives and financial situation; specific requirements to maintain detailed records of suitability information supplied by customers; specific requirements for approval by specially trained personnel with respect to the opening of accounts for options transactions; specific requirements for customer verification of the background and financial information provided to and recorded by the broker; and specific requirements for special criteria and standards to be used in evaluating the suitability of customers for uncovered short options transactions.[78]

75. Rule 9.9, 2 Chicago Bd. Options Ex. (CCH) ¶ 2309 (1998).

76. NASD Conduct Rule 2310, NASD Manual (CCH) ¶ 2310, at 4261 (Apr. 1997).

77. Rule 9.7, 2 Chicago Bd. Options Ex. (CCH) ¶ 2307 (1998).

78. For other SRO options suitability rules that are substantially similar, though not identical, to CBOE Rule 9.9, see NASD Conduct Rule 2860(b)(19), NASD Manual (CCH) ¶ 2860, at 4728 (Feb. 1999), NYSE Rule 723, 2 N.Y.S.E. Guide (CCH) ¶ 2723, at 4561 (Dec. 1995), and Amex Rule 923, 2 Am. Stock Ex. Guide (CCH) ¶ 9723 (1998).

SUITABILITY RULES FOR MUNICIPAL SECURITIES

The Municipal Securities Rulemaking Board (MSRB) has adopted MSRB Rule G-19,[79] which generally requires that before making any recommendation of a municipal security transaction to a customer, a broker must first determine that the proposed transaction is suitable for the customer. More specifically, in recommending a municipal security transaction to any customer, a broker must have reasonable grounds to believe that the recommendation is suitable based upon (i) information available from the issuer or otherwise and (ii) facts disclosed by, or otherwise known about, the customer.[80] In addition, if the recommendation of the municipal security transaction is being directed to a "non-institutional account," the broker has a duty of inquiry.[81] Prior to making the recommendation, the broker must make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives, and such other information considered to be reasonable and necessary by the broker in making recommendations to the customer.[82] The definition of "institutional account" is contained in MSRB Rule G-8[83] and is identical to the definition contained in NASD Rule 2310(c) discussed above.[84] MSRB Rule G-19(d) imposes additional suitability requirements with respect to discretionary accounts.[85]

MSRB Rule G-19 in its present form reflects the elimination of two loopholes from its previous language. First, a broker was previously permitted to make a recommendation even when a customer refused to provide sufficient information about himself for the broker to determine that the recommendation was suitable, so long as the broker had no reason to believe, and did not believe, that the recommendation was unsuitable. Second, the broker also had previously been permitted to recommend specific financial investments to a customer in response to the customer's requests for investment advice and execute transactions at the request of the customer even after the broker had advised the customer that he did not believe investments in municipal securities were suitable for the customer.[86]

79. MSRB Rule G-19, MSRB Manual (CCH) ¶ 3591, at 4891 (Sept. 1996).
80. MSRB Rule G-19(c), MSRB Manual (CCH) ¶ 3591, at 4891.
81. MSRB Rule G-19(b), MSRB Manual (CCH) ¶ 3591, at 4891.
82. *Id.*
83. MSRB Rule G-8, MSRB Manual (CCH) ¶ 3536, at 3654 (Jan. 1999).
84. *See supra* notes 36-37 and accompanying text.
85. MSRB Rule 19(d), MSRB Manual (CCH) ¶ 3591, at 4891 (Sept. 1996).
86. *See* Exchange Act Release No. 33,498, 55 SEC Docket 2482, 2482-83 (Jan. 21, 1994) (proposing amendments to Rule G-19); Exchange Act Release No. 33,869, 56 SEC Docket 1062, 1063 (Apr. 7, 1994) (adopting amendments to Rule G-19); *MSRB Proposes Changes to Strengthen its Customer Suitability Provisions*, 26 Sec. Reg. & L. Rep. (BNA) 171, 171 (Feb. 4, 1994); *SEC Approves MSRB Rules for Muni Market on Suitability, Political Contributions*, 26 Sec. Reg & L. Rep. (BNA) 503, 503 (Apr. 8, 1994).

DISCIPLINARY ACTIONS UNDER SRO SUITABILITY RULES

The various SROs sanction their members for violations of SRO suitability rules. The SRO administrative decisions justifying and imposing these sanctions, which are crafted initially by administrative panels of the various SROs and on appeal by the SEC, establish certain useful parameters in defining unsuitability. At the same time, however, as stated above, the line between conduct which is suitable and conduct which is unsuitable under SRO rules remains ambiguous and uncertain.[87] Unfortunately, such ambiguity and uncertainty seem unavoidable when unsuitable conduct is being defined under the broad and nebulous SRO "ethical" standards of "commercial honor and just and equitable principles of trade."[88] Certain of these SRO administrative decisions are addressed below.

In *In re Holland*,[89] a broker with a previously unblemished record was censured, fined $5000, and suspended from association with any member in any capacity for five business days for violating the identical predecessors of present NASD Rules 2310(a) and 2110 by making unsuitable recommendations to a customer.[90] The NASD panel rendered this decision initially, which was affirmed on appeal by the SEC, in spite of a finding that the broker had acted in good faith and did not intend to harm the customer.[91]

The customer was an eighty-two year old widow, who, until late 1990, was active, independent, and involved in her affairs. She received social security, as well as payments from a land sale contract, and did not depend on income from investments for her living expenses. She also held a portion of her assets outside of her brokerage account. The widow had no children and planned to leave the bulk of her estate to charity.

The broker became her account executive in 1984 and in December 1987, the customer's portfolio consisted of twelve positions, primarily debt, in municipal, utility, and corporate securities. During the next three years, however, as a result of the broker's recommendations, the composition of the portfolio changed. The broker recommended that the customer purchase at least twenty-five different investments and of these the NASD alleged that eleven were unsuitable. The SEC agreed that the broker's recommendations, taken as a whole, were unsuitable for the customer's account.[92] The broker's firm, at one time or another, had been an underwriter for each of the eleven securities at issue. The vast majority of these

87. *See supra* notes 1-8 and accompanying text.
88. NASD Conduct Rule 2110, NASD Manual (CCH) ¶ 2110, at 4111 (Aug. 1998); *see* NYSE Rule 476(a), 2 N.Y.S.E. Guide (CCH) ¶ 2476, at 4057 (Aug 1996).
89. Exchange Act Release No. 36,621, 60 SEC Docket 2935 (Dec. 21, 1995).
90. *Id.* at 2936.
91. *Id.* at 2941-42.
92. *Id.* at 2939.

companies had operating losses and no anticipation of paying dividends. In addition, at least seven of these companies had offerings that were characterized by the prospectus as involving substantial or a high degree of risk. The SEC wrote:

> Holland [broker] asserts that Bradley [customer] understood the recommendations he made for her account and made an informed decision to follow those recommendations. Holland admits that Bradley relied on his advice. Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations.
>
> We recognize that the NASD found that Holland acted in good faith and did not receive more than the normal commissions for these transactions. In light of Bradley's dependence on Holland for recommendations, however, Holland should have considered a more appropriate investment strategy for Bradley. The concentration of high risk and speculative securities in Bradley's account, which were predominately underwritten by Paulson [broker's firm], was not suitable.[93]

Compare the decision in *Holland* to the SEC's opinion in *In re Hassanieh*.[94] In *Hassanieh*, the SEC determined that the NASD had failed to establish that a broker's recommendation to a customer to invest in a limited partnership was unsuitable under the identical predecessors of present NASD Rules 2310(a) and 2110.[95] In early 1990, the customer attended a seminar hosted by the broker at which a limited partnership National Tax Credit Investors II, LP (NTC) was discussed. After the seminar, the customer contacted the broker and asked him to stop by her home. The customer explained that she wanted to invest for her and her husband's retirement in about ten years and that she also was interested in an investment that would reduce tax liability because she and her husband were in their peak earning years. During the relevant time period, the spouses' joint income was about $42,000 and their net worth exclusive of their home was approximately $100,000. Based on the information the customer gave the broker, the broker recommended an investment in NTC and the customer agreed to invest $15,000. The NASD found the broker's recommendation unsuitable.[96]

On appeal, the SEC determined that the customer had dual investment objectives: (i) retirement income and (ii) tax savings.[97] The SEC found that

93. *Id.* at 2941-42.
94. Exchange Act Release No. 35,029, 58 SEC Docket 382 (Nov. 30, 1994).
95. *Id.* at 385.
96. *Id.* at 383.
97. *Id.* at 384.

the spouses received substantial tax credits from their investment which were reinvested and thereby further provided for their retirement years.[98] Moreover, the NTC prospectus stated that individuals investing in NTC should have either net worth excluding homes, furnishings, and automobile of at least $30,000 combined with a net income of at least $30,000, or in the alternative a net worth of at least $75,000. The SEC found that the spouses' financial situation fell well within these guidelines.[99] Finally, the SEC indicated that the broker had discussed the investment with the spouses' accountant who recommended that they invest $15,000 in NTC.[100] The SEC concluded, "we do not believe that the NASD established that [the broker's] recommendation was unsuitable, and we therefore set aside this finding."[101]

In *In re Venters*, the SEC affirmed sanctions of a censure, a $2500 fine, and a one-day suspension from the industry against a broker under the identical predecessors of NASD Rules 2310(a) and 2110 for recommending stock in a company that was losing money, had never paid a dividend, and whose prospects were totally speculative to a seventy-five-year-old widow whose net worth did not exceed $35,000.[102]

Holland, *Hassanieh*, and *Venters* were disciplinary actions decided by the NASD and the SEC under NASD Rules 2310(a) and 2110. As demonstrated above, NASD Rule 2310(a) specifically addresses suitability.[103] Disciplinary actions alleging unsuitability under NYSE rules, however, are decided by the NYSE and the SEC solely under NYSE Rule 476(a),[104] which prohibits conduct that is "inconsistent with just and equitable principles of trade," rather than under the more specific "know your customer" NYSE Rule 405.[105]

In *In re Rangen*,[106] the broker recommended that three unsophisticated, inexperienced investors, two of them elderly and all with limited means, concentrate their investments in margin purchases of non-income-producing U.S. Treasury (STRIP) securities and speculative over-the-counter securities. These recommendations were subsequently adjudged unsuitable on three grounds. First, the recommendations were unsuitable because the customers were "seeking safe, income-producing investments and did not wish to speculate."[107] Second, the extent to which the broker used margin was unsuitably risky for inexperienced customers seeking to generate ad-

98. *Id.*
99. *Id.*
100. *Id.* at 384 n.5.
101. *Id.* at 385 (footnote omitted).
102. Exchange Act Release No. 31,833, 53 SEC Docket 771, 773 (Feb. 8, 1993).
103. *See supra* notes 9-14 and accompanying text.
104. 2 N.Y.S.E. Guide (CCH) ¶ 2476, at 4057 (Aug. 1996).
105. *Id.* ¶ 2405, at 3696 (Aug. 1994).
106. Exchange Act Release No. 38,486, 64 SEC Docket 731 (Apr. 8, 1997).
107. *Id.* at 735.

ditional income through their investments.[108] Third, the concentration of so much of the customers' equity in particular securities "increased the risk of loss . . . beyond what is consistent with the objective of safe non-speculative investing."[109] Echoing its decision in *Holland* the SEC concluded:

> [The broker] admits that [the clients] were investing in a manner that was not suitable for them; however, he contends that they were aware of the risks and it would have been wrong for him to refuse their orders merely because he felt that the investments were not suitable. Even if we were to accept [the broker's] view that these clients wanted to speculate and were aware of the risks—a conclusion not supported on this record—the Commission has held on many occasions that the test is not whether [the clients] considered the transactions in their account suitable, but whether [the broker] "fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs."[110]

As mentioned above,[111] the SEC's opinion in *Rangen* does not reference NYSE Rule 405, but relies exclusively on NYSE Rule 476(a) and cites as authorities decisions interpreting and applying NASD suitability rules. This reliance by the SEC upon NASD precedents in a NYSE disciplinary proceeding under NYSE rules raises intriguing questions as to the possible use of the comparatively sweeping NASD Rule 2310 in private arbitrations convened not only before a NASD panel but also before a NYSE arbitration panel by customers seeking damages for unsuitable transactions from NYSE member firms. Query as to whether it would make a difference if the securities involved in the allegedly unsuitable transactions were or were not listed on the NYSE.

In *In re Nicholaou,*[112] the SEC affirmed sanctions imposed by the NYSE under NYSE Rule 476(a) on a Merrill Lynch representative found by the NYSE to have recommended unsuitable investments to several customers.[113] In the first situation, the broker recommended and sold to Athena Karsiotis shares in several mutual funds designed for investors seeking

108. *Id.* at 736.
109. *Id.*
110. *Id.* at 736-37 (citing *In re* Erdos, 47 S.E.C. 985, 989 (1993)); *see also In re* Wickswat, 50 S.E.C. 785, 786-87 (1991); *In re* Phillips & Co., 37 S.E.C. 66, 70 (1956) (applying the NASD's suitability rule); *In re* Holland, Exchange Act Release No. 36,621, 60 SEC Docket 2935, 2941 (Dec. 21, 1995), *aff'd sub nom.* Holland v. SEC, No. 96-70084, 1997 WL 3625, at *2 (9th Cir. Jan. 3, 1997) (finding violation of NASD suitability rule even though the client understood the risks because salesperson failed to make reasonable recommendations).
111. *See supra* notes 69-72 and accompanying text.
112. Exchange Act Release No. 34,454, 57 SEC Docket 668 (July 28, 1994).
113. *Id.* at 677.

capital appreciation and willing to take on greater risks. Karsiotis—a retiree who told the broker she did not want to invest in any security not guaranteed by the U.S. government—had an annual income of $6000 and a net worth of $75,000. The broker also used margin in Karsiotis' account even though the latter did not understand the concept of buying securities on margin. When Karsiotis asked the broker for an explanation of the margin charges on her statement, the broker deliberately misled her by telling her the charges would be credited to her account by year's end.

On another occasion, the broker serviced a joint account opened by Marjorie Wroblewski for her daughter, Pauline, with Pauline's funds. Pauline had an annual income of approximately $20,000 and a net worth of $60,000. Her mother told the broker that Pauline wanted a safe investment so she could save for retirement and have funds available in case of an emergency. The broker, however, recommended and sold to the Wroblewski account shares in a mutual fund that primarily invested in equities of corporations located in Far Eastern or Western Pacific countries. The fund's prospectus warned of an exposure to risks not existing in domestic stocks.

In a third situation, the broker was informed by Thomas Kydd that he and his wife, Katherine, were looking for conservative, risk-free investments for their Merrill Lynch IRA accounts and that income was their investment objective. The broker, however, recommended and sold to the Kydds shares of several mutual funds that were growth-oriented and risky, as well as interests in a commodity pool whose prospectus warned that investors could " 'lose a substantial portion or even all of the money' they invested."[114]

Finally, the broker's use of margin in a joint account opened by Mary Clough and her mother, Winifred Reder, a seventy-three-year-old widow, violated just and equitable principles of trade. The account was opened for the benefit of Reder with Reder's money, although the broker dealt solely with Clough. During the relevant time period, Reder had an annual income of $4000 and a net worth of $20,000. Clough explained to the broker that the money in Reder's account needed to be readily available to pay medical expenses or other care that Reder might require. Clough also told the broker that she did not want to take any risks. Although Clough did not understand the concept of margin, the joint account incurred over $300 in margin charges. In view of Reder's age and straitened circumstances, the SEC found "the use of margin was not appropriate for her account."[115]

The authors conclude this section with a word about sanctions in SRO disciplinary actions under SRO suitability rules. The sanctions in *Rangen* and *Nicholaou* are not germane because other violations, in addition to

114. *Id.* at 673.
115. *Id.* at 674.

unsuitable transactions, were present in those cases and undoubtedly increased the sanctions levied. The sanctions in *Holland* and *Venters* for participating in violations of SRO suitability rules—short suspensions and small fines—were relatively light. Leniency in this area, however, is not always granted. The NASD Sanction Guidelines, which are reproduced below, provide for severe sanctions in clear and egregious cases of unsuitable recommendations.

Suitability—Unsuitable Recommendations
NASD Conduct Rules 2110 and 2310[1]

Monetary Sanction	Suspension, Bar, or Other Sanctions
Fine of $2,500 to $50,000.[2]	In cases involving recommendations of clearly unsuitable securities and no prior similar misconduct, consider suspending individual respondent in any or all capacities for 10 to 30 business days. In egregious cases, consider a longer suspension (of up to two years) or a bar of an individual respondent. Also consider suspending respondent member firm with respect to any or all activities or functions for up to two years.

[1]This guideline also is appropriate for violations of MSRB Rule G-19.
[2]As set forth in General Principle No. 6, Adjudicators should increase the recommended fine amount by adding the amount of a respondent's financial benefit or require respondent to offer rescission to the injured customers. In this instance, the factors to be considered in the calculation of financial benefit should include the amount of any commissions or other profits that the respondent derived from the unsuitable trading.[116]

SEC SUITABILITY RULES

As stated above, the genesis of the suitability doctrine is rooted more in the ethical guidelines of the SROs than in SEC legal precedents under the federal securities laws. At the same time, however, the SEC has played a meaningful role in the development of the suitability doctrine over the years. In the previous section, the authors examined SEC administrative decisions analyzing and deciding suitability cases based upon SRO suitability rules.[117] These SEC decisions were written on appeals from decisions initially rendered by NASD and NYSE disciplinary panels imposing sanctions upon their members for participating in unsuitable transactions in violation of SRO "ethical" standards of "commercial honor and just and

116. NASD, *Sanctions Guidelines Booklet* (1998) <http://www.nasdr.com/3100_10.htm>.
117. *See supra* notes 88-116 and accompanying text.

equitable principles of trade."[118] Since the enactment of the federal securities laws in the 1930s, however, the SEC has rendered decisions imposing a suitability requirement on broker-dealers not simply as an ethical, but as a legal obligation. These SEC precedents entail the incorporation of suitability concepts into such anti-fraud provisions of the federal securities laws as Exchange Act sections 10(b)[119] and 15(c)(1)[120] and Rules 10b-5[121] and 15c1-2.[122]

Suggestions that section 10(b) and Rule 10b-5 may impose a suitability requirement on broker-dealers not simply as an ethical, but as a legal obligation appeared in a few early 1960s SEC cases.[123] The SEC reasoned that a violation of the suitability doctrine may constitute a violation of Rule 10b-5 based upon the shingle theory. When a broker-dealer hangs out his shingle he impliedly represents, among other things, that he will recommend securities only if he has a reasonable basis for believing that they are suited to a customer's financial circumstances. The SEC utilized this application of the suitability doctrine incorporated into the shingle theory in a large number of boiler room cases.[124] The SEC also utilized this application of the suitability doctrine incorporated into the shingle theory in cases involving intensive selling efforts with respect to low-priced speculative securities which were not necessarily part of a boiler room operation.[125] In these earlier cases, a variety of other violations of Rule 10b-5 were also present, including false or misleading representations regarding the security, excessive markups, and control or domination of the market.

More recently, the SEC has incorporated suitability concepts into Exchange Act sections 10(b) and 15(c)(1) and Rules 10b-5 and 15c1-2 under legal reasoning closely related to, but differing somewhat from, the shingle theory. In *In re Olde Discount Corp.*,[126] a broker-dealer and three senior officials, including the firm's chairman and founder, agreed to pay $5 million and to accept certain other sanctions to settle charges that the firm's compensation, production, hiring, and training policies created an environment that enabled its brokers to commit sales practice abuses. The SEC charged that certain Olde Discount Corp. (Olde) brokers working in

118. NASD Conduct Rule 2110, NASD Manual (CCH) ¶ 2110, at 4111 (Aug. 1998); *see* NYSE Rule 476(a), 2 N.Y.S.E. Guide (CCH) ¶ 2476, at 4057 (Aug. 1996).
119. Exchange Act § 10(b), 15 U.S.C. § 78j(b) (1994).
120. Exchange Act § 15(c)(1), 15 U.S.C. § 78*o*(c)(1).
121. 17 C.F.R. § 240.10b-5 (1998).
122. *Id.* § 240.15c1-2 (1999).
123. *See, e.g.*, *In re* Whitman & Stirling Co., 43 S.E.C. 181, 182-83 (1966); *In re* Powell & McGowan, Inc., 41 S.E.C. 933, 934 (1964).
124. *See, e.g.*, *In re* Mac Robbins & Co., 41 S.E.C. 116, 118-19 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); *In re* Barnett & Co., 40 S.E.C. 1, 4 (1960).
125. *See, e.g.*, *In re* Tallman, Exchange Act Release No. 8830, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,800, at 83,848 (Mar. 2, 1970); *In re* Cea, 44 S.E.C. 8, 18 (1969).
126. Exchange Act Release No. 40,423, 67 SEC Docket 2045 (Sept. 10, 1998).

this environment churned customer accounts, engaged in unauthorized and unsuitable trading, and used high-pressure sales methods in selling "special venture stocks" that the firm recommended. The SEC's legal reasoning with respect to suitability asserted that Olde's registered representatives strongly influenced or controlled their customer accounts thereby creating a fiduciary or similar relationship of trust and confidence with their customers from which arose an affirmative duty to disclose the unsuitable nature of recommendations made to customers. The firm acted with scienter in that its compensation system and aggressive sales techniques encouraged its sales force to sell "special venture stocks" which paid higher sales credits, had larger spreads, and correspondingly were more likely to be speculative to customers without making appropriate suitability determinations. The SEC wrote:

> Making unsuitable recommendations to customers without disclosing the unsuitability of those solicited investments, in breach of an affirmative duty to disclose arising from a fiduciary or similar relationship of trust and confidence, violated Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2.
>
> The Olde customers described above . . . ended up with portfolios consisting primarily of those special venture stocks that were more speculative issues. With respect to such investors, with conservative investment needs and objectives, concentrating most or all of their assets in such special venture stocks was not suitable.
>
> Olde RRs did not disclose this unsuitability to any of the customers in question. As is discussed in more detail above, the RRs exercised strong influence and *de facto* control over some of these accounts. As a result, Olde, through its RRs, stood in a fiduciary or similar relationship of trust and confidence with these customers. From that relationship, there arose an affirmative duty to disclose the unsuitable nature of recommendations made to the customers. Olde acted with scienter, in the form of a reckless disregard for the suitability of investment recommendations made by its RRs to the firm's customers, by focusing the firm's training primarily on aggressive sales techniques . . . . Olde's compensation system encouraged its sales force to sell special venture stocks to their customers and some of the firm's RRs favored those special venture stocks which paid higher sales credits—that is, the special venture stocks with larger spreads which correspondingly were more likely to be speculative—without making appropriate suitability determinations.[127]

Another example of SEC incorporation of suitability concepts into the anti-fraud provisions of the federal securities laws can be seen in Exchange

127. *Id.* at 2058 (citations and footnote omitted).

Act Rule 15g-9,[128] which was adopted as part of the Penny Stock Reform Act of 1990.[129] Rule 15g-9 imposes highly stringent suitability requirements with respect to transactions in "penny stocks."[130]

In 1962, the SEC adopted Exchange Act Rule 15c2-5 that requires a broker-dealer to determine suitability in the sale of equity funding programs.[131] Equity funding programs involve the purchase of mutual fund shares and the pledge of these shares to secure a loan, the proceeds of which are then used to pay the premiums on an insurance policy purchased at about the same time. Rule 15c2-5 provides that a broker-dealer offering an interest in an equity funding program must disclose certain specified facts about the program (including its risks and disadvantages) that might affect the particular customer and

> [o]btain[ ] from such person [customer] information concerning his financial situation and needs, reasonably determine[ ] that the entire transaction, including the loan arrangement, is suitable for such person, and retain[ ] in his files a written statement setting forth the basis upon which the broker or dealer made such determination; *Provided, however*, That the written statement referred to in this paragraph must be made available to the customer on request.[132]

As can be seen from the above excerpt, Rule 15c2-5 places upon the broker-dealer the responsibility for determining the suitability of the particular investment; imposes responsibility on the broker-dealer even though there was no prior established relationship with the customer; forbids the sale of the program even if the customer is highly sophisticated in financial matters and wishes to purchase the program notwithstanding the unfavorable recommendation of the broker-dealer; extends to offers and sales of securities, not merely to recommendations; and imposes a specific duty of inquiry on the broker-dealer. The requirement that the broker-dealer deliver a written statement to the customer regarding suitability is unusual. The justification for the comparatively stringent requirements of Rule 15c2-5 was that, in many cases, equity funding programs were being offered to persons of modest means and little financial experience for whom such programs were wholly inappropriate.

In 1967, the SEC adopted Exchange Rule 15b10-3 as part of the SEC Only (SECO) regulations applicable to broker-dealers who were not members of the NASD. Rule 15b10-3 read as follows:

128. 17 C.F.R. § 240.15g-9 (1999).
129. *See* Securities Enforcement Remedies & Penny Stock Reform Act of 1990, Pub. L. No. 101-429, §§ 501-510, 104 Stat. 931, 951-58 (1990) (codified as amended in scattered sections of 15 U.S.C.).
130. *See* 17 C.F.R. § 240.15g-9 (1998); *see also supra* notes 40-41 and accompanying text.
131. 17 C.F.R. § 240.15c2-5 (1999).
132. *Id.* § 240.15c2-5(a)(2).

> 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.[133]

The SECO regulations, including Rule 15b10-3, were rescinded in 1983[134] and virtually all broker-dealers were required to join an SRO and thereby become subject to its rules.

Finally, in 1994 the SEC proposed to adopt suitability rules under the Investment Advisers Act of 1940 that would, in the Commission's words, "make express the fiduciary obligation of investment advisers to make only suitable recommendations to a client, after a reasonable inquiry into the client's financial situation, investment experience, and investment objectives."[135] To date, this proposed rule has not been adopted.

PRIVATE DAMAGE ACTIONS AND THE SUITABILITY DOCTRINE

The use of the suitability doctrine by customers as the basis for recovering damages in private actions against brokers and their firms has been of great concern to the brokerage industry for many years.[136] Indeed, as noted, the NASD has disclosed that unsuitability claims account for ninety-five percent of filings under NASD members "errors and omissions" insurance policies. The industry's concern with respect to unsuitability claims has been exacerbated within the last decade by three developments. First, the principal forum in which private actions for damages based upon violations of the suitability doctrine have been initiated and resolved has shifted from the courts to the arbitration tribunals of the NASD, the NYSE, and the American Arbitration Association (AAA). Second, with this shift in forum has come a concomitant shift in the legal basis for unsuitability claims from an interpretation and application of rules promulgated by the SEC under the federal securities laws to an interpretation and application of the suitability rules promulgated by the SROs and discussed above.[137] Finally, with this shift in the legal basis for unsuitability claims has come a shift in the legal elements that must be proven to es-

133. 17 C.F.R. § 240.15b10-3 (repealed 1983).
134. *See* 48 Fed. Reg. 53,690 (1983).
135. Suitability of Investment Advice Provided by Investment Advisors, Custodial Account Statements for Certain Advisory Clients, Investment Advisers Act Release No. 1406, 56 SEC Docket 858 (Mar. 16, 1994).
136. *See supra* notes 1-8 and accompanying text.
137. *See supra* notes 9-86 and accompanying text.

tablish a suitability violation, from fraud under Exchange Act section 10(b) and Rule 10b-5 which requires scienter (or at a minimum recklessness) 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. In addition, there have been actions under state statutes and common law claims for negligence and breach of fiduciary duty that also do not require a claimant to establish scienter or recklessness.

In this section, the authors will examine private damage actions alleging unsuitability claims in court under the federal securities laws, state statutory provisions and the common law, and in arbitration under SRO suitability rules as well as under federal and state law.

PRIVATE DAMAGE ACTIONS FOR UNSUITABILITY UNDER EXCHANGE ACT § 10(B) AND RULE 10B-5

There are two types of unsuitability claims which are recognized under Exchange Act section 10(b) and Rule 10b-5. First is the unsuitability claim which is analyzed simply as a misrepresentation or failure to disclose a material fact, a subset of an ordinary fraud claim under Rule 10b-5.[138] Second is the unsuitability claim which is based on fraud by conduct and is closely analogous to a claim of churning.[139]

There has been extensive discussion with respect to the viability of implied private actions against brokers based upon violations of SRO suitability rules.[140] For all practical purposes, however, the only viable claims under these rules today in a federal court are as a subset of an implied private action under Exchange Act section 10(b) and Rule 10b-5 which require claimants to establish scienter.[141] Implied private actions against brokers for violations of SRO suitability rules, however, are being sustained today by securities arbitration panels at both the NASD and the NYSE with or without scienter.[142]

Unsuitability Claims Alleging Misrepresentations and/or Omissions

In *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*[143] the Fourth Circuit held that a brokerage firm, Alex. Brown & Sons, Inc. (Alex. Brown), did not fraudulently sell unsuitable investments when it sold collateralized mortgage obligations (CMOs) to Banca Cremi, S.A. (Banca Cremi) since the

138. *See* Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1021 (4th Cir. 1997); Brown v. E. F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).
139. *See* O'Connor v. R. F. Lafferty & Co., 965 F.2d 893, 898 (10th Cir. 1992).
140. *See, e.g.*, 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 15.06 (2d ed. 1999).
141. *See infra* note 155 and accompanying text.
142. *See infra* notes 182-207 and accompanying text.
143. 132 F.3d 1017 (4th Cir. 1997).

bank was a sophisticated investor with knowledge of the risks. Banca Cremi had lost millions of dollars on six CMOs sold to it by Alex. Brown after the market in CMOs collapsed in 1994. The court found that the bank itself had chosen its investment strategy by balancing CMOs' risks and benefits against its goals.[144]

In the course of its opinion, which carefully summarized the existing authorities and described the two unsuitability claims described above, the court held that a Rule 10b-5 unsuitability claim against a brokerage firm must have five elements:

> While this Court has never considered an unsuitability claim under § 10(b), several courts have recognized an unsuitability claim in certain circumstances. *See, e.g., O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992) (recognizing two types of unsuitability claims, one based on § 10(b) fraud and one similar to churning claim); *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990) (recognizing unsuitability claim as a type of fraud claim); *Lefkowitz v. Smith Barney, Harris Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986) (per curiam) (same); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600-01 (2d Cir. 1978) (recognizing unsuitability claim).
>
> A § 10(b) unsuitability claim has five elements:
>
> (1) that the securities purchased were unsuited to the buyer's needs;
>
> (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs;
>
> (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway;
>
> (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and
>
> (5) *that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.*
>
> *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993) (emphasis added). A claim for § 10(b) suitability fraud "is a subset of the ordinary §10(b) fraud claim." *Id.*; *see also O'Connor*, 965 F.2d at 897 (Court recognizing that this type of suitability claim could be analyzed "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 unstable for the investor's interests. The court may then use traditional laws concerning omission to examine the claim." (citation omitted)).[145]

The court found that the bank had sufficient sophistication combined with sufficient information concerning the risks of CMOs "to render unjustified any reliance on a recommendation that the securities were suitable investments."[146]

For another case analyzing an unsuitability claim under a misrepresentation or omission theory see *Brown v. E. F. Hutton Group, Inc.*,[147] where investors in an oil and gas partnership were unable to sustain a claim that a broker-dealer fraudulently sold them unsuitable securities since the investors recklessly and unjustifiably relied on alleged oral assurances from the broker that the investments were low risk.[148] The written offering materials provided to the investors contradicted the oral assurances by adequately disclosing the high risks associated with the investment.

Unsuitability Claims Alleging Fraud by Conduct

In *O'Connor v. R. F. Lafferty & Co.*,[149] the Tenth Circuit ruled that a disappointed investor was not entitled to recover $329,000 in damages from her broker for purchasing unsuitable securities in her discretionary account.[150] The court found no indication in the record that the broker intentionally or recklessly defrauded the investor.[151] The court established a newly adopted three-part test for unsuitability based on fraud by conduct and compared its test to the "misrepresentation or omission" test:[152]

> Under a misrepresentation or omission theory, a plaintiff can establish §10(b), Rule 10b-5 liability by showing that in connection with the purchase or sale of a security—the broker made an untrue statement of a material fact, or failed to state a material fact, that in so doing, the broker acted knowingly with intent to deceive or defraud, and that plaintiff relied on the misrepresentations, and sustained damages as a proximate result of the misrepresentations . . . .
>
> In contrast, Ms. O'Connor [investor] asserts an unsuitability claim based on fraud by conduct. She does not assert Mr. Foulke [broker] omitted to tell her the stocks he purchased were unsuitable for her investment needs. Rather, she claims that his purchase of the stocks for her account acted as fraud upon her.
>
> Fraud by conduct is a violation of Rule 10b-5(a) and (c) and is analogous to a churning claim . . . .
>
> As noted above, churning deals with the quantity of securities purchased for an account, while unsuitability concerns the quality of the purchased securities. Federal courts have used the NYSE and NASD rules to analyze both forms of broker misconduct. Thus, we will

144. *Id.* at 1033.
145. *Id.* at 1032.
146. *Id.*
147. 991 F.2d 1020 (2d Cir. 1993).
148. *Id.* at 1030-31.
149. 965 F.2d 893 (10th Cir. 1992).
150. *Id.* at 900.
151. *Id.*
152. *Id.* at 897.

> examine the elements of a churning claim to aid our analysis of unsuitability elements.
>
> While the elements of a churning claim are well established, the elements of an unsuitability claim based on fraud are not. To sustain a churning claim, the plaintiff must prove: (1) trading in the account is excessive in light of the investor's objectives; (2) the broker exercised control over trading in the account; and (3) the broker acted with an intent to defraud or with willful disregard for the investor's interests . . . .
>
> Because an unsuitability claim is so similar to a churning claim, we are persuaded the established "churning" elements can aid in our determination of the appropriate elements for an unsuitability cause of action. Today we adopt three elements to establish unsuitability based on fraud by conduct: The plaintiff must prove (1) the broker recommended (or in the case of a discretionary account purchased) securities which are unsuitable in light of the investor's objectives; (2) the broker recommended or purchased the securities with an intent to defraud or with reckless disregard for the investor's interests; and (3) the broker exercised control over the investor's account.
>
> Whether the control element of a churning claim applies to its cousin the unsuitability claim has been an open question. We believe the control element is essential to satisfy the causation/reliance requirement of a §10(b), Rule 10b-5 violation.
>
> In this case, we conclude the scienter element is dispositive. Based on our review of the record we hold Ms. O'Connor has failed, as a matter of law, to establish the scienter requirement of an unsuitability claim and affirm the district court's summary judgment against Ms. O'Connor's §10(b), Rule 10b-5 claim.[153]

While the "misrepresentation—omission" test for unsuitability differs from the "conduct" test described above, one essential component, scienter or at a minimum recklessness, is at the heart of both tests. Indeed, *Clark v. John Lamula Investors, Inc.*,[154] the first federal appellate court decision holding that an unsuitable recommendation constituted a Rule 10b-5 violation, made it very clear that in order to sustain a private damages claim for unsuitability, a claimant had to allege and prove scienter.[155] This crucial requirement of scienter has for all practical purposes rendered somewhat obsolete a claim of unsuitability resting solely upon Rule 10b-5. Today, customers involved in arbitration proceedings, where the overwhelming majority of customer-broker disputes are presently heard, secure a substantial advantage by asserting their unsuitability claims under state statutes, common law, or SRO suitability rules where the element of scienter is often not required.[156]

PRIVATE DAMAGES ACTIONS FOR UNSUITABILITY UNDER STATE LAW

There are a number of causes of action that may be employed to assert unsuitability claims by customers against brokers under state law. First, there are cases holding that unsuitability claims may be brought under state securities fraud statutes. Such claims are treated substantially the same as unsuitability claims initiated under Rule 10b-5, and claimants are required to establish scienter.[157] Second, there are cases holding that unsuitability claims may be asserted under state law based upon a breach of fiduciary duty owed by the broker to his or her customer.[158] Third, there is authority that suitability rules establish a standard or duty of care owed by securities brokers to their customers and violations of these rules may constitute negligence on the part of the broker towards the customer.[159]

The authors will examine each of these causes of action initially in state court decisions[160] and subsequently in arbitration proceedings.[161] The number of state court decisions is limited because most contemporary customer-broker disputes are resolved in arbitration. The number of arbitration authorities is limited because most securities industry arbitration panels avoid preparing written, reasoned decisions.

State Unsuitability Claims Under State Securities Fraud Statutes

One cause of action employed to support an unsuitability claim by a customer against a broker under state law is an action under the state's securities fraud statute. To sustain such a cause of action, state courts normally require a showing of fraudulent intent or recklessness.

153. *Id.* at 897-98 (footnote and citations omitted); see also *Craighead v. E. F. Hutton & Co.*, 899 F.2d 485 (6th Cir. 1990), in which unsuitability claims by a customer against a broker were dismissed. To state an "unsuitability" claim, a customer must plead which transactions and securities are involved and the reasons why these securities are unsuitable.

154. 583 F.2d 594 (2d Cir. 1978).

155. *Id.* at 600.

156. *See infra* notes 182-207 and accompanying text.

157. *See, e.g.*, Minneapolis Employees Retirement Fund v. Allison-Williams Co., 519 N.W.2d 176, 181 (Minn. 1994); Boettcher & Co. v. Munson, 854 P.2d 199, 209 (Colo. 1993).

158. *See, e.g.*, Duffy v. Cavalier, 259 Cal. Rptr. 162, 170-71 (Ct. App.), *review granted and cause transferred by* 778 P.2d 549, *transferred to and aff'd*, 264 Cal. Rptr. 740 (Ct. App. 1989); Csordas v. Smith Barney, Harris Upham & Co., [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,230, at 95,000 (Fla. Cir. Ct. July 16, 1992).

159. *See, e.g.*, *Csordas*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,000; Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 461 (9th Cir. 1986); Mihara v. Dean Witter & Co., 619 F.2d 814, 825 (9th Cir. 1980).

160. *See infra* notes 152-81 and accompanying text.

161. *See infra* notes 153-207 and accompanying text.

In *Minneapolis Employees Retirement Fund v. Allison-Williams Co.*,[162] a pension fund for retired employees of Minneapolis brought an unsuitability action against a securities broker for recommending high-yield, high-risk bonds to the fund in violation of Minnesota's statutory counterpart to Rule 10b-5. The Supreme Court of Minnesota, sitting en banc, noted that the executive director of the fund had approved every purchase in advance and had never requested nor received any review, analysis, or recommendations with respect to its portfolio from the broker.[163] The court held that to establish an unsuitability claim under the Minnesota statute the plaintiff must prove the same three elements required by the Tenth Circuit to prove unsuitability under Rule 10b-5 in *O'Connor v. R. F. Lafferty & Co.*:[164] (i) broker's recommendation of unsuitable securities, (ii) made with intent to defraud or reckless disregard for investors' interest, and (iii) the broker exercised control over investor's account.[165] The court found that plaintiff had failed to establish any of these elements and dismissed the claim. With respect to scienter the court wrote:

> MERF [customer pension fund] claims a showing of fraudulent intent or recklessness should not be required for unsuitability claims brought under the Minnesota Securities Act. MERF points out Minn. Stat. §§80A.01(b) and 80.01(c) may in some instances proscribe negligent as well as intentional misconduct. See *Aaron v. Securities and Exchange Comm'n*, 446 U.S. 680, 695-97, 100 S.Ct. 1945, 1954-56, 64 L.Ed.2d 611 (1980) (holding scienter is not required under sections 17(a)(2) or (a)(3) of Securities Act of 1933, even though scienter is required for all claims brought under Rule 10b-5); *Sprangers v. Interactive Technologies, Inc.*, 394 N.W.2d 498, 503 (Minn. App. 1986), *pet. for rev. denied* (Minn. November 19, 1986) (recognizing seller of stock may be liable for misrepresentation irrespective of scienter).
>
> We believe unsuitability claims brought under the Minnesota Securities Act should be treated similarly to unsuitability claims brought under federal Rule 10b-5. As stated by the Colorado Supreme Court in *Boettcher & Co., Inc. v. Munson*, 854 P.2d 199, 209 (Colo. 1993): "The gravamen of a fraud claim premised on unsuitability is that a broker recommended an investment to an investor while knowing, or reasonably believing, that the investment was not suited to the investor's needs."[166]

The court concluded its opinion with respect to scienter and unsuitability claims in sweeping fashion: "We are unaware of any court decision under federal or state securities law which has ever recognized an unsuitability claim without requiring a showing of fraudulent intent or recklessness."[167]

162. 519 N.W.2d 176 (Minn. 1994).
163. *Id.* at 180-81.
164. 965 F.2d 893, 898 (10th Cir. 1992); *see supra* notes 149-53 and accompanying text.
165. *Minneapolis Employees Retirement Fund*, 519 N.W.2d at 180.
166. *Id.* at 181.

State Unsuitability Claims for Breach of Fiduciary Duty

A second legal theory used to support an unsuitability claim by a customer against a broker under state law is an action to redress a breach of fiduciary duty owed by the broker to his or her customer. To sustain such a cause of action, state courts commonly do not require plaintiffs to prove fraudulent intent or recklessness.

In *Duffy v. Cavalier*,[168] trustees of a corporate profit-sharing and retirement trust recovered damages from a broker for recommending substantial purchases of highly speculative and unsuitable stock options for the account. The California Court of Appeal broadly defined the fiduciary role of a stockbroker and affirmed the judgment below that the broker had breached his fiduciary duty by recommending unsuitable securities to the customer.[169] The court defined this fiduciary duty in the following fashion:

> A stockbroker's fiduciary duty requires more than merely carrying out the stated objectives of the customer; at least where there is evidence, as there certainly was here, that the stockbroker's recommendations were invariably followed, the stockbroker must "determine the customer's *actual* financial situation and needs." If it would be improper and unsuitable to carry out the speculative objectives expressed by the customer, there is a further obligation on the part of the stockbroker "to make this known to [the customer], and [to] refrain from acting except upon [the customer's] express orders. Under such circumstances, although the stockbroker can advise the customer about the speculative options available, he or she should not *solicit* the customer's purchase of any such speculative securities that would be beyond the customer's "risk threshold."[170]

The court in *Duffy* relied to a considerable extent upon *Twomey v. Mitchum, Jones & Templeton, Inc.*,[171] a state court action based on common law fraud where a California court relied upon a departure from the suitability doctrine as evidence of fraud and breach of fiduciary duty.[172] In *Twomey*, there was a failure to ascertain the financial condition of a widow who, as a customer, had invariably accepted the broker-dealer's recommendations.

167. *Id.*
168. 259 Cal. Rptr. 162 (Ct. App.), *review granted and cause transferred by*, 778 P.2d 549, *transferred to & aff'd*, 264 Cal. Rptr. 740 (Ct. App. 1989).
169. *Id.* at 164, 167-68.
170. *Id.* at 173 (citations omitted).
171. 69 Cal. Rptr. 222 (Ct. App. 1968); *see Duffy*, 259 Cal. Rptr. at 167-73.
172. *Twomey*, 69 Cal. Rptr. at 243.

A Florida state court awarded damages to a customer on an unsuitability claim for breach of fiduciary duty as well as negligence in *Csordas v. Smith Barney, Harris Upham & Co.*[173] In *Csordas* an account executive trainee with a brokerage firm breached his fiduciary duty and was negligent by failing to exercise due care in recommending that his customer purchase bonds of a company that eventually went into bankruptcy and reorganized.[174] The trainee failed to make an adequate inquiry into his customer's current financial situation and needs. Further, the trainee did not obtain for his customer the bonds' pricing history, which was immediately available from an office computer. The history would have shown that the bonds had continuously declined in value approximately one point per month since the date they were issued. Lastly, among other things, the trainee did not tell his customer that, according to a standard bond ratings reference available in the office, the bonds' rating meant that they had speculative elements.

State Unsuitability Claims Based Upon Negligence

A third legal theory used to support an unsuitability claim by a customer against a broker under state law is a negligence action for breach of a duty or standard of care owed by the broker to the customer. In such actions customers contend that SRO suitability rules establish the duty or standard of care which brokers owe to their customers and violations of this duty constitute negligence for which there is a right of action and a remedy. In short, industry unsuitability rules, when breached, constitute common law negligence.[175]

173. [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,230, at 94,998 (Fla. Cir. Ct. July 16, 1992).

174. *Id.* at 95,000.

175. *See* Vucinich v. Paine, Webber, Jackson & Curtis, Inc., 803 F.2d 454, 461 (9th Cir. 1986) (stating that NASD and NYSE rules "reflect the standard to which all brokers are held") (citations omitted); Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980) (same). For a state court decision awarding damages to a customer on an unsuitability claim for negligence as well as breach of fiduciary duty, see *Csordas*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,999 ("While there is no cause of action for violation of agency rules such as the NYSE 'know your customer' rule, . . . these matters may be considered on the issue of the scope and extent of a broker's duty of care owed his customer."). For a state court decision refusing to award damages to a customer on an unsuitability claim for negligence and breach of fiduciary duty, see *Minneapolis Employees Retirement Fund v Allison-Williams Co.*, 519 N.W.2d 176, 182-83 (Minn. 1994) ("MERF argues that [Minnesota] Securities Act regulations prohibiting the recommendation of unsuitable securities . . . create a new standard of care for brokers, and that breach of these regulations is negligence per se. We disagree . . . . The particular hazard or form of hazard against which the [Minnesota] Securities Act is designed to give protection is fraudulent conduct. The [Minnesota] Securities Act expressly provides a buyer with a statutory cause of action where a seller violates the provisions therein.") (footnote omitted); *see also* Tatum v. Legg Mason Wood Walker, Inc., 83 F.3d 121, 123 (5th Cir. 1996) ("Under Mississippi law, a broker-dealer operating a non-discretionary account has no duty to determine the suitability of a customer's trades or to prevent the customer from losing money. *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, 587 So.2d 273, 279 (Miss. 1991) . . . . Therefore, [customers did] not state a cause of action against [brokers] for negligence.")

It is also possible that a state court could imply private damage actions on a negligence theory based upon breaches of suitability prohibitions and/or standards contained in state securities statutes or in the regulations promulgated thereunder. For example, section 204 of the 1956 Uniform Securities Act[176] authorizes denial, revocation, or suspension for dishonest or unethical practices in the securities business. Some states construe these practices to include suitability.[177] Uniform Securities Act section 212(a)(8)[178] is the same as section 204(G) in the 1956 act.

The North American Securities Administrators Assoc., Inc. (NASAA) has a Policy Statement on *Dishonest or Unethical Business Practices*[179] that includes suitability standards. Its Omnibus Guidelines[180] also include suitability standards. The policies or guides on particular kinds of securities include similar suitability standards, but with some variations for the specific security.[181] These suitability standards tend to emphasize income/asset criteria but most have sufficient general language to support a vague unsuitability claim.

PRIVATE DAMAGES ACTIONS FOR UNSUITABILITY IN ARBITRATION

As this Article has emphasized repeatedly, the principal forum where private actions for damages based upon violations of the suitability doctrine are presently heard is before the securities industry arbitration tribunals of the NASD, NYSE, and AAA. These arbitration tribunals have a great deal of flexibility in deciding cases initiated by customers against brokers for unsuitable transactions. The arbitrators are free to adopt or reject in whole or in part any of the legal theories discussed above. They

176. 1 Blue Sky L. Rep. (CCH) ¶ 5524, at 1539 (Aug. 1997).

177. *See, e.g.*, 1 Blue Sky L. Rep. (CCH) ¶ 8411(5), at 4409 (Dec. 1990) (Alaska); 1A Blue Sky L. Rep. (CCH) ¶ 13,437(B), at 9414 (Dec. 1998) (Colorado); *id.* ¶ 14,464(a)(2), at 10,415 (Oct. 1995) (Connecticut); 2 Blue Sky L. Rep. (CCH) ¶ 24,613M(a)(1), at 19,475-17 (Feb. 1992) (Indiana); 3 Blue Sky L. Rep. (CCH) ¶ 50,406C(C)(1), at 45,506 (Feb. 1998) (Rhode Island); 3A Blue Sky L. Rep. (CCH) ¶ 64,566(1)(c), at 56,530 (Jan. 1999), ¶ 64,820, at 56,612 (Apr. 1985) (Wisconsin).

178. Uniform Securities Act (1985) § 212(a)(8), [Extra Edition] Blue Sky L. Rep. (CCH) No. 748m, at 24 (Aug. 27, 1985).

179. NASAA Rep. (CCH) ¶ 1402, at 901 (Aug. 1997).

180. NASAA Rep. (CCH) ¶ 2323, at 1388 (Oct. 1993).

181. Registration of Asset-Backed Securities, NASAA Reports (CCH) ¶ 506, at 464 (Nov. 1995); *id.* ¶ 1203, at 806 (Oct. 1993) (Registration of Commodity Pools); *id.* ¶ 1603, at 1009 (Oct. 1993) (Equipment Programs); *id.* ¶ 703, at 518-19 (Oct. 1996) (Mortgage Programs Guidelines); *id.* ¶ 2624, at 1553 (Oct. 1993) (Registration of Oil & Gas Programs); *id.* ¶ 3603, at 2010 (Oct. 1993) (Real Estate Programs).

can require scienter or reject scienter. They can base a decision upon breach of fiduciary duty or upon a negligence analysis. They can step beyond any legal constraints and, following the mandate of *The Arbitrator's Manual*, decide the case primarily upon the equities. "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."[182]

Bearing in mind that most securities industry arbitration panels do not promulgate reasoned decisions in writing and that arbitrators' decisions are not binding on any court or on any other arbitration panel, the following is a discussion of a number of these decisions involving the suitability doctrine.

One particular area involving suitability in which the arbitrators appear to be pushing beyond accepted legal doctrine is the so-called "dram shop" series of cases where a bartender in a tavern (a "dram shop" in England) may be responsible for the person who becomes intoxicated at his bar. Does the bartender at some point have a duty to cut off the drinker's supply of liquor? Similarly, by analogy, does a broker at some point have a duty to intervene to prevent even a wealthy and sophisticated investor from engaging in reckless, unsuitable trading which approaches financial suicide?

In *Peterzell v. Charles Schwab & Co.*,[183] a customer sought damages in arbitration alleging that his discount broker had induced him to purchase options which were not suitable investments in light of his investment objectives. The firm responded that its employee had never held himself out as an expert in options, that the customer had represented he was experienced and suitable for these investments, and that the customer had been provided with a prospectus. It was not clear from the opinion whether or not a recommendation had been made to the customer by the firm. Two of the three arbitrators awarded the customer a portion of his claim and wrote:

> Claimant, Joel Peterzell, contributed to his losses by providing false information, devising a questionable strategy and continuing to trade as losses mounted. Suitability, however, is an ongoing obligation and, although Charles Schwab initially met its suitability obligations, it failed to maintain any ongoing supervision of the Claimant's suitability.
>
> At some point in time, Claimant became unsuitable, even with his false representations. Charles Schwab's Compliance Department should have, at that time, realized his losses were disproportionate to his claimed net worth and annual income.[184]

It is interesting to note that a majority of the arbitrators apparently balanced the negligence of the firm's supervision with respect to suitability against the customer's intent to defraud evidenced by the making of false representations and still awarded the customer a partial recovery.

Similarly, in *Peterzell v. Dean Witter Reynolds, Inc.*,[185] a securities industry arbitration panel awarded the ubiquitous Mr. Peterzell substantial damages for his broker's breach of a "duty imposed on [the broker] to take adequate steps when it became apparent that [the customer] was trading inappropriately, that he was losing large amounts of money and, that he was putting excessive amounts of his net worth at risk."[186] The panel's determination was limited to a finding that what had been done was not adequate. The panel did not specify what the broker should have done to satisfy its duty.

In *Aaron v. PaineWebber, Inc.*,[187] the brokerage firm was ordered to pay its seventy-one-year-old customer, a former art supplies dealer, $500,000 in damages for failing to "take reasonable steps to limit or otherwise safeguard the extent of [the customer's] risks and possible losses."[188] In addition, the panel rejected the broker's counterclaim for a debit balance in excess of $1,000,000. The panel expressly found that the customer was "an experienced and knowledgeable businessman and stock and options investor [who] devoted a substantial amount of his time to investments in the securities markets and maintained brokerage accounts with several brokerage houses."[189] In addition, the customer controlled his account at all times, was fully aware of the transactions, had a good understanding of the mechanics of options trading, and understood the risks. Nonetheless, the panel relied upon PaineWebber's failure to fulfill its "fiduciary and contractual" obligations as well as its violations of suitability and supervisory rules promulgated under the California Securities Law in rendering its award.[190] California's suitability rule was substantially similar to NASD Rule 2310(a).[191]

In *Peterzell v. Charles Schwab & Co.*,[192] the panel referred cryptically to a failure to maintain ongoing suitability obligations.[193] In *Peterzell v. Dean*

182. Domke on Aristotle, The Arbitrator's Manual, app. H (compiled by Securities Industry Conference on Arbitration).
183. No. 88-02868, 1991 WL 202358 (N.A.S.D. 1991) (NASD arb. panel).
184. *Id.* at *2.
185. Am. Arb. Ass'n Case No. 32-136-0416-88-ID, at 1 (Nov. 9, 1990) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter *Peterzell*].
186. *Id.* at 3.
187. Am. Arb. Ass'n Case No. 72-136-1146-87, at 1, (June 28, 1989) (Wilson, Arb.) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter *Aaron*].
188. *Id.* at 2.
189. *Id.* at 1.
190. *Id.* at 2.
191. *Id.* at 3.
192. No. 88-02868, 1991 WL 202358 (N.A.S.D. 1991) (NASD arb. panel).
193. *Id.* at *2.

Witter Reynolds, Inc.,[194] the panel rested its decision upon the broker's breach of a duty, perhaps a fiduciary duty, to its customer.[195] In *Aaron*, the panel relied upon the broker's breach of "fiduciary and contractual" obligations and of state securities regulations.[196]

In *Cass v. Shearson Lehman Hutton*,[197] an NASD arbitration panel rendered a partial award to the widow of a wealthy, sophisticated investor on the grounds that the broker violated "the suitability rules of the New York Stock Exchange and other self-regulatory organizations."[198]

> The panel believes it was especially improper for Shearson to allow Mr. Cass to continue his disastrous trading strategy . . . since Shearson holds out its registered representatives to be not merely brokers but "financial consultants." A competent financial consultant never would have permitted Mr. Cass to continue his disastrous trading strategy, in the wake of back-to-back $1 million losses, without first taking careful inventory of his whole financial situation.
>
> In December, 1987, when the individual account was transferred to the joint account, it is our opinion that, in view of the loss or more than $1-million in the individual account, and the cumulative loss of some $2-million in both the Merrill Lynch and Shearson accounts, Respondents should have made a diligent inquiry into Mr. Cass's financial resources and his suitability for continued speculative trading, risking the remnants of his capital. The failure to make such an inquiry is a violation of the suitability rules of the New York Stock Exchange and other self-regulatory organizations.[199]

In another example of an arbitrator resting his decision to award damages to a customer based solely upon a violation of SRO suitability rules, *McCotter v. Shearson Lehman Hutton Inc.*,[200] the panel stated: "[NYSE] Rule 405 is a Rule adopted to protect investors and thus can serve as a basis for civil liability by itself."[201]

An interesting variation on the "dram shop" issue may be seen in *Brumm v. McDonald & Co. Securities, Inc.*[202] In *Brumm*, an elderly widow placed two-thirds of her entire "liquid net worth" in 5000 Federated Department Stores call options. Three days after the trade date an alert Compliance

194. *Peterzell, supra* note 185.
195. *Id.* at 8.
196. *Aaron, supra* note 187, at 2.
197. NASD Case No. 91-01484, at 1 (Jan. 31, 1994) (Dolan, Arb.) (on file with *The Business Lawyer*, University of Maryland School of Law).
198. *Id.* at 7.
199. *Id.*
200. Am. Arb. Ass'n Case No. 13-136-0048-8, at 1 (Apr. 27, 1992) (Camody, Arb.) (on file with *The Business Lawyer*, University of Maryland School of Law).
201. *Id.* at 2.
202. NASD Arb. Award No. 89-02881, at 1 (Apr. 10, 1990) (on file with *The Business Lawyer*, University of Maryland School of Law).

Department reviewed the trade, found suitability lacking, notified the plaintiff-customer of cancellation, and "bought-out" (reimbursed) the customer at her cost resulting in a loss to the firm. When the options ultimately increased substantially in value, the customer sued the brokerage firm and an NASD arbitration panel awarded only nominal damages.[203] Plaintiff's appeal to vacate the arbitration award in her favor was rejected by the Ohio courts.[204]

In *Weinstein v. Brokers Exchange Inc.*,[205] an arbitrator's opinion rejected as absurd the idea that a broker has a duty under the "know your customer" rule to save a sophisticated customer from himself. A *Wall Street Journal* reporter has documented awards in "dram shop" cases totalling $10 million in the three-year period between 1992 and 1995.[206]

As regards the measure of damages, predictability in securities industry arbitrations involving the suitability doctrine is virtually impossible. Indeed, panels are meticulous in carefully tailoring their damage awards to fit the peculiar facts of each individual case.[207]

203. *Id.* at 2.
204. Brumm v. McDonald & Co. Securities, Inc., 603 N.E.2d 1141, 1141 (Ohio Ct. App. 1992).
205. No. 93-04713, 1997 WL 741939 (N.A.S.D. 1997) (Cohn, Arb.).
206. Michael Siconolfi, *Brokerage Firms Pay Big Damages in "Dramshop" Cases*, WALL ST. J., May 17, 1995, at C1.
207. For a discussion of damages in securities industry arbitrations generally, see 4 BROMBERG & LOWENFELS, *supra* note 140, § 16.03(360)-(370).