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### Recommended Citation

Gregory A. Hicks, *Defining the Scope of Broker and Dealer Duties - Some Problems in Adjudicating the Responsibilities of Securities and Commodities Professionals*, 39 DePaul L. Rev. 709 (1990)  
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# DEFINING THE SCOPE OF BROKER AND DEALER DUTIES—SOME PROBLEMS IN ADJUDICATING THE RESPONSIBILITIES OF SECURITIES AND COMMODITIES PROFESSIONALS

Gregory A. Hicks\*

## INTRODUCTION

There is considerable confusion over the expectations that investors may have in their dealings with securities and commodities brokers and dealers. A main source of that confusion is the uncertain significance of the fiduciary label often attached to these market professionals, and an accompanying uncertainty about the legal duties which the fiduciary label implies.<sup>1</sup> Certain

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1. See, e.g., *Romano v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 834 F.2d 523, 530 (5th Cir.), *cert. denied*, 108 S. Ct. 2846 (1986); *Leib v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978). Resistance to the fiduciary label has led some courts to insist that the bare relationship between broker and customer or dealer and customer is not fiduciary, and to require the existence of special circumstances before such a relation will be found. See, e.g., *Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co.*, 800 F.2d 177, 182 (7th Cir. 1986) (fiduciary relation arises where dealings between customer and broker have caused customer to repose special trust or confidence); *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb*, 769 F.2d 561, 567 (9th Cir. 1985) (broker must control customer's account before fiduciary duty arises); *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Boeck*, 127 Wis. 2d 127, 131, 377 N.W.2d 605, 609 (1985) (nondiscretionary account does not give rise to fiduciary duty; court adopts very exacting standard for finding a "special relationship" giving rise to extended duties). While these decisions seem concerned with containment of the over-broad duties that might arise from application of the fiduciary label, most courts have chosen to address the risks of application of the fiduciary label by tailoring duties to the facts before them rather than by banning the label altogether. See, e.g., *Romano*, 834 F.2d at 530 (nature of fiduciary duty owed will vary depending on relationship between broker and investor); *Leib*, 461 F. Supp. at 953 (degree of broker's duty to customer depends on sophistication of customer and his ability to understand potential risks of particular transaction).

One common solution to the problem of determining the content of legal duties created by broker-customer relations has been the development of fixed categories of relationships, carrying relatively well-defined sets of duties. The most familiar effort of this type is the distinction between "discretionary" trading accounts, where the market professional directs investment decisions, and "nondiscretionary" accounts where the customer retains control over trading decisions. These distinctions must be seen, however, more as administrative expedients, valuable to the courts in setting initial expectations, rather than as hard and fast lines defining protected interests. It commonly happens that courts search out and find special circumstances narrowing or broadening the scope of an investor's protected interests. This phenomenon emphasizes,

specific duties have developed from the "shingle theory," the principle requiring fair dealing by securities dealers,<sup>2</sup> and others have arisen under

again, the thirst for facts that most courts have when approaching questions of the existence and scope of duties labelled as fiduciary. See, e.g., *Romano*, 834 F.2d at 530; *Leib*, 461 F. Supp. at 953.

Among the more thoughtful analyses of the sources and content of fiduciary duties are J. SHEPHERD, *THE LAW OF FIDUCIARIES* 96-110 (1981) (defining the fiduciary relationship as one where one person acquires powers to act with respect to another's affairs in circumstances where the powers are obtained subject to the condition that they be exercised to benefit another, a so-called "encumbered power"); Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 802-04 (1983) (finding that the modern phenomena of increasingly greater specialization of knowledge and the development of systemic inequalities of information and access to information creates classes of persons who must "entrust" their well-being to others, and that the necessity of entrustment should create protectable reliance interests); DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 914-15. DeMott's article gives the particularly helpful insight that most satisfactory explanations of the fiduciary relation are descriptive. DeMott emphasizes the importance of analyzing particular relations to arrive at specific requirements of the fiduciary duty in setting of a given relationship. DeMott explains the fiduciary duty as follows:

Described instrumentally, the fiduciary obligation is a device that enables the law to respond to a range of situations in which, for a variety of reasons, one person's discretion ought to be controlled because of characteristics of that person's relationship with another. This instrumental description is the only general assertion about fiduciary obligation that can be sustained.

*Id.* at 915. See also Jacobson, *Capturing Fiduciary Obligation: Shepherd's Law of Fiduciaries*, 3 CARDOZO L. REV. 519 (1982) (book review of J. SHEPHERD, *supra*). Both DeMott and Jacobson conclude that efforts at more abstract formulations, whether Scott's theory of voluntary assumption or Shepherd's theory of encumbered power, fail as analytical tools because they, like the fiduciary label itself, tend to operate as after-the-fact explanations of decisions and do not provide guidance to the particular content of fiduciary duties in individual cases. See DeMott, *supra*, at 885-915.

2. The Securities and Exchange Commission promulgated the "shingle theory" in *In re Duker & Duker*, 6 S.E.C. 386 (1939). The courts adopted this theory in *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943). The heart of the theory is that securities dealers, although trading for their own accounts and not as agents for their customers, are under a special duty by virtue of their expertise and pivotal role in providing public access to the markets, to deal fairly with their customers "in accordance with the standards of the profession." *Duker*, 6 S.E.C. at 388. Those "standards of the profession" are embodied in the Rules of Fair Practice of the National Association of Securities Dealers ("NASD") which require, *inter alia*, that dealers not charge excessive fees for trade execution; that sales and purchases to and from a dealer's own inventory be at fair prices; that quoted prices be honored, and that purchase and sale recommendations reflect a reasonable belief that the proposed transactions are suitable for the customer, representing neither excessive trading ("churning") nor overly risky trading. *NASD Rules of Fair Practice*, art. III, §§ 1-6, NASD MANUAL (CCH) ¶¶ 2151-56 (1989).

The Securities Exchange Act of 1934 may provide remedies for a dealer's failure to comply with duties under the "shingle theory," but the interaction of an array of federal court decisions has made this less likely and increased the importance of NASD tribunals in adjudicating violations of the Rules of Fair Practice. Among the rulings narrowing access to 1934 Act remedies for violations of broker and dealers' duties are: (1) the Supreme Court's requirement that *scienter* be established to make recovery under Rule 10b-5 available, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); (2) the Supreme Court's denial of actions under Rule

common law agency principles.<sup>3</sup> The fiduciary duty is imprecise, however, and often creates expectations of levels of service and methods of dealing which may not fit comfortably with the market roles of brokers and dealers. These expectations are nonetheless the source of continual pressure for the expansion of the market responsibilities of brokers and dealers beyond the range of recognized duties, especially in a regulatory culture that insists on holding accountable those who provide public access to investment markets.

There are two main risks which result from relying on a tool as powerful and amenable as the fiduciary principle to establish a foundation for broker and dealer duties. First, it invites the creation of extravagant duties.<sup>4</sup> Second,

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10b-5 for breaches of fiduciary duty unless the culpable act involved deception or manipulation, *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-75 (1977) (followed by *Shivangi v. Dean Witter Reynolds, Inc.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,142, at 95,639 (D. Miss. June 20, 1986)); and (3) the decisions holding that breaches of the NASD Rules of Fair Practice are not actionable under Rule 10b-5 unless there is fraud, *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 601 (2d Cir. 1978) (10b-5 action permitted where the conduct that breached the rule was also fraudulent under the federal securities laws). Moreover, the enforceability of pre-dispute arbitration agreements, in *Shearson/American Express Inc. v. McMahon*, 107 S. Ct. 2332 (1987), and the unwillingness of the courts to allow implied rights of action under section 15(c) of the 1934 Act—the section specifically prohibiting fraudulent and manipulative practices by brokers and dealers, for example, as in *Asch v. Philips, Appel & Walden, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,196, at 91,718 (2d Cir. Feb. 9, 1989)—have caused the resolution of dealer cases to be shifted to disciplinary tribunals of the NASD.

Some broker and dealer duties arising under the “shingle theory” are the subject of specific federal regulation, and accordingly can give rise to enforcement actions under the 1934 Act. *See, e.g.*, General Rules and Regulations, Securities Exchange Act of 1934 Rule 10b-10, 17 C.F.R. § 240.10b-10 (1989) (duty to disclose mark-ups and status as principal or market maker in transaction); Rule 15c1-7(a), 17 C.F.R. § 240.15c1-7(a) (1989) (specific prohibition against churning of discretionary accounts); Rule 15c2-11, 17 C.F.R. § 240.15c2-11 (1989) (requirement that broker-dealer have information available with respect to securities for which they quote prices); Proposed Penny Stock Rule, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,352, at 89,693 (Feb. 8, 1989) (proposed 1934 Act Rule 15c2-6 requiring that broker-dealer gather information which permits fair assessment of a customer’s suitability for trading risky “penny stocks”).

3. For descriptions of the agency relationship of a broker to its customer, see *Marchese v. Shearson Hayden Stone, Inc.*, 734 F.2d 414, 418 (9th Cir. 1984) (securities broker stands in fiduciary relationship with his customers and is held to utmost good faith which requires full and fair disclosure of all material facts); *McMann v. SEC*, 87 F.2d 377, 378 (2d Cir. 1937) (broker is an agent who is bound to act for his customer and not to betray, to others, information he learns through his duties). The essential fiduciary character of the relation is widely assumed, stemming from the existence of the agency relation itself. *See, e.g.*, *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949) (broker acting as fiduciary must actually disclose material facts to ones she is being paid to protect, her willingness to divulge information will not suffice); *see generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 958-68 (1983).

4. *Merrill, Lynch, Pierce, Fenner & Smith v. Boeck*, 127 Wis. 2d 127, 377 N.W.2d 604 (1985), is a particularly good example of a decision shaped by the fear that the assertion of a fiduciary relation between investor and broker could lead to extravagant expectations. The court in *Boeck* first stated that the basic relationship of a broker to a sophisticated customer who retained trading control of his account was not fiduciary. *Id.* at 131, 377 N.W.2d at 609. The

the choice of an exacting model of accountability can, by itself, invite carelessness by courts and regulators in thinking through the soundness of specific proposed duties.<sup>5</sup> The purpose of this Article is to stress the need for grounding broker-dealer duties in sound, articulated understandings of the investment markets, as well as defensible statements of the responsibilities and expectations of both customers and market professionals. This important need will be demonstrated through the use of several cases illustrating problematical or failed processes by which broker-dealer duties have been established.

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plaintiff had argued that the broker's ongoing practice of offering incidental advice and counsel with respect to commodities investments had created an obligation to inform him of a material, revised soybean crop estimate known to the broker, especially since that estimate was completely at odds with information the broker had given him two days before the broker received the new forecast. The court, rejecting that theory, seemed motivated in large part by an unwillingness to turn a jury loose with instructions on fiduciary duties, especially in view of the common practice among stock and commodities brokers of offering incidental investment advice as a part of their services. The court was concerned that the practice of providing incidental advice should not become the tool for routinely imposing duties on brokers that approached those of personal investment advisors. The decision left ample room for incidental advice to continue without threat of application of fiduciary labels. The court seemed determined not only to reject a fiduciary characterization of the broker-client relation, but to strictly confine the range of special circumstances justifying expansion of duties. *Id.* at 133, 377 N.W.2d 609.

The concurring and dissenting opinions would have addressed the problems of jury control and the overreaching brokerage client by deriving the content of fiduciary duties from a fair examination of the specific facts of particular broker-client relations, and drafting corresponding jury instructions on the scope of duties. *Id.* at 143-54, 377 N.W.2d at 612-18.

The most interesting aspect of *Boeck* is its indication of the wrangles that will almost inevitably accompany efforts to decide whether particular relations between brokers and clients can give rise to more expansive duties. The resolution of these questions will depend on value-laden assessments of the relative capacities and responsibilities of customers and market professionals. For example, the dissent's conclusion in *Boeck* that Merrill Lynch had a clear fiduciary duty to correct its earlier communicated forecast is based in part on the assumption that when heightened expectations of advice and counsel are created by broadcast and print advertising that touts the acumen and service of the brokerage house, such statements create a basis for customer reliance and are not to be taken as mere puffery. 127 Wis. 2d at 152-53, 377 N.W.2d at 617. For a different view, see, e.g., *Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (use of word "marvelous" to describe bonds did not constitute actionable misrepresentation); *Rotstein v. Reynolds & Co.*, 359 F. Supp. 109, 113 (N.D. Ill. 1973) (statements that stock was "red hot" and it was impossible to lose money in investment was considered puffing); *Bowman v. Hartig*, 334 F. Supp. 1323, 1328 (S.D.N.Y. 1971) (statement that investors would make "substantial profits without speculative risks" was puffing).

5. The adoption of a particular model of legal duties may be the first stage in determining the scope of duties owed and may even shape eventual factfindings, a phenomenon revealingly explored in Malone, *Ruminations on Cause-in-Fact*, 9 STAN. L. REV. 60, 73 (1956).

For an early, wry comment on the aggressive expansion of duties under the "shingle theory," originally so tentatively propounded, see Loss, *Duke University School of Law: Conference on Securities Regulation*, 18 J. LEGAL ED. 238 (1965) (book review of conference devoted to discussion of increasingly higher standard of conduct imposed on broker-dealers).

This Article will focus primarily on two recent decisions, *In re E.F. Hutton & Co.*,<sup>6</sup> and *Wasnick v. Refco, Inc.*,<sup>7</sup> both of which have been criticized for inappropriately expanding broker and dealer duties.<sup>8</sup> Each decision is better understood, however, as a case where the creation of a sound substantive duty becomes suspect because of the failure to state a wholly persuasive foundation for the establishment of that duty.

*Hutton* and *Wasnick* have been chosen because the facts and processes of their decisions contain helpful clues for the development of a sound approach to the definition of broker and dealer duties against a vague fiduciary background. *Hutton* will be emphasized in particular because it permits discussion of the creation of an apparently controversial duty and illustrates the misapplication of a fiduciary model. What is most interesting about *Hutton* is that a duty of disclosure, although quite reasonable in fact and ultimately endorsed by the defendant, generated enormous controversy because of the rationale offered for the creation of that duty. Ultimately, the Article emphasizes the need for care in adequately grounding proposed duties, and the threat of lost legitimacy when duties seem suspect.

*Hutton* and *Wasnick* are also notable because they do not involve the common instances of self-dealing or failure to perform easily implied obligations. In *Wasnick*, a federal district court found that a commodities broker<sup>9</sup> had an obligation to protect a customer from that customer's proclivity for erratic and irrational trading.<sup>10</sup> *Wasnick* imposes a duty which has only uncertain support in existing commodities legislation, case law, and industry practices. The opinion fails to make the case that a special duty to protect a client from self-destruction can co-exist with the narrower vision of duties reflected in current commodities regulation. Neither does the case show that the narrower view of brokers' duties reflected in those regulations is itself unreasonable. Such a showing might have been made, and the survival of

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6. Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (SEC July 6, 1988).

7. [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).

8. See, e.g., Angrist, *Stop Him Before He Trades Again, Brokers Are Told By A Federal Judge*, Wall St. J., May 5, 1989, at C1, col. 3 (article about *Wasnick*); Securities Industry Association, *SEC Affirms NASD Decision: Broker-Dealers Must Give Priority to Customers' Limit Orders Unless Prior Disclosure and Agreement*, in Legal Alert (July 15, 1988) (article about *Hutton*).

9. In commodities transactions, those who perform the tasks corresponding to those of stock brokers are properly called "agents" or "associated persons." This Article will adopt the common practice of referring to them as commodities "brokers." See, e.g., *United States v. Dial*, 757 F.2d 163, 165 (7th Cir. 1985); P. JOHNSON, COMMODITIES REGULATION 101 (1982).

10. Briefly, liability in *Wasnick* was based on the broker's actual knowledge of the customer's obsessive pursuit of an approach to trading that was inevitably destructive and wholly without reason, even in a trading environment known for irrational schemes and losing strategies that sometimes work.

the duties in *Wasnick* may require that it yet be made.<sup>11</sup> The teaching of *Wasnick* is that if courts intervene to propose seemingly marginal duties in a highly regulated setting, they must demonstrate how the duties they seek to impose fit into a sound model of accountability for brokers and dealers.

Similarly, *Hutton* is a case where a seemingly unanticipated duty was imposed upon a broker-dealer. The Securities and Exchange Commission ("SEC" or "Commission") sustained a finding that an over-the-counter ("OTC") market maker had an obligation to inform its customer, prior to engaging in normal buying and selling of securities as a dealer, while awaiting a movement in market price that would permit execution of the customer's order to buy or sell the same securities. *Hutton* was adamant that its conduct was necessary to its role as a market maker in the OTC market, a position that seemed supported by earlier policy statements of the National Association of Securities Dealers ("NASD").<sup>12</sup>

This Article will begin with a rather detailed description of the *Hutton* litigation as it unfolded. Next, the aftermath of *Hutton* and a market-based alternative argument for the disclosure of the limit order execution policy required by *Hutton* will be discussed. Finally, the Article will review *Hutton* in the context of other litigation, focusing in particular on the expansion of a commodities broker's duty to the customer resulting from *Wasnick*.

## I. THE *HUTTON* LITIGATION

The historical setting of the *Hutton* litigation helps to explain its evolution. The *Hutton* case<sup>13</sup> arose during a period when both the SEC and the NASD were endeavoring to eliminate the last vestiges of self-serving practices by OTC dealers, and to bring the norms of exchange-based trading to the OTC markets to the greatest extent possible.<sup>14</sup> Moreover, public confidence in

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11. The appeal in *Wasnick* is currently pending in the United States Court of Appeals for the Ninth Circuit. *Wasnick v. Refco, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988), *appeal docketed*, No. 88-4346 (9th Cir. May 31, 1989).

12. The NASD, formed pursuant to section 15A of the Securities Exchange Act of 1934, 15 U.S.C. § 780 (1982), is the self-regulatory body charged with disciplining and setting standards of professional conduct for broker-dealers trading in the over-the-counter ("OTC") market. Section 15A of the Exchange Act also sketches out the structure of a substantive code of conduct for broker-dealers now embodied in the NASD's Rules of Fair Practice.

13. *In re E.F. Hutton & Co.*, Exchange Act Release No. 25,887, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988). Disciplinary proceedings against NASD member broker-dealers under the association's Rules of Fair Practice are heard first by District Business Conduct Committees. Decisions made by that committee may then be appealed first to the NASD Board of Governors, then to the Securities and Exchange Commission, and ultimately to the United States Court of Appeals either for the District of Columbia Circuit or for the circuit in which the complaining party has his residence or principal place of business. NASD Code of Procedure, arts. II, III, NASD MANUAL (CCH) ¶¶ 3023-50; Securities Exchange Act of 1934, §§ 15A(h), 25, 15 U.S.C. §§ 780-3(h), (y) (1982).

14. See Calvin, *The National Market System: A Successful Adventure in Industry Self-Improvement*, 70 VA. L. REV. 785, 789-99 (1984) (creation of national market system assured

securities and commodities markets had been eroded by the October 1987 market crash and by continuing reports of misconduct by market professionals.<sup>15</sup> The courts, the SEC, and the self-regulatory organs of the securities and commodities industries were motivated to restore that confidence. In such a climate the practices of market professionals were under suspicion,

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practicability of executing investors' orders for best price, more efficient transactions, fair competition and timely information both for exchange-traded and OTC stocks); Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 896-901 (1981) (customers used OTC traders to avoid minimum commission rates charged by NYSE institutional brokers; this switch ultimately lead to a greater equality of transaction fees in the two markets); Simon & Colby, *The National Market System for Over-The-Counter Stocks*, 55 GEO. WASH. L. REV. 17, 91-102 (1986) (both NASD and Congress emphasized fiduciary responsibilities of broker-dealers in order to reduce following abuses: dealers violating orders by filling orders at inferior prices, and dealers preferring own shares over customers). See also C. WELLES, *THE LAST DAYS OF THE CLUB* 335-427 (1975); Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663, 668 (1964) (descriptions of the early and persistent concern that "clubby" values on the exchanges and in investment banking circles were inconsistent with the public importance of the capital markets).

A frequent question posed in discussions of the SEC's regulation of trading markets is whether the agency has either the will to challenge existing market institutions or the resources to undertake the studies needed to produce reforms responsive to the best functioning of the different types of exchange and inter-dealer markets. See, e.g., J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 265-89, 439-568 (1982); see also Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755, 773-74 (1984).

15. Recently, the issue of public confidence in the securities markets has been frequently addressed by representatives of the securities industry and regulatory communities. For example the New York Times published the following comments:

The flight of individual investors worries the securities industry to a degree unparalleled since the early 50's, when the New York Stock Exchange launched a campaign urging small investors to 'Own Your Share of American Business.'

'I think everybody is concerned about the flight of the small investor—the S.E.C., the exchanges, everyone,' says Howard L. Kramer, assistant director of the Securities and Exchange Commission's division of market regulation. Kramer notes that without the liquidity provided by small orders, it is much more difficult for specialists and other market makers to do their jobs.

Govoni, *In the Market: Fear of Buying*, N.Y. Times, Sept. 25, 1988, § 6 (The Business World), pt. 2, at 55, col. 1.

A recent report by the Securities Industry Association notes that the small individual investor may have withdrawn from the market because of this loss of confidence. The disappearance of individual traders from the market has caused fears that market liquidity might be impaired and that the risks of market specialists might be increased by the absence of a broad base of active investors at all stages of a market. Power, *Small Investors are Punier Than Many Think*, Wall St. J., Mar. 28, 1989, at C1, col. 3.

On the general issue of current public confidence in the securities markets and in the integrity of market professionals, see also A Report by the Division of Market Regulation of the Securities and Exchange Commission, *The October 1987 Market Break*, in Fed. Sec. L. Rep. Special Report (CCH) (Feb. 1988); Ricks, *Many Crash Complaints Unresolved—Firms Don't Respond Well to Small Investor Problems, Report Says*, Wall St. J., Oct. 10, 1988, at C1, col. 6 (describing report by the North American Securities Administrators Association and rebuttal effort by the Securities Industry Association); *Wall Street's Credibility Gap*, Wall St. J., Nov. 23, 1987, sec. C, at 29.



and the need for improved accountability seemed obvious.<sup>16</sup> This may explain why each tribunal which heard the facts in *Hutton* was unresponsive to defense efforts to argue that the dynamics of the market and the special risks undertaken by market makers in OTC stocks should be considered in determining the content of a market maker's duties with respect to the execution of customer orders.

*A. The Precipitating Events in Hutton and the Complaint to the National Association of Securities Dealers*

On January 11, 1984, William Manning, an experienced investment advisor and president of a company that managed more than \$1.4 billion in assets,<sup>17</sup> placed a limit order with E.F. Hutton for his own account to sell in the OTC market 5,000 shares of Genex Corporation common stock ("Genex" or "Genex common") at a price of 17 1/8.<sup>18</sup> The limit order meant that Manning wanted his shares sold at a fixed minimum price rather than at the market price. Therefore, whenever the bidding interest for Genex produced a market maker's bid of 17 1/8 per share, Hutton would be obligated to execute Mr. Manning's sale order.

At the time Hutton received Mr. Manning's limit order, the "inside" price quotation for Genex common appearing on the NASDAQ system<sup>19</sup> was "17

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16. The securities regulation community has never quite made its peace with the seemingly necessary expedient of permitting market makers and dealers to perform brokerage functions. See Mayer, *Broker-Dealer Firms*, in ABUSE ON WALL STREET—CONFLICTS OF INTEREST IN THE SECURITIES MARKETS (A TWENTIETH CENTURY FUND REPORT) 433, 476-81 (1980). The earliest version of the 1934 Act would have separated the two roles. See H.R. 9323, § 11, 73d Cong., 2d Sess. (1934); S. REP. NO. 1455, 73d Cong., 2d Sess. 3 (1934). Unease about the possibilities for abuse when securities professionals perform both brokerage and market making functions has affected federal securities regulation and generated adverse comment from the earliest days. See, e.g., Douglas & Bates, *Stock 'Brokers' as Agents and Dealers*, 43 YALE L.J. 46, 49-53 (1933). This concern has been a major engine for reforming the practices of dealers. In particular, it has generated a body of regulations requiring disclosure of conflicts of interest and of information about transactions which are seen as vulnerable to self-preferencing. The unwillingness to divide brokerage and dealer functions has generated a regulatory approach more disposed to compel disclosure of conflicts than to compel cessation of the split loyalties that give rise to the conflicts. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SEC, H.R. Doc. No. 95, 88th Cong., 1st sess., pt. 2, ch. VII, at 610-53 (1963) [hereinafter SPECIAL STUDY].

17. Manning's firm commonly placed 40-50 buy or sell orders on a given business day. Those orders included limit order transactions. *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 2 (Feb. 12, 1985) (Board of Governors of the NASD).

18. The reconstruction of the facts appearing here is based on the reported decisions of the NASD Board of Governors and the SEC and on agreed-upon facts described in briefs in the *Hutton* litigation. Respondent's Brief at 12-17, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Sept. 23, 1985).

19. The National Association of Securities Dealers Automatic Quotation system ("NASDAQ") is the electronic interdealer quotation system for OTC stocks, providing access to quotations of all market makers trading securities listed on the system. For a description of the NASDAQ system and of the different levels of access to its quotations. See Simon & Colby *supra* note 14, at 34-44.

bid, 17 1/8 asked.” An “inside” price represents the *best* purchase and sale price available to professional dealers from other professional dealers making a market in a given security.<sup>20</sup> Hutton was one of nine dealers making a market in Genex,<sup>21</sup> but none of those dealers, including Hutton, would pay more than 17 for Genex common at the time Manning placed his order. Hutton’s own prices to the inter-dealer market were “17 bid, 17 1/2 asked,” reflecting a somewhat higher price for sales of Genex by Hutton than the best price available in the market.<sup>22</sup> The relevant price for execution of Manning’s order, however, was the “bid” price,<sup>23</sup> and no one bid more than 17 for Genex while Manning’s limit order was outstanding.

While Hutton held Manning’s sell order, it continued its activities as a market maker in Genex common, buying and selling from its own inventory to other dealers and retail customers. On January 11 and 12, 1984, Hutton sold 4,755 shares of Genex from its own inventory at prices ranging between 17 1/4 to 17 1/2, the “ask” prices for Genex. Meanwhile, the Manning sell order remained unexecuted, awaiting an upward movement on the “bid” side of the market which would indicate the willingness of some market maker somewhere to pay as much as 17 1/8 for Genex common. Unfortunately, the hoped-for-increase in the “bid” price never occurred. At no time after Hutton’s receipt of Manning’s order did the “inside” bid price for Genex exceed \$17 per share. Worse still, in the late morning of January 12,

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20. *Hutton*, Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,327 (July 6, 1988).

21. *Id.*

22. Such discrepancies are not uncommon in the OTC market. These discrepancies can reflect such things as the relative liquidity of the market maker, the market maker’s assessment of the risk associated with holding certain inventories, and the rate of turnover the market maker experiences for particular stocks. See Stoll, *Alternative Views of Market Making*, in *MARKET MAKING AND THE CHANGING STRUCTURE OF THE SECURITIES INDUSTRY* 67 (1985) [hereinafter Stoll, *Alternative Views*]; Stoll, *The Pricing of Security Dealer Services: An Empirical Study of NASDAQ Stocks*, 33 J. FIN. 1153, 1161-66 (1978) [hereinafter Stoll, *Pricing of Dealer Services*]. See also Ho & Stoll, *The Dynamics of Dealer Markets Under Competition*, 38 J. FIN. 1053, 1060-67 (1983).

There was evidence, however, that it was Hutton’s practice when executing transactions involving 1000 or more shares, to execute customer orders at the “inside” bid or ask price even though its own bid or ask price might be less attractive. A Hutton executive testified that Manning would have received at least partial execution had the “inside” bid price reached Manning’s desired price of 17 1/8. See *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 3 (Feb. 12, 1985) (Board of Governors of the NASD).

23. All dealers maintain a differential, represented by “bid” and “ask” quotations, between the price they are willing to pay for customers’ stock and the price at which they are willing to make that same stock available to nondealer buyers in the market. The argument for this differential is simply that the gap between the “bid” and “ask” prices represents the market maker’s profit. The differential compensates the market maker for continually exposing his capital by standing willing to buy and sell for his own account to provide a market for others. If a selling limit order customer were instead granted execution at the “ask” price at which the market maker sells the same stock to the public, the executing market maker would thereby be deprived of the profit represented by the mark up included in the “ask” price.

the day following Manning's order, the market for Genex fell off sharply, so that Hutton never executed the order.

Manning later reviewed the published NASDAQ quotations listing "ask" prices of 17 1/4 and 17 1/2 for January 11 and 12, and discovered that Hutton had sold for its own account at these prices while his own order at 17 1/8 languished. Consequently, Manning complained to the NASD that Hutton had misappropriated his own sales opportunity.<sup>24</sup> However, the NASD's counsel wrote in reply, indicating that Hutton had done nothing wrong.<sup>25</sup>

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24. Letter from William Manning to Gordon Macklin, President, NASD (Jan. 26, 1984).

25. The NASD's counsel's letter stated in relevant part:

The NASDAQ market is composed of independent competitive market makers each maintaining a bid price and an offer price. . . . Therefore if you place an order with a firm to sell stock at a price, the only way the firm would be able to access other markets to fill that order [i.e., find market makers willing to buy the customer's stock] is if there was a market maker willing to buy at that price . . . . Turning to the particulars of your sell order of 5,000 shares at 17 1/8, according to NASD records at no time during the afternoon of the 11th or the entire day of the 12th was any market maker willing to buy shares of Genex at 17 1/8. Therefore E.F. Hutton could not have accessed other market makers to fill your order.

Letter from Frank J. Wilson, Executive Vice President, Legal and Compliance, NASD to William Manning (March 22, 1984). The letter continued, addressing the specific question of whether Hutton, as a Genex market maker who was also Manning's broker, might have violated duties to Manning by continuing to trade on its own behalf while Manning's order went unexecuted:

With respect to your question relating to E.F. Hutton's transactions on the 11th and 12th it is true that E.F. Hutton did execute sale transactions at prices of 17 1/8 on the 11th and 17 1/8 and 17 1/4 on the 12th. *However, under the established custom and usage in the over-the-counter market, and the Association's rules, its members are not required to always sell customers' securities ahead of their own sales from market maker positions in which they may have substantial risks.*

*Id.* (emphasis added).

The position adopted in the letter, that Mr. Manning's rights were circumscribed by practices built into the structure of the OTC market and that these practices were reasonable, is also reflected in a consumer information publication by the NASD. NASD, *TRADING IN THE NASDAQ NATIONAL MARKET: A QUESTION AND ANSWER GUIDE FOR INVESTORS AND REGISTERED REPRESENTATIVES* (1983) (available in Respondent's Brief, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Sept. 23, 1985)). This publication contains the following question and answer presentation of the limit order execution problem:

Q: At 10:30 a.m. . . . , my registered representative told me that a transaction in EFGH stock had taken place at 40 1/4. I told him to sell 100 shares for me *at that price*. My order was never executed. Why?

A: The inside market was probably 40 bid - 40 1/4 offered which means that the 40 1/4 transaction mentioned by your registered representative was more than likely a customer buying from a market maker at his offer of 40 1/4. *As a customer selling EFGH stock, your transaction would have to take place at the market maker's bid—the price at which he buys from you for his own account.*

*Id.* at 5 (emphasis added).

*B. The Proceedings**1. The Case Brought Before the District Business Conduct Committee*

Despite his initial discouragement, Mr. Manning persevered. Supported by a subsequent letter from the NASD's General Counsel, which adopted a less categorical view of Manning's claim,<sup>26</sup> Mr. Manning filed a formal complaint with the District Business Conduct Committee ("District Committee") of the NASD, in early June of 1984.<sup>27</sup> The complaint restated Manning's basic challenge to Hutton's practice of "trading through" its customer's order. Manning claimed that by accepting his order, Hutton undertook a fiduciary duty to represent him in the marketplace, and breached that duty by not giving his order priority in both time and price over Hutton's own transactions.<sup>28</sup> In the complaint he insisted that where a market maker undertakes a broker's duties, the agency relationship of broker to customer requires either that the market maker cease to trade on its own behalf on terms not available to its brokerage customer, or that the broker grant the customer priority by trading the customer's shares under terms customarily available only to market makers. Manning further asserted that the brokerage relationship should be the exclusive context for defining a market maker's duties when performing brokerage functions.<sup>29</sup>

Hutton maintained that its duty to Manning was limited to an obligation to sell his stock in a normal OTC brokerage transaction. Hutton argued that it had neither an obligation to execute the order at other than a "bid" price of 17 1/8, nor a duty to advise Manning of the fact that it engaged in trading as a market maker while representing its clients as a broker.<sup>30</sup> Hutton further argued that its transactions neither appropriated Manning's sales opportunity nor prejudiced the trade execution that he might have received had Hutton not traded as a market maker.<sup>31</sup> Rather, Hutton argued, it had

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26. Letter from Frank J. Wilson, Executive Vice President and General Counsel to William Manning (April 16, 1984). The letter emphasized that the scope of particular broker duties was highly dependent on the specific facts of given cases, and encouraged Mr. Manning to pursue his action.

27. See *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 2 (Feb. 12, 1985) (Board of Governors of the NASD) (complaint was filed on June 4, 1984).

28. *Id.*

29. The complaint challenged fundamentally the view expressed in the NASD communications that a market maker's duty to its brokerage customers consists of a duty to execute customer transactions when the offered bid price permits, and does not require that he suspend his market making activities or grant his customer access to the special trading advantages enjoyed by market makers. For a description of the features of a diffuse, interdealer market which arguably entitle market makers to the spreads represented by gaps between bid and ask prices, see *infra* notes 88-110 and accompanying text.

30. See *Manning v. E.F. Hutton & Co.* No. NY-2099, at 3 (Feb. 2, 1985) (Board of Governors Decision); Respondent's Brief at 21-26, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Sept. 23, 1985).

31. Brief at 21-26.

simply performed the market maker's normal function of executing the market orders of others on an ongoing basis at "bid" and "ask" prices while awaiting market conditions permitting execution of Manning's limit order. Therefore, according to Hutton, Manning claimed a form of trade execution that threatened market usages essential to Hutton's role as a market maker.

Hutton also argued that the prevailing customs, usages and rules of the market became implied terms of the contract between broker and customer, delimiting customer rights and broker duties.<sup>32</sup> The acceptance of this principle is always subject to the condition that such customs and usages be neither against public policy, nor at odds with a prior, contrary agreement between broker and customer.<sup>33</sup> Hutton, and the Securities Industry Association ("SIA") in its *amicus* brief,<sup>34</sup> argued, however, that the practice of market makers' continuing to trade for their own accounts while holding customer limit orders reflected the underlying dynamics of the OTC market and should properly be deemed an implied element of Hutton's contract with its customer.<sup>35</sup>

The heart of Hutton's argument was that a market maker is entitled to continue selling at the "ask" price while customers await a favorable movement in the bid price because the market maker is exposed to the risk of carrying inventory. The market maker carries inventory because of its obligation to stand ready to deliver shares to buyers in the market when other sellers may not be present.<sup>36</sup> That market risk is addressed only in part by allowing the market maker to collect the spread between "bid" and "ask" prices. That spread not only provides a mechanism for profit, it also implicitly creates a limited right to priority in time that allows the market maker to sell all its own inventory at the inside "ask" price, while it sells retail customers inventories only when the *bid* price permits. Thus, Hutton argued, and was well supported by standard interpretations of the market, that retail customers must await a favorable bid for their shares, even as

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32. E.F. Hutton & Co., Exchange Release Act No., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. ¶ 84,303, at 89,327 (July 6, 1988). See, e.g., C. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES § 157 (1931); W. PALEY, A TREATISE ON THE LAW OF PRINCIPAL AND AGENT 8 (2d American ed. 1840); J. STORY, COMMENTARIES ON THE LAW OF AGENCY §§ 96, 199 (1844); F. WHARTON, COMMENTARIES ON THE LAW OF AGENCY §§ 232, 235, 239, 760 (1876).

33. See C. MEYER, *supra* note 32, at 160-63.

34. Brief of the Securities Industry Association as *amicus curiae*, Manning v. E.F. Hutton & Co. (No. 3-6490) (SEC Jan. 10, 1985).

35. Their belief was in part grounded on past statements by the NASD and the Commission and in part on their understanding of the unique risks and market dynamics of the OTC markets, conditions which in their judgment should be the most important context for the development of NASD and Commission trade execution policies. The *amicus* brief of the SIA indicated that both the NASD and the SEC seemed to have regarded market maker trading priority as an endemic element of the OTC market. *Id.* at 19-25.

36. Indeed, such market "support" is a major expectation of underwriters of public offerings of OTC stocks.

the market maker may continue selling to the market at an "ask" price higher than the customer's desired sale price.<sup>37</sup>

The District Committee decided against Hutton, but not on Manning's theory.<sup>38</sup> Instead, it found Hutton's action justified discipline because Hutton failed to disclose the terms under which the Manning order would be executed.<sup>39</sup> The District Committee concluded that absent a clear understanding with a customer, a dealer should not buy or sell for its own account at prices more favorable than the customer's limit order unless the dealer executed the limit order first.<sup>40</sup>

The District Committee's decision seems inspired by the principle of agency law that prohibits an agent from competing with its principal with respect to the subject matter of the agency without the principal's agreement.<sup>41</sup> However, this principle does not clearly apply to the facts of *Hutton*, compelling such disclosure. Hutton, as previously noted, had argued and was to maintain throughout the litigation, that its trading in a parallel inter-dealer market at prices to which its customer had no right of access simply did not constitute direct competition nor deprive Manning of the execution

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37. See Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1162-71. Other possible balances between a dealer's selfishness and selflessness might be struck. The market maker might be required to execute the customer's limit order in preference to his own trades, charging only an ordinary broker's commission. Such a balance seems inappropriate if we accept the validity of the spread between "bid" and "ask" prices as representing compensation for some real market risk for which the market maker should be compensated. See, e.g., *In re* Peter J. Kisch, No. 19005 (SEC Aug. 24, 1982) (acknowledging right of integrated broker-dealer, functioning as both broker and market maker, to collect spread as compensation). See *infra* notes 88-110 and accompanying text, for a complete discussion of this issue.

Similarly, if Hutton had matched Manning's sell order at 17 1/8 with some of the incoming buy orders at 17 1/4, granting Manning execution while Hutton pocketed the 1/8 point spread as its transaction fee, Hutton would have been exposed to the risk that if buyers were scarce in the market, Hutton may have been left with unsalable inventory if it had executed Manning's order first. Alternatively, the market maker might be permitted to act completely selfishly, continuing to sell out his own inventory in preference to his customer's trades even after the "bid" price had reached the customer's desired sales level. Such a rule of no-priority-at-all for the customer's limit order would allow the market maker to appropriate all sales opportunities at a given price level. It would negate the obligation undertaken by the market maker when it accepted the customer's limit order to execute that order at the stated price. Such a breach of an undertaking to sell at an offered price is also inconsistent with Article III, Section 6 of the NASD Rules of Fair Practice. See *NASD Rules of Fair Practice*, *supra* note 2, at ¶ 2156.

These possible variations on the selfishness of a market maker suggest that the distinction between legitimate and illegitimate expectations with respect to trade execution depends on the market position and market risks of broker-dealers and customers, respectively. An approach appropriate to the OTC market is suggested *infra* notes 88-110 and accompanying text.

38. *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 3 (Feb. 12, 1985) (Board of Governors of the NASD).

39. *Id.* ("when a member accepts a limit order, it assumes an obligation of fair dealing which requires that there be a clear understanding with the client as to the manner in which the order will be handled").

40. *Id.*

41. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 393 comment a (1959).

to which he was entitled.<sup>42</sup> Indeed, unless the District Committee intended to challenge the "bid" and "ask" price structure of the OTC market, it had no basis for the charge that Hutton's proprietary sales had appropriated Manning's sales opportunity, and thus had given rise to a disclosure obligation. Moreover, there was no evidence that Hutton had abused its position as a market maker to prevent Manning's access to the market. Certainly, instances will arise where "bid" and "ask" prices are the creatures of a market maker's manipulative bidding rather than of broader based market activity,<sup>43</sup> so that a market maker can prevent a customer's sales price from ever being reached. In *Hutton*, however, there was no suggestion that Hutton so dominated the Genex market that it prevented the market "bid" price from reaching Manning's target price.<sup>44</sup>

The rapid falling off of Genex trading following Hutton's trades suggests another concern that may have informed the District Committee's decision. If a market maker were aware of an impending decline, it might sell ahead of its customer in order to liquidate its own risk in a thin market that could not absorb both the customer's and the market maker's sales.<sup>45</sup> However, the District Committee, and later the NASD Board of Governors, absolved Hutton of any such willful wrongdoing.<sup>46</sup>

A final argument that could have been advanced for imposing a disclosure duty on Hutton might have been that its failure to disclose its intention of "trading through" Manning's order deprived Manning of the opportunity to retain another broker who might have offered superior trade execution. The District Committee did not, however, address this argument directly in its opinion. The idea permeates the subsequent stages of the litigation, always hinted at as a possible reason for compelling a duty to disclose, but never satisfactorily analyzed.<sup>47</sup>

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42. *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 3 (Feb. 12, 1985) (Board of Governors of the NASD).

43. See *Alstead, Strangis & Dempsey, Inc.*, Exchange Act Release No. 20,825, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,607, at 86,740 (Apr. 5, 1984); *Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 874 (1946). For a description of the uncertainties of proving cases of market domination and for a criticism of the SEC's willingness to infer fraud and manipulation from the fact that market making in a given stock is dominated by one or a handful of dealers, see Bloomenthal, *The Case of the Subtle Motive and the Delicate Art—Control and Domination in Over-The-Counter Securities Markets*, 1960 DUKE L.J. 196.

44. Hutton was one of nine dealers making a market in Genex. There seems to have been agreement that Hutton did not dominate the Genex market. See generally *E.F. Hutton & Co.*, Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988).

45. See, e.g., *In re Shearson, Hammill & Co.*, Exchange Act Release No. 7743, [1965 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,306, at 82,518-19 (Jan. 12, 1965) (broker sold own shares at price from 14 1/2 to 15 before selling customers' shares for below 12).

46. *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 6 (Feb. 12, 1985) (Board of Governors of the NASD).

47. See *E.F. Hutton & Co.*, Exchange Act Release No. 25887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,329 (July 6, 1988).

The essential point is that none of the arguments for establishing either a lost trading opportunity for Manning or a breach of duty by Hutton was adequately made during the District Committee proceedings. The charges were, at this stage of the litigation, chiefly substantiated by a vaguely articulated vision of what a broker's fiduciary duties should be. In any event, the District Committee concluded that Hutton's actions had violated its obligation of fair dealing with its customer, and therefore issued Hutton a letter of caution as a sanction.<sup>48</sup>

## 2. *Hutton's Appeal to the NASD Board of Governors*

The District Committee's problematic handling of Manning's "lost opportunity" was repeated by the NASD Board of Governors.<sup>49</sup> First, the Board of Governors found that although the bid price for Genex stock had indeed never reached Manning's target price of 17 1/8, Hutton still had a duty to disclose the terms under which Manning's order would have been executed. This duty was grounded, in part, on a finding that Mr. Manning, although sophisticated and generally knowledgeable about the operation of the OTC market, had never fully appreciated that a market maker who was also a broker could properly continue trading for its own account while holding a customer's unexecuted limit order.<sup>50</sup> However, to establish such a duty to disclose, the Board of Governors also needed to conclude that Hutton's failure to tell Manning about its limit order execution policy may have made some difference—either by appropriating a trading opportunity or by causing Manning to forego better chances elsewhere. In denying these charges, Hutton relied principally on two things. One was the admitted fact that the market "bid" price had never reached 17 1/8. The other was the argument that the prevailing practice by market makers was to trade continually for their own accounts while holding customer limit orders, only executing those limit orders when the "bid" prices established by normal market movement permitted execution.<sup>51</sup>

The Board of Governors rejected, out of hand and without analysis, Hutton's argument that its practices conformed with prevailing industry practice. The Board stated, "Hutton further contends that its actions were consistent with standard industry practice in situations such as this. We are

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48. *Manning v. E.F. Hutton & Co.*, No. NY 2099, at 3 (Feb. 12, 1985) (Board of Governors of the NASD). The specific basis for the violation and sanction was Article III, Section 1 of the NASD Rules of Fair Practice, requiring that member broker-dealers "observe high standards of commercial honor and just and equitable principles of trade." See *NASD Rules of Fair Practice*, *supra* note 2, at ¶ 2151.10.

49. *Manning v. E.F. Hutton & Company*, No. NY-2099, at 6 (Board of Governors of the NASD).

50. *Id.* This finding was based on sharply disputed testimony. Indeed the evidence supporting Manning's claim of ignorance was highly equivocal, requiring a rather determined reading to support a finding for him.

51. *Id.* at 2, 6.



unable to conclude that this is the case."<sup>52</sup> The hasty rejection was inappropriately abrupt in view of the position reflected both in published NASD materials and in the original letter by the General Counsel to Manning.<sup>53</sup> The Board's decision made clear that even if Hutton had acted in conformity with industry practice, Hutton would nonetheless have faced discipline because the practice itself was inconsistent with Hutton's fiduciary duty unless previously disclosed.<sup>54</sup>

The position adopted by the Board of Governors would be more easily acceptable were it merely a prophylactic measure intended to assure that brokerage customers will be routinely alerted to the inherent conflicts of interest of broker/market makers. This would warn brokerage customers of possible abuses such as a market maker's bailing out of a falling market. But a disciplinary proceeding against an individual broker-dealer, resulting in a letter of censure, hardly seems the occasion for promoting such broad policy objectives, at least where proof of misconduct has not been established and where the defendant relied upon a seemingly well-accepted conception of its duties to its customers.<sup>55</sup> Evident in the Board of Governors' statement

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52. *Id.* at 6.

53. *See supra* notes 24-25 and accompanying text.

54. According to the Board of Governors:

*Even if Hutton's actions had constituted normal industry practice, which we do not believe it does, we conclude that a member's obligation to deal fairly with its customers and the fiduciary relationship assumed in accepting a customer's limit order require that, before the obligation inherent in that relationship can in any way be modified, there must be a clear and unequivocal understanding between the member and the customer as to the extent of the modification. . . . We believe that this conclusion is supported by general principles of agency law as well as the precedent provided both in decisions by the Securities and Exchange Commission and the courts as well as by practices in the securities industry. Of equal importance . . . is the overriding obligation of Association members to deal fairly with their customers. We do not believe complainant was treated fairly in this case. Respondent, therefore, violated its fiduciary duty to its customer.*

*Manning v. E.F. Hutton & Co.*, No. NY-2099, at 6 (Feb. 12, 1985) (Board of Governors of the NASD) (emphasis added).

Perhaps the most telling portion of the decision is the phrase "before the obligation *inherent in* that relationship can in any way be modified." *Id.* This phrase suggests an assumption that the performance of ordinary market making functions at prices not available to brokerage customers constitutes *per se* a dilution of the order execution services which the customer could legitimately expect when a market maker functions as a broker.

55. A perceived tendency by the SEC and the self-regulatory organizations to rely on prosecutions rather than on formal rule development to institute regulatory policies has long been a subject of controversy. *See, e.g.,* Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 *LAW & CONTEMP. PROBS.* 691, 714-19 (1964) (emphasizing that adjudication provides flexibility while acknowledging problems arising from multiple regulatory roles of SEC); *see generally* R. KARMEL, *REGULATION BY PROSECUTION* 77-245 (1982) (pointing out weakness in SEC's procedure). Judge Henry J. Friendly of the United States Court of Appeals for the Second Circuit eloquently argued that the court should recognize that local circumstances of a given adjudication might not produce the best considered policy results. He emphasized the need to balance

is its eagerness to expand a market maker's obligations to conform with a broadly stated and somewhat featureless conception of broker-dealer fiduciary duties.

The Board of Governors' statement demonstrated this eagerness when it found that the duty of disclosure imposed on Hutton was consistent with well-established views of broker-dealer and market maker duties.<sup>56</sup> However, earlier cases which had imposed sanctions on brokers who preferred their firms' trades to those of their customers simply do not support the Board of Governors' view. In leading cases such as *In re Investment Service Co.*,<sup>57</sup> and *Opper v. Hancock Securities*,<sup>58</sup> an additional element of abuse or overreaching, distinct from the bare practice of subordination of customer limit orders was always required to find the market maker's conduct sanctionable.<sup>59</sup> In both *Investment Service Co.* and *Opper*, brokers egregiously failed to honor expressed assurances that a trade would be executed within a given time frame without fail.<sup>60</sup> In *Opper*, there was the further suggestion of market domination and manipulation of "bid" and "ask" prices by the market maker, preventing the customer's execution price from being attained.<sup>61</sup> In contrast to these cases, which did not challenge limit order subordination as such, but which relied upon other sanctionable conduct,<sup>62</sup> the Board of Governors in *Hutton* viewed the basic activity of a market maker trading for its own account, while holding customers' limit orders, as fundamentally inconsistent with that broker's fiduciary duties. Although the narrow duty affirmed by the Board of Governors was a duty of disclosure, not a duty to cease all subordination of customer limit orders, it was based on a highly restrictive view of agency duties that did not fully acknowledge

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adjudicative and administrative processes in the orderly development of policies and rules. See H. FRIENDLY, *THE FEDERAL ADMINISTRATIVE AGENCIES—THE NEED FOR BETTER DEFINITION OF STANDARDS* 143-45 (1962).

56. *Manning v. E.F. Hutton & Co.*, No. NY-2099, at 6 (Feb. 12, 1985) (Board of Governors of the NASD).

57. 41 S.E.C. 188 (1962), *aff'd sub nom.* *Barnett v. United States*, 319 F.2d 340 (8th Cir. 1963).

58. 250 F. Supp. 668 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966).

59. The SEC, in its hearing of the appeal in *Hutton*, made much of these cases. In its treatment of *Opper*, the SEC concluded wrongly that because *Opper* had found that "trading ahead" was a breach of a fiduciary duty, even in a case where no special relationship of trust had been established between dealer and customer, "trading ahead" must inevitably be regarded as inconsistent with the most rudimentary conception of fiduciary duties. See E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,328, 89,330 (July 6, 1988). It may well be true that no relationship of special trust is needed to protect a customer against abusive "trading ahead" by a dealer, but it is also true that the conduct is not abusive in itself when the dealer's priority is simply a product of the "bid" and "ask" price structure of the OTC market. *Opper* and *Investment Service Co.* are consistent with such a reading.

60. See *Opper*, 250 F. Supp. at 673; *Investment Service Co.*, 41 S.E.C. at 198.

61. 250 F. Supp. at 675.

62. *Opper*, 250 F. Supp. at 676; *Investment Service Co.*, 41 S.E.C. at 189-98.

that a customer's expectations may be limited by legitimate market making activities.

The irony of the Board of Governors decision is that a close analysis of the dynamics of the OTC market and the risk position of OTC market makers would have supported the very disclosure duty ultimately imposed by the Board of Governors. This disclosure duty does not arise, as the Board of Governors would have it, from an *a priori* conception of an agent's duties.<sup>63</sup> Rather, as developed in Part C of this Article, the disclosure duty arises from an accommodation of the legitimate need for OTC market makers to protect themselves from the special risks of standing ready to either buy or sell in a decentralized market, and the need of the market and of its customers to restrict the market maker's self-protective trading to the minimum justified by its special market position.

### 3. *Hutton's Appeal to the SEC*

A 3-2 majority of the Commission affirmed the NASD Board of Governors' decision in a *de novo* review, adopting the argument that Hutton's failure to disclose its limit execution practices deprived Manning of an opportunity to seek superior execution terms. The Commission agreed with the Board of Governors that Hutton's practice of trading ahead of customer limit orders without disclosure violated existing duties under the NASD Rules of Fair Practice.<sup>64</sup> In the Commission's view Hutton had breached an obvious fiduciary duty.<sup>65</sup>

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63. The notice sent to NASD broker-dealers immediately after the *Hutton* decision demonstrates the effort in the *Hutton* litigation to make disclosure of limit order subordination seem an obvious duty. The notice suggested the natural provenance of *Hutton's* disclosure duty from the NASD Rules of Fair Practice and from earlier interpretations of those rules. NASD NOTICE TO MEMBERS 85-12, RE: FIDUCIARY OBLIGATIONS OF MEMBERS WHEN HANDLING CUSTOMER LIMIT ORDERS (Feb. 15, 1985).

The notice prompted a concerned letter from the Securities Industry Association, which raised the question whether customers could reasonably expect their market making broker to cease trading for the market maker's own account while holding a customer limit order. See Letter from William R. Harman, Chairman, Federal Regulation Committee, Securities Industry Association to Frank J. Wilson, Executive Vice President and General Counsel, National Association of Securities Dealers (April 17, 1985) (available in Respondent's Brief at app. 4, *Manning v. E.F. Hutton* (No. 3-6490) (SEC Sept. 23, 1985)). The arguments made in the letter were developed fully in the SIA's *amicus* brief in *Hutton*. See Brief of the Securities Industry Association as *amicus curiae*, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Jan. 10, 1985).

64. E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,327 (July 6, 1988).

65. The majority illustrated this insistence in the following portion of its decision:

Hutton's willingness to sell Genex stock for its own account at prices equal to or higher than the price of Manning's limit order created a conflict between the interests of Hutton and Manning that affected the task Hutton had undertaken on Manning's behalf. Hutton was, in effect, competing with Manning with respect to the subject matter of their relationship—the execution of Manning's order. *As the*

Like the Board of Governors, the Commission did not genuinely engage the question of whether the peculiar risks of the OTC markets may justify a market maker's continual trading in the interim before a limit order strike price is reached. Nor did the Commission satisfactorily address the issue of whether Hutton's conduct may in fact have denied Manning a realistic chance of obtaining other execution terms, either from Hutton or another dealer. In the same manner as the Board of Governors, the Commissioners offered, but failed to substantiate the argument that Hutton had "seized" Manning's trading opportunity.<sup>66</sup>

A sound argument for compelling disclosure of execution terms was available to the Commission, as it had been to the Board of Governors, but the argument is different from that offered by the Commission. The argument is not, as the Commission suggests, that Manning may have had a realistic opportunity of negotiating superior trading terms, whether with Hutton or with another market maker.<sup>67</sup> For if Hutton's subordination of Manning's limit order execution reflected an accurate assessment of Hutton's risks of holding an inventory and making a market in Genex common, Hutton may not have offered Manning substantially different terms nor terms different from those of any other market maker.<sup>68</sup> The rationale for disclosure is, instead, that in a decentralized market where prices are set by market makers, who simultaneously function as broker and dealer, rather than by an auction process, any market maker's terms of execution must always be regarded as suspect. The customer should have information to allow him an opportunity to compare those terms with other available, possibly better, terms. However, this open-ended rationale for disclosure, grounded in the decentralized struc-

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*facts in this case illustrate, this can result in a broker-dealer seizing a customer's only opportunity for execution at his limit order price. . . . If Manning had known . . . , he would have had an opportunity to . . . attempt to negotiate better terms with Hutton, or look for another broker willing to give his limit order priority in filling incoming buy orders.*

*Id.* ¶ 84,303, at 89,329 (emphasis added).

66. Market domination by one or a very few market makers is normally required to control price movements so dramatically. The fact that there were nine dealers making a market in Genex common at the time of Manning's trades, and the absence of any showing that Hutton was a particularly dominant market maker, makes it rather unfair to assume without explanation that Hutton's proprietary trades prevented the bid-side price movement needed by Manning. Indeed, there was no evidence in the case of opportunistic trading by Hutton or of influence of the movement on prices on the "bid" side of the market. See E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,336 n.20 (July 6, 1988) (Grundfest, Comm'r, dissenting).

For a description of the phenomenon of market domination of OTC stocks, the potential abuses that flow from domination, and the problematical aspects of establishing a case of market domination, see Bloomenthal, *supra* note 43, at 205-20.

67. See E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,329 (July 6, 1988).

68. See *infra* notes 95-96. Unless, of course, Manning could have taken advantage of a less well-informed trader.

ture of the OTC markets, is not the argument offered by the Commission. The Commission seems instead to have concluded that Hutton may indeed have deprived Manning of opportunities elsewhere.

The most immediate reason the Commission was willing to conclude that Manning may have been deprived of a real trading opportunity was Hutton's introduction of a poorly designed study intended to justify its limit order execution policy.<sup>69</sup> As previously discussed, Hutton argued throughout the course of the litigation that its limit order execution policy conformed with generally prevailing industry practices. Hutton attempted to substantiate this line of defense by submitting an empirical study commissioned from Arthur Andersen & Co.<sup>70</sup> The study was intended to prove the generality of Hutton's limit order execution policy, but produced highly ambiguous results. It focused on OTC limit order execution practices in a small sample of transactions placed with ten large retail brokers who made markets in the stocks randomly selected for the study.<sup>71</sup> The study showed that twenty percent of the market makers, representing twenty percent of the transactions sampled, chose to fill incoming market "buy" orders from customer limit orders to sell, rather than from their own inventories.<sup>72</sup>

Any hope that Hutton could establish its own practice as universal was undone. The showing that twenty percent of market makers in the study were willing to fill orders from the other side of the market from customer limit orders indicated that Manning might have had some chance of finding a market maker willing to execute his limit order in preference to the market maker's proprietary transactions. Moreover, the study failed to show that for the remaining eighty percent of transactions where market "buy" orders were filled from sources other than customer limit orders, the alternative source was the market maker's inventory and not some other source.<sup>73</sup> The study as a whole failed to make Hutton's case for the universality or generality of customer limit order subordination or the preference of dealer proprietary trades among market makers. Even though the study contained strong evidence supporting Hutton's broader argument that neither a customer's limit order stock nor any other source that deprived the dealer of his normal compensation would be the first sources used to fill a market order, the case for routine subordination of limit orders had failed.<sup>74</sup>

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69. See *infra* notes 70-77 and accompanying text.

70. Arthur Andersen & Co. Limit Order Study (September 25, 1985) [hereinafter *Limit Order Study*] (available in Respondent's Brief, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Sept. 23, 1985)).

71. Brief at 2.

72. *Id.* at 1.

73. *Id.* at 1-2.

74. In each instance where the customer limit order was not executed but where a market order to buy was filled by the market maker, the market maker's account executive was asked why the limit order was not executed. In eight of the twelve instances of non-execution, the executive replied that the limit order had not gone through because the market "bid" price

Although the Commission did not allow admission of the study as evidence,<sup>75</sup> it seized upon the mixed findings to demonstrate that Manning may indeed have had other, superior trade execution opportunities if Hutton had disclosed its policies. In addition, the Commission viewed the study as evidence that Hutton had not proved that its conduct was anything less than a clear breach of fiduciary duties.<sup>76</sup>

The study could not have been more inappropriately used, however much its ambiguities may have tempted the Commission. The greatest flaw in the study is that, having selected random stocks for study by a method that did not consider or label factors which touch on the market maker's risk in making a market in those particular stocks, as compared with the risk of making a market in Genex common, the study created no basis for saying one way or the other whether Manning might have had the same, superior or inferior execution opportunities as those existing for the stocks included in the study. Hutton's case could only be made, or undone, by a study of stocks with market maker risk characteristics similar to those of Genex common.<sup>77</sup> The unfortunate consequence of the study is that it may have helped the Commission impose disclosure duties on Hutton for the wrong reasons. Furthermore, it may have helped excuse the Commission from addressing Hutton's sound argument that the fiduciary duties of market makers should be developed with an awareness for the special risks undertaken by market makers in the OTC markets.

The majority opinion was correct in grounding its disclosure duty on the argument that the absence of disclosure may have deprived Manning of a trading opportunity, but failed in assuming the reality of those opportunities. Specific trading conditions for Genex common may well have denied any such opportunity. The Commission, predisposed, and abetted by an ill-considered defense tactic, resorted to pronouncements of fiduciary duties and inappropriate reliance on earlier case authority rather than a closer examination of market processes to develop its disclosure duty. The sometimes unfortunate effect of adopting broad scale policy positions in a litigation setting could not be better demonstrated.

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had never reached the limit price. This evidence indicates that a primary concern of most dealers surveyed was to conduct trades in a way that would not deprive them of their accustomed spreads. *Id.* at 2.

75. The evidence was refused because it could have been introduced, but had not been, in the NASD Board of Governors proceeding below. See *E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,327-28 n.7 (July 6, 1988).*

76. *Id.* ¶ 84,303, at 89,328-29 & n.11.

77. Any study valid for Hutton's, or the Commission's, purposes should have isolated factors such as the number of market makers trading a given stock, the depth and breadth of the market for the stock, and the number and types of markets in which the stock was listed, before concluding that the respondent's replies permitted any valid conclusions of any kind about the likely pattern of limit order execution for Genex stock.

a. The dissent

The 3-2 split in the Commission resulted chiefly from the dissenters' conclusion that Mr. Manning had not shown that he reasonably could suppose, unless Hutton informed him otherwise, that Hutton would cease its normal market making activities while holding his limit order.<sup>78</sup> The dissenters' reservations were based in part on the strong evidence of Manning's awareness of Hutton's limit order execution policies,<sup>79</sup> but chiefly on their conviction that the necessary processes of the OTC markets might make Manning's claimed expectations unreasonable.<sup>80</sup> Each of the dissenting opinions urged a remand so that the scope of Hutton's duties and the range of the customer's protected expectations could be evaluated in light of the market risks and economic constraints of market makers.<sup>81</sup> Both opinions insisted that neither the trade execution nor disclosure obligations of market makers could be developed in a vacuum, but must be informed by a sound vision of market mechanics and the particular relationships of individual broker-dealers and their customers.<sup>82</sup> The tone of these opinions is heated and disappointed, reflecting a conviction that whatever Hutton's duties should have been, it was imperative that such duties be more carefully and persuasively grounded. The deep division the case produced in the Commission illustrates the failure of adequate explanation of the disclosure duty imposed by the majority.

b. The aftermath of *Hutton*

The unease surrounding the entire *Hutton* litigation and the weakness of the Commission's reasoning are suggested by the events subsequent to the SEC's decision. Following a petition for rehearing before the SEC and denial of that petition,<sup>83</sup> Hutton filed a notice of appeal in the United States Court of Appeals for the District of Columbia.<sup>84</sup> Hutton presented a statement of issues that challenged anew the NASD's and the Commission's position that limit order customers in the OTC market have a right to assume their brokers will cease normal market making activities pending execution of their cus-

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78. See E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,333 (July 6, 1988) (Grundfest, Comm'r, dissenting); *id.* ¶ 84,303, at 89,336 (Fleischman, Comm'r, dissenting).

79. *Id.* ¶ 84,303, at 89,334.

80. *Id.* ¶ 84,303, at 89,333-334, 89,335-340.

81. *Id.* ¶ 84,303, at 89,336, 89,340.

82. *Id.* ¶ 84,303, at 89,333, 89,336.

83. E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,330 (July 6, 1988) (petition for rehearing filed and denied July 18, 1988).

84. E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988), *appeal docketed*, No. 88-1649 (D.C. Cir. Oct. 11, 1988).

tomer's limit orders.<sup>85</sup> Hutton agreed to drop the appeal, however, when it was able to negotiate with the SEC and the NASD an informal agreement that permitted Hutton's counsel to draft a proposed safe harbor regulation to permit ongoing market making activities by NASD dealers holding customer limit orders.<sup>86</sup> The draft regulation was submitted in the form of a proposed addendum to the NASD Rules of Fair Practice. In substance, the draft regulation would produce a result identical to that required by the Commission—limit order subordination would be permitted if adequately disclosed.<sup>87</sup> The proposed Rule has been approved by the NASD membership and is expected to be approved by the SEC.

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85. Among the issues noted for appeal were:

2. Whether, under the unusual facts of the case, Hutton acted in a manner consistent with "just and equitable principles of trade" by

A. accepting Manning's limit order and assuming the limited agency function of monitoring the Genex market and executing the order only if the bid side of the market reached the limit price;

....

C. continuing its normal market-making activities by selling Genex stock at prices equal to or better than the limit price while Manning's limit order remained unexecuted because the bid side of the market never reached the limit price?

3. Whether in a dealer market, where a market maker realizes its profit on the spread between the bid and the asked, it was unreasonable for Manning to expect

A. that Hutton would shut down its sell side marketmaking activities in Genex stock and forego its customary dealer's spread on sales from its inventory while Manning's order remained unexecuted, and

B. that during such shut down, Manning would be able to step into Hutton's dealer shoes and sell his own stock at Hutton's *asked* price, notwithstanding that he had assumed none of the risks or obligations of an NASD market maker.

4. Whether the SEC erred in holding that the NASD's newly, announced requirement of limit order priority in the absence of a waiver by a customer after full disclosure could be "reasonably and fairly implied by an existing rule," notwithstanding widespread industry practice, the NASD's own prior statements and the inherent structure of the interdealer market negating the existence of such a requirement.

*Id.* (Petitioner's Statement of Issues).

86. Telephone interview with Richard T. Sharp, counsel for E.F. Hutton & Co., Inc. (April 13, 1989).

87. NASD NOTICE TO MEMBERS NO. 89-39, PROPOSED NEW RULE RE: HANDLING CUSTOMER LIMIT ORDERS (May 1989). The Notice solicits members' votes on the text of proposed new section 45 to Article III of the NASD Rules of Fair Practice. The proposed regulation reads as follows:

(a) A member firm that has accepted and holds an unexecuted limit order from a customer and continues to trade the subject security for its own market-maker account at prices equal to or better than the limit order price shall not be deemed to have acted in a manner inconsistent with Article III, Section 1 of the Rules of Fair Practice if the member firm provides to its existing customers as of the effective date of this rule and to each new customer at the time his or her account is opened a written statement clearly disclosing:

(i) the circumstances in which the firm accepts limit orders, and



In the end, the manifest awkwardness of *Hutton's* analysis of the limit order execution problem, and the threat of judicial review, may have generated enough pressure to initiate an off-board rule making approach to reconciling market making activities with limit order execution. Such non-public resolutions of disputes are common in the field of securities regulation. Still, the ultimate disposition of *Hutton* is disquieting, because it permits the SEC's roughshod proclamation of duty to stand. The process through which the safe harbor rule was proposed means that the Commission's arguments in *Hutton* remain unchallenged, and the need for careful articulation of the best foundations for proposed duties is not acknowledged.

The next section will describe the foundations of the argument that the Board of Governors, and later the SEC, should have made for disclosure of limit order policies of OTC market makers. The section will describe the lost opportunities in *Hutton* and make clearer the reasons for the sharp division among the SEC Commissioners in the final appeal of *Hutton*.

### C. *A Market-Based Argument for Disclosure of Limit Order Execution Policy as an Alternative to the Decision in Hutton*

As previously noted, Hutton relied on two basic arguments to justify its practice of customer limit order subordination. The first was that a selling limit order customer could not reasonably expect trade execution at other than the market "bid" price.<sup>88</sup> The second was that the customer could not

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(ii) the policies and procedures followed by the firm in handling such orders.

(b) If it is the policy of a member firm that acts as a market maker to accept limit orders from its customers but not to grant priority to such orders over transactions for its own market-maker account, a written statement substantially as follows provided by the member firm would be deemed to constitute adequate disclosure to its customers for purposes of paragraph (a) of this Section:

"By accepting your limit order for transactions in securities in the NASDAQ or over-the-counter market, we undertake to monitor the interdealer market and to seek to execute your order only if the inside bid (in the case of a limit order to sell, the highest price at which a dealer is being quoted as willing to buy securities) or the inside asked (in the case of a limit order to buy, the lowest price at which a dealer is being quoted as willing to sell securities) reaches your limit price. We reserve the right, while your limit order remains unexecuted, to trade for our own market-maker account at prices equal to or better than your limit order price and not to execute your order against incoming orders from other customers. For example, if the inside market is 10 bid, 10 1/4 asked and you place a limit order to sell securities at 10 1/8, we will seek to execute your order only if the inside bid reaches your limit price of 10 1/8 (exclusive of any markdown or commission equivalent that we may charge in connection with the transaction) and, while your order remains unexecuted, we may continue to sell securities for our market-maker account at prices at or above 10 1/8."

*Id.*

88. See *supra* note 32 and accompanying text.

reasonably expect that a market maker would cease to buy and sell for its own account while awaiting conditions permitting execution of the customer's trade.<sup>89</sup> Each argument is justified by the market risks thought to be undertaken by OTC market makers. The key question is whether Hutton's account of the risks faced by market makers is accurate enough both to justify limit order subordination as the normal expectation of trade execution in the OTC market, and to obviate a disclosure duty. To place the question in perspective, it must be kept in mind that one of the unspoken pressures operating in the Hutton litigation was the fact that the exchanges, including the New York Stock Exchange, prohibit the exchange specialists who perform market making functions, from preferring the execution of their proprietary trades to the execution of customer limit orders.<sup>90</sup>

It seems an appealing idea that market makers in OTC markets should subject themselves to the same discipline as exchange specialists by intervening to trade only when required for the maintenance of an orderly and

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89. See *supra* notes 32-33 and accompanying text.

90. For example, NYSE Rule 92 provides that:

(b) No member shall (1) personally buy or initiate the purchase of any security on the Exchange for any such account [its own account or any account in which it is directly or indirectly interested], at or below the price at which he personally holds . . . an unexecuted limited price order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security on the Exchange for any such account at or above the price at which he personally holds . . . an unexecuted limited price order to sell such a security in the unit of trading for a customer.

NYSE GUIDE (CCH) ¶ 2092, at 2683 (1989).

The role of the exchange specialist in an auction market requires such a prohibition. In an auction market, the operation of the auction process is expected to set prices through a matching of offers to buy and offers to sell at agreed-upon prices. If an exchange specialist were routinely to execute its own sales transactions in advance of and at a price higher than a customer's limit order sales price, the specialist would thereby have preempted the operation of normal market forces by substituting a sales price for the price the market would have produced without his intervention. By the same token, a specialist's purchase of stock in advance of and at a price lower than a customer's limit order purchase price would give the market a purchase price lower than it would have produced through its own operation. See SPECIAL STUDY, *supra* note 16, at 66-67. Therefore, the exchange market specialist is permitted to substitute his own "bid" and "ask" prices for those which the market would have produced if left to itself only when his intervention is needed to prevent abrupt price movements caused by serious imbalances in supply and demand. On such occasions, his duty to maintain an orderly and continuous market compels intervention. See New York Stock Exchange Rule 104, 2 NYSE GUIDE (CCH) ¶ 2104 (1989); *id.* at ¶ 2104.10 (definition and duties of "regular specialists"); *id.* at ¶ 2104.50 (regulation of income records). See also Securities Exchange Act of 1934 § 11(b), 15 U.S.C. § 78k(b) (1982); Rule 11b-1, 17 C.F.R. § 240.11b-1; N. WOLFSON, R. PHILIPS & T. RUSSO, REGULATION OF BROKERS' DEALERS AND SECURITIES MARKETS ¶ 11.04-11.06 (1977). The origin of the exchange specialist's duties, and of Rule 11b-1 is described in J. SELIGMAN, *supra* note 14, at 335-44. Seligman has suggested elsewhere that the creation of an integrated national market system and the introduction of trading competition between exchange specialists and OTC market makers might necessitate some change in the specialist's duty to maintain an orderly market. See J. SELIGMAN, THE SEC AND THE FUTURE OF FINANCE 61-62 (1985).

continuous market. Yet, despite some legislative enthusiasm for the adoption of customer limit order priority for OTC stocks,<sup>91</sup> there exists a consensus among commentators that limit order priority is a creature of centralized auction markets and is impracticable for the OTC market as it is now constituted.<sup>92</sup>

The special characteristics of the OTC markets thought to dictate subordination of customer limit orders are: (1) decentralization of the markets; and, (2) the greater risk associated with making markets in stocks generally less liquid than those traded on the exchanges.<sup>93</sup> OTC market makers have in the past been subject to more competition and suffered the disadvantage of less accurate market information when compared with stock specialists on the major exchanges, due to a decentralized market.<sup>94</sup> Unlike the traditional exchange specialist who controls all trading in a given security,<sup>95</sup> the market maker in an OTC stock is typically one of several dealers making a market in a security.<sup>96</sup> The market maker, unlike the specialist, will not have

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91. See SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMM. ON SECURITIES, *Report to Accompany S. 249*, S. REP. NO. 75, 94th Cong., 1st Sess. 14-16 (1975).

92. *Id.*; see SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMM. ON SECURITIES, SECURITIES INDUSTRY STUDY, S. DOC. NO. 13, 93d Cong., 1st Sess., 111 (1973). See also Development of a National Market System, Exchange Act Release No. 14,416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,502, at 80,033 (Jan. 26, 1978) (suggesting "Central File" to give all agency orders auction-type protections).

An important question is whether the movement towards an integrated national market system for publicly traded securities should look to the practices of the OTC interdealer market or to the practices of the exchange auction markets for its basic model for setting execution prices and for compensating market makers. Better understanding of the complexity of market structures, and an appreciation that the particular features and practices of different markets may be sound in context, has produced greater reluctance to suppose that the development of a national market system will produce complete uniformity of practice among markets, or that true integration of markets is a feasible or even a desirable goal. See, e.g., SPECIAL STUDY, *supra* note 16, at 610; J. SELIGMAN, *supra* note 14, at 49-53; Simon & Colby, *supra* note 14, at 82-90; Calvin, *supra* note 14, at 802-06 (arguing that true integration is unnecessary but that the greater equality in terms of trading on a nationwide basis has increased public confidence). New research into the functioning of markets has produced this caution and skepticism. See Ho & Stoll, *supra* note 22, at 1071.

93. See SPECIAL STUDY, *supra* note 16, at 660; Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1154; Stoll, *The Supply of Dealer Services in Securities Markets*, 33 J. FIN. 1133 (1978) [hereinafter Stoll, *Supply of Dealer Services*].

94. Stoll, *Alternative Views*, *supra* note 22, at 80, 85.

95. The Securities and Exchange Commission has tried to encourage multiple specialists for the exchanges in the interest of improved competition in pricing and execution, but the effort has largely failed because of the tendency of trading volume to flow to the specialist with the greatest volume. See *infra* note 101. Customers apparently prefer the certainty of speedy execution in a deep order book to the possibility that competition for trading might bring the same speed and quality of execution. See Poser, *supra* note 14, at 909, 951-57. There may exist other pressures for even a monopolist specialist to price his services fairly. He will be subject to the constant indirect competition of a wide universe of alternative investment opportunities in a variety of markets.

96. See Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1155, 1157-60, 1167-70 (stating

direct information about the future flow of orders by all buyers and sellers interested in a given security. There is no window on the entire market for the market maker equivalent to the specialist's order book which allows the specialist to monitor all trading and to gauge the future direction of the market.

The relative blindness of the market maker in a decentralized market carries with it acute risks of opportunistic trading by sophisticated traders and by other dealers in the market, seizing upon short term information advantages. An example offered by one study is the sophisticated trader who divides a substantial buy or sell order among several market makers.<sup>97</sup> Were such an order placed with an exchange specialist, the specialist would be able to match the order to a comprehensive record of orders on the other side of the market, so that if the market's appetite for the large placement was not keen, the customer's execution price would deteriorate through the order. By contrast, the placement of simultaneous orders among several market makers might more easily result in execution prices that did not reflect an over supply of the stock.<sup>98</sup> These additional risks of the OTC market maker are reflected in the fact that the spreads in the "bid" and "ask" prices of OTC stocks are typically wider than the execution fees of specialists.<sup>99</sup> These same risks have also been argued to justify a market maker's continuous trading while holding customer limit orders. The market maker may need continued access to the market and to the spread represented by the difference between "bid" and "ask" prices to hedge risks and to respond to an evolving market. The spread reduces the exposure necessarily undertaken in maintaining an inventory in a security and standing ready to accept orders of others in the market.<sup>100</sup>

While superior information reporting for OTC stocks through the NASDAQ system and some deterioration of the information advantages formerly enjoyed by exchange specialists when they enjoyed true monopolies in their

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that as number of active dealers for given security increases, median concentration of trading accounted for by any one dealer decreases; Stoll found that when there are 10 active dealers, no more than 30% of trading is concentrated in any one dealer). *But see* Poser, *supra* note 14, at 951-57 (indicating that active competition among market makers is sometimes exaggerated because orders will gravitate to market-maker with largest volume, who can provide the best assurance of prompt execution). The Stoll study claims to anticipate and allow for this phenomenon, however. *See* Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1161.

97. *See*, Ho & Stoll, *supra* note 22, at 1071; Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1161.

98. Ho & Stoll, *supra* note 22, at 1071.

99. *Id.* The interaction in the OTC market between dealer competition, which depresses spreads between bid and ask prices, and the risk created by imperfect market information, which widens spreads, is complex. The market maker must try simultaneously to maintain a spread between "bid" and "ask" prices narrow enough to stimulate trading, yet broad enough to allow an adequate profit on each transaction to provide protection against uncertainty as to the trading positions of other traders in the market.

100. Respondent's Brief, *Manning v. E.F. Hutton & Co.* (No. 3-6490) (SEC Sept. 23, 1985); Simon & Colby, *supra* note 14, at 93.

stocks, have reduced the informational disadvantages of OTC trading,<sup>101</sup> the market information about OTC stocks traded by multiple market makers remains relatively inexact when compared with the corresponding information possessed by specialists on the major exchanges.

Moreover, there is evidence that the cure for this disparity is not to duplicate the exchange specialist system for OTC stocks. The presence of multiple market makers may in fact be desirable and necessary for some types of securities, especially those that are lightly traded or relatively volatile.<sup>102</sup> Multiple market makers are able to distribute market risk and produce greater liquidity at lower transaction prices than would a solitary specialist.<sup>103</sup> As one commentator has suggested, where the risks associated with a market maker holding a position in a given stock are magnified by the relative illiquidity of the market for that stock, there will be a tendency for the market making function for that stock to become dispersed as market makers attempt to minimize risk and to diversify their holdings.<sup>104</sup> Moreover, this pattern, intended to reduce market maker risk, is desirable for the customers of market makers because it produces lower transaction costs for trades in such illiquid stocks. At any given price level for the securities, a monopolist dealer would be compelled to charge higher transaction fees for purchase and sale orders in order to cover the concentrated risk he had undertaken.<sup>105</sup> The presence of multiple dealers spreads both risk and creates

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101. Greater access to market information about OTC stocks has been facilitated by NASDAQ, and especially by "Level II" reporting of prices, which gives trading departments a complete display of all market maker quotations in any given security. See Simon & Colby, *supra* note 14, at 36-44. Multiple listings of securities and the proliferation of private trading away from the market may blunt the information advantages of the exchange specialist, but the notable failure of the efforts both to promote OTC trading of exchange-listed securities and competition among exchange specialists resulted in little real change in the centralized order flow of exchange-listed securities to monopolist exchange specialists. For comment on the mix of sound and self-interested arguments that have delayed elimination of off-board trading restrictions and other barriers to inter-market competition, see J. SELIGMAN, *supra* note 14, at 35-53; Simon & Colby, *supra* note 14, at 47-53. For comment on the failure of active competition to emerge among market makers and specialists, see Poser, *supra* note 14, at 951-57.

102. Stoll, *Pricing of Dealer Services*, *supra* note 22, at 1162-71.

103. *Id.*

104. Stoll, *Supply of Dealer Services*, *supra* note 93, at 1147.

105. *Id.* Other commentators have pointed out that the existence of greater risk will not by itself produce a spreading of risk among many market makers when a stock is thinly traded. Securities characterized by high risk and low volume attract few market makers, and those few demand relatively wide spreads between "bid" and "ask" prices. These spreads reflect not only exposure to high market risk, but the trading advantages conferred by near monopoly and by the unavailability to other traders in the market of information about the true supply of and demand for the security. With respect to thinly-traded stocks, market makers cannot count on the continuous presence of other traders in the market. This absence of a ready market creates a dependence on isolated market makers to provide prompt execution and informed pricing. See Stoll, *Alternative Views*, *supra* note 22, at 87.

It has been suggested that such securities could be traded on terms more advantageous to the market if the OTC market required exposure of a market maker's limit order book to other

pressures on all market makers to set transaction prices that will improve their chances of enjoying those transactions that do occur.<sup>106</sup> Markets in relatively illiquid stocks thus depend on competition to improve risk distribution and to lower costs of trade execution to customers.<sup>107</sup>

The risk profiles of certain OTC securities thus makes desirable, and to some extent produces, the decentralized market competition among multiple market makers, and the bid and asked pricing structure characteristic of the OTC market. Those who support the market maker's right to the spread between bid and ask prices argue that these broad characteristics of the OTC market—decentralized, competitive, and relatively more risky than the exchange markets—provide the rationale for compelling retail customers to defer to the bid-ask price structure and to limit order subordination, all as a rough and ready approach to the basic dynamics of the market in OTC stocks.<sup>108</sup>

These arguments focus on the inherent risks of a decentralized market as the rationale for the inferior treatment of customer limit orders in the OTC market. Therefore, these arguments lose much of their force when the pattern of trading in specific OTC stocks mimics trading in exchange-listed securities with respect to liquidity and availability of market information. For example, in the case of OTC stocks for which a deep, broad, and liquid market exists, limit order execution practices should more closely mimic the structure found in liquid auction markets. In a manner similar to a liquid auction market, the dealer should match incoming buy and sell orders "at the market" and rely principally on transaction commissions for compensation. Indeed, the narrower dealer spreads which are typical in OTC transactions in highly liquid stocks reflect the modest transaction risks of holding such securities.

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traders so that the fairness of "bid" and "ask" prices posted by a monopolist market maker could be more readily gauged and other willing market makers possibly attracted if transaction costs of the monopolist were revealed to be too high. See Ho & Macris, *Dealer Market Structure and Performance*, in MARKET MAKING AND THE CHANGING STRUCTURE OF THE SECURITIES INDUSTRY 43, 63 (1985).

106. See Farrar, *The Coming Reform on Wall Street*, 50 HARV. BUS. REV. 108, 114-115 (1972); Ho & Stoll, *supra* note 22, at 1065-70.

Bid and ask quotations in any given stock are set by dealers with a view to encouraging transactions which reduce the dealer's risk associated not only with holding the stock in question, but the risks associated with his portfolio holdings as a whole. See Stoll, *Supply of Dealer Services*, *supra* note 93, at 1142-43.

107. See *Id.*

108. The impact of these market dynamics on the pricing of transactions in securities is suggested strongly by one study showing that the OTC market spread appears to be higher than the specialist's spread on the NYSE when similar stocks are compared. W. Newton & R. Quandt, *An Empirical Study of Spreads*, Research Memorandum No. 30, Financial Research Center, Princeton University (Jan. 1979). Ho and Stoll have attributed this difference to the advantages of centralized information and capacity to control the volume of trades at a given price level that characterizes the monopoly specialist system and distinguishes it from the multiple market maker system characteristic of the OTC market. Ho & Stoll, *supra* note 22, at 1071.

It is precisely the uncertainty over whether risks thought of as endemic to the OTC market are in fact present with respect to particular transactions that makes the disclosure duty imposed in *Hutton* appropriate. If the practice of "trading through" customer limit orders both seems justified to some (undefinable) degree because of risks inherent in decentralized markets, yet carries with it the risk of abuse, a disclosure rule both permits the practice and creates a climate where the market maker/broker must continually alert customers to its conflict of interest. Market makers will be pressed to provide the best execution possible to customers and will be discouraged from resorting to protective trading practices except to the extent necessary to respond to inherent market risks which threaten their ability to function as market makers. Disclosure of limit order execution policies may discourage marginal and doubtful recourse to trading through customer limit orders, yet allow the practice to survive where needed.

The result in *Hutton* would have been far more satisfactory had the NASD and the Commission treated the case as one where a disclosure duty was imposed in order to narrow the range where a necessary but risky practice was allowed to operate. What was required in the case, especially in view of the existence of a body of NASD statements indicating that limit order subordination might be justified by the dynamics of the OTC market,<sup>109</sup> was some effort to convey just why the earlier accepted models of OTC market dynamics and market maker risk required modification. A simple statement that a decentralized market necessarily creates greater uncertainty about the terms of trading which a retail customer might have available, and therefore justifies disclosure of limit order execution practices, would have sufficed. Instead, the SEC's decision in *Hutton* turned on a sloppy dispute between the Commission's invocation of broad fiduciary principles and an unconvincing marshalling of earlier authority, on the one hand, and *Hutton*'s wide-of-the-mark effort to establish the universal validity of limit order subordination on the other. At the very least, the Commission should have more positively tied its disclosure duty to the fact that the complexities of conditions of trading in a decentralized market make it reasonable that a market maker inform the customer of its own practices, as those practices might not represent the best available terms in the market.

*Hutton* illustrates that as much, if not more, care need be taken in stating the foundations for the legal duties imposed on stock and commodities professionals as in stating what those duties are. Rather than exercising such care, the duties imposed by the SEC in *Hutton* were made to appear as reflexive responses to market practices which were presumed to be unfair. This failure reduces confidence in the processes of decision. One can sense in the case an intuitive opposition to a fiduciary's trading for its own account, but the case illustrates the perils of such intuitive responses when trouble is not taken to validate them. Even the adoption of a modest disclosure duty

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109. See *supra* note 25.

may require adequate explanation, especially against the background of orderly rule development and disciplined adjudication in technical areas that has characterized the regulation of securities markets and market professionals. The Commission in *Hutton* offered the bland statement that "the choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency."<sup>110</sup> The flexibility and immediacy of response offered by adjudication can, however, be perilous, and courts and agency tribunals must proceed with care.

## II. *HUTTON* IN THE CONTEXT OF OTHER CASES

The disposition of *Hutton* seems all the more heavy footed when compared with other recent cases in which a need to define the duties and primary allegiances of brokers who perform multiple market roles has arisen. This section will discuss three of those cases: *United States v. Dial*,<sup>111</sup> *Eichler v. SEC*,<sup>112</sup> and *Wasnick v. Refco, Inc.*<sup>113</sup> *Dial* and *Eichler* were chosen because each represents, in contrast to *Hutton*, instances where a court's efforts to come to terms with the vague generality of fiduciary expectations produced duties responsive to the reasonable expectations of brokers and customers, and to the broker's role in the marketplace. Moreover, the SEC in *Hutton* relied upon both cases as authority for its treatment of limit order subordination as nothing other than a form of the self-preferential trading by brokers and dealers that agency and security laws had always prohibited.<sup>114</sup> These cases are described here also so that their points of difference from *Hutton* can be appreciated. The third case, *Wasnick v. Refco, Inc.*,<sup>115</sup> illustrates a trial court successfully overcoming the difficulties of making a persuasive case for the enforcement of broker duties exceeding the range of duties established in a highly-regulated environment. The case shows the desirability of continuing judicial participation in the development of broker-dealer duties, and suggests ground rules for the helpful participation by the courts in the development of duties in a highly-regulated field.

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110. E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,330 (July 6, 1988) (quoting *SEC v. Chenery Corporation*, 332 U.S. 194, 203 (1947)).

For a consideration of the relation between formal rulemaking, ad hoc policy statements, and adjudication as sources of broker-dealer duties in executing customer orders, see Cohen & Rabin, *supra* note 55, at 691.

111. 757 F.2d 163 (7th Cir. 1985), *cert. denied*, 474 U.S. 838 (1985).

112. 757 F.2d 1066 (9th Cir. 1985) (appealing Exchange Act Release No. 18,401, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,088 (Jan. 8, 1982)).

113. [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).

114. E.F. Hutton & Co., Exchange Act Release No. 25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303, at 89,330 (July 6, 1988).

115. [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).



A. *United States v. Dial and Eichler v. SEC: Instances of Self-Preferential Trading Unjustified by the Broker's Market Position, and Inconsistent with Legitimate Customer Expectations.*

In both *Dial* and *Eichler*, brokers executed their own trades in preference to those of their customers in settings where their practices were unjustified by their positions in the market and inconsistent with the legitimate expectations of their customers. In *Dial*, the Seventh Circuit affirmed the criminal mail and wire fraud conviction of a commodities broker, based in part on the broker's "trading ahead" of his brokerage clients in silver futures on the Chicago Board of Trade.<sup>116</sup> "Trading ahead" occurs when a commodities broker, aware that the accumulated outstanding orders of his customers, when executed, will be of sufficient volume to cause an upward or downward movement in the market, buys or sells for his own or others' account in advance of execution of those orders.<sup>117</sup> The object of the practice is to take advantage of the expected price movement when the customer orders go through. The vice of the practice is not only that it erodes general public confidence in the fairness of the markets, but that it injures the interests of the clients whose known trading intentions the broker exploits.<sup>118</sup>

The *Dial* court properly characterized the defendant's conduct as a simple act of misappropriation.<sup>119</sup> Despite the defendant's argument that no existing statute, regulation, ethical norm, or rule of the Commodities Futures Trading Commission ("CFTC") or the Chicago Board of Trade prohibited "trading

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116. *Dial*, 757 F.2d at 171.

117. *Id.* at 166. The court explained "trading ahead" as follows:

The broker obtains a profit from information that he has not invested in producing but that comes to him automatically in his capacity as broker. It is like a lawyer's discovering that his client is about to make a takeover bid for another company and rushing out and buying some of that company's stock before the bid is made public.

*Id.*

118. A customer buy order executed after the broker's trade would be executed at a market price inflated by the broker's anticipatory purchases; customer orders to sell would be executed at a market price depressed by the broker's anticipatory sales. *Id.* at 169. Even if the customers later liquidated their investments at a profit, they would nonetheless have been deprived of a part of the profit they would have earned if the broker had placed the customers' orders first.

*Id.*

119. *Id.* In *Dial*, the defendant broker solicited the customer orders, implicitly representing that he would seek the best price for his customers as their agent. *Id.* at 168. The duty not to trade ahead does not depend, however, on who initiates the brokerage transaction. There is no market risk to which commodities brokers are exposed nor is there a legitimate market function that they perform that could justify the profit skimming represented by "trading ahead." In fact, commodities exchange floor brokers, whose specialist-like risks might conceivably justify hedging purchases or sales against anticipated market movements, are completely prohibited from trading ahead of customer orders and even from trading for their own accounts except insofar as it may be necessary to maintain an orderly market. *Id.* at 168 (citing Chicago Board of Trade Rule 150(b) (1989)).

ahead" by ordinary brokers, the Seventh Circuit affirmed the criminal conviction.<sup>120</sup> The court relied principally on the argument that the communication of trading information by customer to broker required that the broker not use the information to the customer's detriment.<sup>121</sup> Although the court in *Dial* resorted to a broad fiduciary norm as the basis for liability, the specific duty imposed and the rationale for that duty fully responded to the legitimate expectations of both customer and commodities broker. Unlike *Hutton*, where the operations of OTC markets give some support for the defendant's argument that its practice of subordinating customer limit orders was privileged by its risks as a market maker, there is no colorable argument for the practice of trading ahead on misappropriated information.

*Eichler v. SEC*,<sup>122</sup> like *Dial*, involved a case of unjustified subordination of the customer's trading interests. In *Eichler*, the petitioner, Eichler, was president of Bateman Eichler, Hill Richards, Inc. ("BEHR"). BEHR was managing underwriter of an initial public offering of a stock to be listed on the OTC market.<sup>123</sup> Evidently there was some breakdown in communication among the dealers organizing the offering, because when the dealers began to fill subscriptions for the new issue, it quickly became clear that more subscriptions had been accepted than there was stock available.<sup>124</sup> Moreover, the managing underwriter had made insufficient provision for enlargement of the offering to cover the oversubscriptions. BEHR and the other members of the underwriting and dealers' syndicates thus found themselves needing to buy shares of the newly issued stock in the rapidly developing after-market to honor their commitments to original subscribers. Worse, the hot market for the new shares threatened to raise the cost of buying the shares the syndicate members would need to fill original subscriptions.<sup>125</sup> BEHR further contributed to market demand by having begun to accept orders

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120. *Id.* The criminal context of the litigation led the defendant to offer the defense that no specific prohibition barred "trading ahead." This line of defense was appropriate in the setting of a criminal prosecution because its object is not only to cast doubt on the assertion that "trading ahead" is a breach of a legal duty, but also to suggest that even if there was such a breach, the wrongdoing was not sufficiently specified to sustain a charge of criminal wire and mail fraud. The court noted that reliance on charges of breach of fiduciary duty, without more, was a problematical foundation for a criminal conviction. *Id.* at 170 (citing Coffee, *Some Reflections on the Criminalization of Fiduciary Breaches and the Problematical Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117 (1981)). The court concluded, however, that the defendant's state of mind was consistent with a finding of criminal fraud. 757 F.2d at 170.

121. The practice is expressly forbidden for NASD broker-dealers. The reason is the manifest violation of a customer's confidence. NASD NOTICE TO MEMBERS 87-69, FRONT-RUNNING OF BLOCKS, INTERPRETATION OF THE BOARD OF GOVERNORS ON ARTICLE III, SECTION 1 OF THE RULES OF FAIR PRACTICE (Oct. 20, 1987).

122. 757 F.2d 1066 (9th Cir. 1985).

123. *Id.* at 1068.

124. *Id.*

125. *Id.* The situation would also be embarrassing because it would have indicated to the issuer of the stock that appetite for the stock had been badly underestimated and the stock poorly priced.

from its brokerage customers to buy shares of the newly issued stock in the after-market.<sup>126</sup>

To avoid a rapid run-up in price, BEHR decided both to delay purchases of stock needed to fill original subscriptions and to execute only prorated portions of brokerage customers' orders. BEHR did not advise its clients of either of these decisions.<sup>127</sup> Rather, BEHR continued to buy the desired stock in moderate amounts for its own account to hedge the risks created by its obligation to deliver shares at original issue prices to subscribers in the public offering.

A customer complained that BEHR was buying in competition with its brokerage clients and failing to execute orders. This gave rise to disciplinary proceedings by the NASD.<sup>128</sup> BEHR took the position that the conflicts created by its dual role as broker-dealer for its retail customers and as syndicator for the new issue constituted market conditions which limited its order execution capacity and the legitimate expectations of its brokerage customers.<sup>129</sup> Specifically, BEHR stated that it had declined to bid aggressively enough to execute customer orders in an effort to halt the after-market price rise,<sup>130</sup> arguing that its duty as a market maker to maintain an orderly market dictated its restraint in bidding. Furthermore, BEHR maintained that as dominant market maker for the stock, it might have exposed itself to sanctions for market manipulation had it raised its "bid" price for the stock to levels high enough to fill customer orders.<sup>131</sup> Therefore, BEHR maintained that, far from injuring the interests of brokerage clients, it had both maintained an orderly market and offered partial execution at per share prices that were lower than they would have been, had the stock been bid up sufficiently to allow full execution.<sup>132</sup>

The NASD, the SEC, and eventually the Ninth Circuit properly rejected each of these defenses. The main point of each tribunal was that a broker-dealer has a specific and clearly established duty to execute market purchase orders sequentially and in their entirety, or to obtain a customer's consent to alternative arrangements.<sup>133</sup> If a dealer judges that the customer might be better served by partial execution or other arrangements, the dealer must consult with the customer before taking such action.<sup>134</sup> Moreover, BEHR had no duty, either in its capacity as market maker, or as syndicator of the new issue, to maintain an orderly market or to control the rate of price

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126. *Id.*

127. *Id.* at 1070.

128. *Id.* at 1068.

129. *Id.* at 1069.

130. *Id.*

131. *Id.* at 1069-70. *See also supra* notes 43-44 and accompanying text for discussion of the issue of market domination.

132. 757 F.2d at 1069-70.

133. *Id.*

134. *Id.*

increase.<sup>135</sup> BEHR's duties to the market were not analogous to an exchange specialist's, rather, BEHR's sole obligation to the market, as one among several market makers, was to establish its own "bid" and "ask" prices in a way that fairly reflected an unmanipulated market. The court rejected BEHR's claim that any bidding up of the stock might have exposed it to a charge of market manipulation on the simple ground that actual demand for the new stock would have justified price increases.<sup>136</sup>

Unlike the position of the OTC market maker holding a customer limit order in *Hutton*, nothing about the risk of an underwriter of an initial OTC public offering justifies restriction of a brokerage customer's expectations for first-come-first-serve execution in the after-market. Indeed, BEHR placed itself in the awkward position of needing to compete with customer market orders. BEHR had both failed to assess accurately the market demand for the new offering and failed to address the risks of over-subscription by the customary means of contracting for the issuance of additional shares to provide for unanticipated demand. In violation of an unambiguous duty to execute customer orders fully and in sequence, BEHR attempted to shift to its retail customers risks created by its own doubtful performance as an underwriter.<sup>137</sup>

B. *Wasnick v. Refco, Inc.: The Broker's Duty to  
Refuse to Trade for an Unfit Customer*

The important question raised by *Wasnick v. Refco, Inc.*,<sup>138</sup> is whether there should be room for a court to impose a common law duty that a commodities broker refuse to trade for an unfit customer, given the reluctance of existing regulations, of case law under the Commodities Exchange Act and of industry practice to insist upon such a duty.<sup>139</sup> *Wasnick* thus presents the difficult questions of when judicial action to re-order legal duties, established by expert regulation, is appropriate, and what restrictions of form and content should be imposed on such intervention.<sup>140</sup> The challenge is to articulate controls and limiting principles for judicial intervention so that a court's approach to the question of broker duties will produce results responsive to a sound conception of the mutual expectations of brokers and customers, and to a desirable model of the relative roles of courts and

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135. *Id.* at 1070-71.

136. *Id.* at 1069 n.3, 1070. The point was more clearly made in the original disposition by the SEC of BEHR's appeal from NASD sanctions. See Exchange Act Release No. 18,401, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,088, at 84,797 (Jan. 8, 1982).

137. The sanctions ultimately imposed included fines and censure on the ground that BEHR's conduct violated the NASD's Rules of Fair Practice. See *NASD, Rules of Fair Practice*, *supra* note 2, at ¶ 2151.

138. [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).

139. See *infra* text accompanying notes 147-64.

140. See generally CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES (1982).

administrators in developing the specific content of broker-dealer duties.

The plaintiff in *Wasnick* had for seven years prior to the onset of the litigation maintained various commodities trading accounts with the defendants Conti Commodities and its successor Refco, Inc.<sup>141</sup> The plaintiff, controlled the accounts and during the period of his relationship with Conti and Refco, frequently engaged in binges of frenzied and irrational trading. He traded large numbers of contracts in wide varieties of commodities, far beyond his capacity to monitor. On a given day's trading, he would move precipitately and randomly in and out of various trading positions. Even in a market environment known for its acceptance of bizarre trading strategies and for the unaccountable success of irrational trading systems, practices such as the plaintiff's are regarded as doomed and virtually certain of destroying the investor's capital.<sup>142</sup> The plaintiff did much of his trading in person at the defendants' offices, and he was well-known to the brokers who handled his account and to the managers of the offices where he traded.

141. *Wasnick v. Refco*, [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315 (W.D. Wash. Aug. 24, 1988).

142. See, e.g., Melamed, *A Professional's View of Commodity Trading*, in *BEFORE YOU SPECULATE*, at 11 (Chicago Mercantile Exchange 1978) (Remarks of Chairman of the Chicago Mercantile Exchange Board):

One must approach commodity trading as a business venture and apply good business techniques and judgment. Commodity trading is not a game or a gamble to which one can apply rules of chance or probabilities.

.....

One must have a certain degree of technical knowledge, both regarding market trading in general and the commodity or commodities in particular. . . .

One must work with a competent broker who is both conscientious and relatively knowledgeable. . . . dividing the winners from the losers.

#### DON'T OVER TRADE

*Perhaps the second-most-important principle is not to overtrade.* This cannot be defined in terms of money or in terms of how many trades to make in a week, a month, or a year. It will depend on a number of factors, but *the important consideration is that overtrading will necessarily overexpose you to risk, not to mention unnecessary commissions.*

You must accept the fact that you cannot take part in every move the market will make—and you shouldn't want to. The most successful trader—of those not on the trading floor of an exchange daily—will pick his spots very carefully.

*Id.* at 12-13, 16 (emphasis added). See also O'Brian, *Speculating and Money Management*, in *BEFORE YOU SPECULATE*, at 18 (Chicago Mercantile Exchange 1978) (Remarks of a former governor, treasurer, and chairman, Chicago Mercantile Exchange):

#### RESTRICT TRADING

Many speculators make the common mistake of trying to trade every day, without waiting for trends to develop, and of jumping all over the lot into dozens of different commodities looking for that pot of gold at the end of the rainbow. This type of trading has two distinct disadvantages: One, it spreads the speculator's risk capital too thin, making him vulnerable to small adverse moves of the market. And two, he cannot have sufficient knowledge about every one of the commodities that he is involved in to make proper trading decisions. *Most brokerage firms will urge this customer to restrict his trading to not more than a half-dozen commodities.*

*Id.* (emphasis added).

Furthermore, the court found that as early as 1979, the defendant brokers were aware that the plaintiff had a history of gambling problems and that he had been active in Gamblers Anonymous.<sup>143</sup> Although the plaintiff enjoyed occasional success, he eventually lost approximately \$1.3 million during his seven year relationship with Conti and Refco and paid some \$400,000 in commissions on his trades.<sup>144</sup> The court found that the defendants' failure to intervene to prevent Mr. Wasnick from destroying himself financially constituted a negligent breach of a duty to act by a broker who had actual knowledge that its customer was unfit to trade.<sup>145</sup>

Such duties to intervene can arise under the common law from the vulnerability of one party and the relative ease with which another party can intervene to prevent injury or loss.<sup>146</sup> Typically, however, the common law has been unwilling to impose such "good samaritan" duties in the absence of some legally recognized relationship between the victim and the proposed rescuer,<sup>147</sup> or in the absence of some clear public policy directive indicating that special duties should be imposed.<sup>148</sup> *Wasnick* does not fit clearly into these classifications, because a regulatory policy choice had been made not to impose the very duties the plaintiff argued were owed him. Although there are decisions which have imposed civil liability on commodities brokers for failure to determine investor suitability,<sup>149</sup> these decisions were based on the willingness of the CFTC to infer such a duty from the general antifraud provisions of the Commodities Exchange Act ("CEA").<sup>150</sup> The CFTC was

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143. *Wasnick v. Refco, Inc.*, [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315, at 35,381 (W.D. Wash. Aug. 24, 1988).

144. *Id.* ¶ 24,315, at 35,382.

145. *Id.* ¶ 24,315, at 35,379.

146. See Ames, *Law and Morals*, 22 HARV. L. REV. 97, 110-13 (1908).

147. See Weinrib, *The Case for a Duty to Rescue*, 90 YALE L.J. 247, 279-92 (1980) (effort to make case for duty to intervene, based on relative ease to rescuer and vulnerability of victim). The SEC has frequently pointed out that the duty of securities dealers to treat their customers fairly arises from holding themselves out as possessing specialized knowledge and skill and from cultivation of their customers' trust and confidence. See, e.g., *In re Allender Co.*, 9 S.E.C. 1043, 1053-57 (1941); *In re Duker & Duker*, 6 S.E.C. 386, 388-89 (1939); Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 527 (1948).

148. See D. DOBBS, R. KEETON & D. OWEN, PROSSER & KEETON ON TORTS § 56 (5th ed. 1984).

149. See, e.g., *Shefter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,022 (CFTC Apr. 23, 1986); *Yi v. Int'l Trading Group, Ltd.*, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,958 (CFTC Mar. 13, 1986); *Phacelli v. Conti Commodity Servs., Comm.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,345 (CFTC Sept. 12, 1984).

150. See also *Bieganek v. Wilson*, 642 F. Supp. 768, 772-74 (N.D. Ill. 1986), *vacated in part sub nom.* *Bieganek v. Taylor*, 801 F.2d 879 (7th Cir. 1986) (describing importance of CFTC's views on willingness of courts to imply an obligation to determine investor suitability).

The relevant language of the Commodity Exchange Act provides:

It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent or employee of any member, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate

later to express doubts whether a duty to determine investor suitability should be inferred from the CEA's antifraud prohibition,<sup>151</sup> and by the time of the *Wasnick* litigation, most courts had begun to interpret this administrative ambivalence as a signal to discontinue imposing that duty. Their actions reflected the fear that however attractive a duty to screen out inappropriate traders might sound, such a duty might be inconsistent with an informed regulatory view of the appropriate allocation of responsibilities between customer and broker.<sup>152</sup> The court in *Wasnick* makes clear that its imposition of a duty to protect an unsuitable customer is not based on the discredited

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commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity . . . , or (b) determining the price basis of any such transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof—(A) to cheat or defraud or attempt to cheat or defraud such other person; (B) willfully to make or cause to be made to such other person any false report or statement thereof, . . . ; (C) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order to contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person . . . .

7 U.S.C. § 6 (1988 & Supp. I 1989).

151. For a description of the Commission's initial adoption of a "suitability" rule, its abandonment of that rule and its eventual retrenching of the policy position on which the rule had been grounded, see *Bieganeck*, 642 F. Supp. at 772-74.

152. *Id.* at 774. See also *Puckett v. Rufenacht, Bromagen & Hertz, Inc.*, No. H88-0035, at 12-15 (S.D. Miss. May 31, 1989); *Kearney v. Prudential-Bache Securities, Inc.*, 701 F. Supp. 416, 430 (S.D.N.Y. 1988) (court recognized there is no suitability rule under Security Exchange Act); *Foster v. First Commodity Corp. of Boston*, [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,970, at 34,405 (CFTC Nov. 5, 1987); *Kats v. Merrill Lynch Commodities, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep., (CCH) ¶ 21,998, at 28,387 (CFTC Feb. 3, 1984) (no basis for finding a duty to prevent unwise trading where trades were authorized by customer; broker's obligation with respect to advising client as to client's financial and temperamental suitability to invest in commodities futures consists of no more than duty to advise client of risky nature of transaction contemplated by client); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952 (E.D. Mich. 1978) (broker had no obligation to inform client that his pattern of trading was almost too risky to be profitable; broker had no duty to restrain client from trading heavily where client retained control of the account).

Even the main case support for the argument that a duty exists to determine customer suitability does not hold that a broker has an obligation to intervene to stop a foolish course of trading that the customer knowingly undertakes. See *Phacelli v. Conti Commodity Servs. Comm.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,345, at 32,674 (CFTC Sept. 12, 1984) (customer who makes a knowing and meaningful election to undertake the risks of commodity future trading cannot recover his losses by claiming that his account executive should have warned him that he was unsuitable for such risk).

implied duty theory,<sup>153</sup> but the choice to impose a duty specifically rejected by the CFTC placed the court under pressure to justify that duty.

The court in *Wasnick* defended its proposed duty in its finding that prevailing practices and standards of a substantial part of the commodities dealers' community supported an obligation by brokers to protect unsuitable customers from ill-advised trading.<sup>154</sup> The court noted that the dealer community had itself chosen to respond to the high risks of commodities futures trading by adopting norms of fair dealing requiring protection of unsuitable traders. In the court's view, the translation of these norms into an affirmative legal obligation to intervene in clear cases of trading incompetence seemed a practicable and obvious precaution to reduce investor risk.<sup>155</sup>

The difficulty with the court's findings of industry practices is that despite the existence of any number of general statements by leaders of the commodities industry attesting to their awareness of the riskiness of trading and their wish to screen inappropriate participants from the market,<sup>156</sup> the case for a duty to intervene based on industry practices and policies is far from clear. First, the general statements themselves were made in anticipation of the adoption of a rule that has since been withdrawn that required commodities traders to establish the suitability of potential clients.<sup>157</sup> Later statements by the Commission and the strong trend of recent litigation suggest that the consensus in favor of a broker's duty to protect unsuitable

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153. The court in *Wasnick* made clear that the decision was not based on the antifraud provision of the CEA. The Ninth Circuit requires proof of *scienter* in civil suits under the CEA. See *Commodity Futures Trading Comm'n v. Savage*, 611 F.2d 270, 283 (9th Cir. 1979). The court in *Wasnick* was unwilling to find that the defendant had acted with the willfulness or recklessness needed to establish *scienter*. Nonetheless, Judge Dwyer stated that had *scienter* been established, Conti-Reco's failure to make clear to Mr. Wasnick his unsuitability for trading would have supported an action under the CEA. See *Wasnick v. Refco*, [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,315, at 35,379 (W.D. Wash. Aug. 24, 1988).

154. *Id.* ¶ 22,315, at 35,379-80.

155. *Id.*

156. See Weinberg, *Who are Those Commodity Speculators and What are They Doing To Us?* in *BEFORE YOU SPECULATE*, at 19, 23 (Chicago Mercantile Exchange 1978) (Remarks by former chairman of the Board, Chicago Mercantile Exchange):

NOT ALL WELCOME

Not all speculators are welcomed by the Chicago Mercantile Exchange, however. The Exchange's extensive educational and advertising program devotes much of its attention to discouraging the UNSuitable speculator; the person who has prior financial obligations to meet, or who has insufficient risk capital, or who simply doesn't have the temperament to study commodities and make rapid and realistic decisions. . . .

*Id.* See also MERRILL LYNCH PIERCE FENNER & SMITH, INC., POLICY BULLETIN No. 76-12 (May 24, 1976) (setting out guidelines for trading practices and for recognition of danger signals and customer liquidity).

157. The CFTC's proposed suitability rules were under consideration at the time of the public statements appearing in notes 142 and 156 *supra*. See also Consumer Protection Rules (Proposed), 42 F.R. 44742, [1977-1978 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,474, at 21,928 (CFTC Sept 6, 1977).



traders may not have survived withdrawal of the rule.<sup>158</sup> Second, the evidence of specific screening practices among brokerage firms is highly equivocal, and more often suggests that screening is meant to establish that clients will pay their bills and not be bad losers rather than that clients are well advised to trade commodities.<sup>159</sup> Further, while it seems that the riskiness of commodities trading is routinely communicated to potential customers, there also seems to be a common expectation that it is the customer who will be responsible for deciding whether those risks fit his tastes or his abilities to suffer loss.<sup>160</sup>

The doubtful support of industry practice for *Wasnick's* rule of intervention and the clear discomfort of the CFTC and many courts with imposing a duty to halt unfit traders suggests that willing choices may have been made not to adopt a model of broker's duties which requires the solicitousness and intervention implied by *Wasnick*. Both courts and regulators seem quite uncomfortable with recognizing an obligation for a broker to prevent ill-advised trading when the trading is directed by the customer.<sup>161</sup> Thus, if the duty imposed by *Wasnick* is to be persuasive, it must be reconciled with or allowed to supplant the vision of broker duties reflected in current commodities cases and legislation.

The reasons why a customer screening rule has not been adopted may help answer the question whether such a reconciliation is possible or such a supplanting is desirable. The current reluctance to require brokers to screen their customers seems not to be caused by a feeling that it should be acceptable for brokers to reap commissions from persons whose unfitness could be agreed upon, but by fears that the burden of defining and applying standards of unfitness may be too great.<sup>162</sup> That is, brokers are not spared

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158. See *supra* note 150.

159. The author has reviewed the office procedure manuals of Conti Commodities, Refco, Inc., Merrill Lynch Commodities, and Smith, Barney, all introduced as trial exhibits in the *Wasnick* litigation. The obvious concern of these materials is the welfare of the brokerage house. The fact that customer screening practices are intended to reduce the broker's, not the customer's, risk has been adopted by some courts as reason enough to deny a customer's right to rely on screening to stop his ill-advised trading. See *J.E. Hoetger & Co. v. Ascencio*, 572 F. Supp. 814, 821 (E.D. Mich. 1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Goldman*, 593 F.2d 129, 130 (8th Cir.), *cert. denied*, 444 U.S. 838 (1979).

160. Risk disclosure statements are routinely provided to commodities customers, and the signing of such statements is usually insisted on as a condition of trading. Such warning of the riskiness of commodities trading is the typical extent of the broker's duty for a nondiscretionary account. See, e.g., *Kats v. Merrill Lynch Commodities, Inc.*, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,998, at 28,387 (CFTC Feb. 3, 1984).

161. *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 337 F. Supp. 107, 111-12 (N.D. Ala. 1971) (usually "[t]he affair entrusted to a broker who is to buy or sell through an exchange is to execute the order, not to discuss its wisdom").

162. The rejection by the CFTC of its former position that a suitability rule could be inferred from the anti-fraud provisions of the CEA seems to reflect more a concern with the practicability of requiring brokers to determine suitability than a toleration of the idea that the market would be well-served by a culture of stark opportunism among brokers. See *Avis v. Shearson Hayden Stone, Inc.*, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,379, at 25,829-30 (CFTC Apr. 13, 1982).

the duty of declining to execute trades for customers who are clearly unsuitable because the expectation that they do is unreasonable. Indeed, there is a consensus that brokers, who provide public access to a risky, volatile market, the honesty of which is often suspect, should avoid trading for customers who are plainly unsuited to the market. Rather, the duty not to trade for unsuitable customers has not been imposed because of the difficulty in developing acceptable regulatory guidelines for identifying cases where the duty should be imposed among a universe of cases where the duty might be imposed.<sup>163</sup> The question of the appropriateness of judicial entry into the field is therefore a question of whether courts should, under the common law, proffer and enforce standards of presumed investor unfitness and of the evidence needed to establish the broker's knowledge of that unfitness when specialized bodies have been unwilling or unable to do so as a matter of regulation.

The argument for acceptance of such judicial intervention is strong in *Wasnick*. The duty imposed by the *Wasnick* court, to refuse to trade for a manifestly unfit customer, is a duty that arises from the uncontested norm that brokers should curb their opportunism when their actions would unjustifiably injure their client's interests. In spite of regulatory reluctance to adopt a comprehensive statement defining the reasonable steps that a broker should take to screen unfit customers, there is room in *Wasnick* for the creation of a specific, tailored duty to refuse to trade for a customer who is known to be vulnerable. This is so precisely because the narrow factual basis of the litigation does not require the adoption of a regulatory statement which would be adequate to describe the totality of a broker's duty to screen his customers. The reluctance of regulators to adopt universal rules ought not to deter courts from the development of duties to address particular fact patterns.

The *Wasnick* court focuses on the particulars of a given broker-customer relationship and imposes a duty to intervene only after finding that *Wasnick's* brokers could not have been unaware that their customer's trading pattern would lead to his financial ruin. The concern with the particulars of a given broker-client relation as the source of duties, and the finding that *Wasnick's* brokers possessed actual knowledge on which they might have acted creates a foundation for the recognition of a duty to intervene that is valid whether or not there is a universal regulatory approach. It may be that there will be

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163. The present form of the SEC's proposed "Penny Stock Fraud Rule," Rule 15c2-6, which would require a suitability determination before trading customers in risky "penny stocks," Exchange Act Release No. 34-26529, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,352 (Feb. 9, 1989), may come to be rejected for the same reason. Although there seems to exist a willingness to prevent broker's trading unsuitable investors in high risk securities, the burdens of information gathering, record keeping, and disagreements about what "suitability" means, have generated opposition to the penny stock suitability rule. See ABA Members Comment on SEC Proposed Penny Stock Fraud Rule, Fed. Sec. L. Rep. (CCH), at 8 (May 10, 1988).

errors in fact-findings from case to case. Only if brokers and dealers are to be made immune to a risk universal to litigation is there room to insist that courts should be denied the right to develop *ad hoc* duties responsive to existing and accepted norms.

It could be argued that the very fact of imposing exacting norms of conduct on brokers and dealers tends to so distort fact-findings that it is unfair to expose brokers and dealers to the risks of an indefinite standard of care without bright line expectations. There will inevitably be disputes about whether the facts of a particular relationship between a broker and client should give rise to particular duties, but the courts have generally shown themselves capable of weeding out the more dubious cases, and of developing sound and workable duties from broadly stated principles.<sup>164</sup> *Wasnick* too, though it errs in identifying existing industry practices as a clear foundation for a duty to protect unsuited customer's from trading, is sound in its focus on the particular features of a broker-customer relationship as the proper source of a broker's duties. The pivotal role of brokers and dealers in affording public access to investment markets, and the public importance of cultivating public confidence in the markets, is reason enough to encourage the development of judge-made duties and of the maintenance of standards of care that are open to some interpretation.

### III. CONCLUSION

*Hutton* and *Wasnick* have been criticized most severely for imposing duties on brokers and dealers that are neither grounded in a sound view of the operation of financial markets and the broker-dealer's function in those markets, nor precisely contained enough to avoid impositions of unreasonable duties in later cases.<sup>165</sup> The criticism is significant. However much the choice of a fiduciary label may imply a choice to burden one party with obligations to subordinate his interests in ways he might not have chosen, the particular duties flowing from that choice must make sense in the setting where they are asserted. Current conceptions of the fiduciary relation have been particularly insistent that fiduciary language be less amenable to the creation of extravagant duties, and that statements of duties be more particularized and

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164. See, e.g., *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,702, at 93,427-430 (Apr. 2, 1986). In *Xaphes* the plaintiff attempted to argue his unsuitability for trading and his broker's wrongful failure to bar his trading in options. The plaintiff did not present the same evidence of mania nor engage in the erratic course of frenzied trading that seems to have determined the result in *Wasnick*. The court in *Xaphes* had no difficulty rejecting the plaintiff's argument that his broker should have intervened.

The point is also borne out in *Wasnick* where the court, after finding that the broker had breached a duty of care in continuing to exercise trades for *Wasnick*, apportioned causation for the loss equally between *Wasnick* and the brokers. *Wasnick v. Refco*, [1987-1988 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,315, at 35,383 (W.D. Wash. Aug. 24, 1988).

165. See sources cited *supra* note 8 (criticisms of *Hutton* and *Wasnick*).

sound in context. The need for such responsiveness is especially great in a field such as securities and commodities regulation. Technical conditions of the market may play a role in defining which duties can reasonably be imposed. Furthermore, the legitimacy of those who propose duties will demand that the duties imposed on brokers and dealers represent a fair accommodation of the interests of these market professionals and their customers and that the process of duty creation itself be sound.

The cases examined demonstrate that formulating untested broker and dealer duties through adjudication requires a combination of circumspection and boldness. Deliberative bodies must frame duties that respond to legitimate market constraints on a broker's or dealer's functioning. Yet they must not flinch from the task of developing specific duties on an *ad hoc* basis when an informed and reasonable public vision of a market professional's responsibilities to its customers demands it. The legitimacy of proposed duties depends on the conformity of those duties with a sound vision of how markets operate and of the proper accommodation of the rights of customers and market professionals.

