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# Is the Shingle Theory Dead?

Roberta S. Karmel

*Brooklyn Law School*, [roberta.karmel@brooklaw.edu](mailto:roberta.karmel@brooklaw.edu)

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Roberta S. Karmel\*

## *Table of Contents*

I. Introduction	1271
II. The Shingle Theory	1273
A. Generally	1273
B. Variations	1275
III. Key Cases Interpreting the Antifraud Provisions	1280
A. Rule 10b-5 Before 1975	1280
B. The Antifraud Provisions Since 1975	1281
C. Implied Claims Under Provisions Other Than Rule 10b-5	1285
IV. Possible Shingle Theory Liability Under Sections 12(2) and 17(a) of the Securities Act and Section 15(c) of the Exchange Act	1290
V. Collateral Developments	1293
A. Securities Industry Arbitration	1293
B. Securities Reform Legislation	1295
VI. Analysis and Conclusion	1295

## *I. Introduction*

Broker-dealer liability to customers frequently is analyzed under the "shingle theory," whereby it is presumed that a broker-dealer that hangs out a shingle and solicits customers makes an implied representation of fair dealing.<sup>1</sup> Although breach of this representation has resulted in liability under the antifraud provisions of the federal securities laws, the shingle

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\* Roberta S. Karmel, B.A., Radcliffe, 1959, LL.B., New York University, 1962, is a Professor of Law and Co-Director of the Center for the Study of International Business Law, Brooklyn Law School. She is also Of Counsel to Kelley Drye & Warren and was a Commissioner of the Securities and Exchange Commission from 1977-80. A research stipend from Brooklyn Law School was helpful in the preparation of this article. The research assistance of Brooklyn Law School student Peter Sack is gratefully acknowledged.

1. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 879 (3d ed. 1995).

theory also can be justified by the obligation to adhere to just and equitable principles of trade under the rules of the securities industry's self-regulatory organizations. Part II of this article will discuss the development of the shingle theory and its variations.<sup>2</sup>

After years of expanding the parameters of the antifraud provisions, the United States Supreme Court in 1975 began cutting back on liability under the antifraud provisions. This retrenchment has accelerated in recent terms, under both the implied and express liability provisions. Nevertheless, in cases involving regulated entities such as securities firms, the Court has not shown the same enthusiasm for eliminating liability for broker-dealers as for other types of defendants. Part III of this article will analyze the Supreme Court cases interpreting the antifraud provisions, emphasizing the requirements for scienter and a duty to speak under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and explaining the limits the Court has put on the use of other statutory sections for implying private rights of action.<sup>3</sup> Part IV of this article then will speculate concerning the continuing viability of the shingle theory under Sections 17(a) and 12(2) of the Securities Act of 1933 (Securities Act) and Section 15(c) of the Exchange Act, as well as under the controlling person provisions of both statutes.<sup>4</sup>

Recent Supreme Court case law has cast considerable doubt on customers' ability to use the antifraud provisions to impose liability on broker-dealers. Ironically, however, most suits instituted by customers against broker-dealers now are prosecuted in securities industry self-regulatory arbitrations in which breach of just and equitable principles of trade can be the basis for recovery. Accordingly, the question has rarely arisen as to whether or to what extent Supreme Court cases have undermined the theoretical underpinnings for the shingle theory. Furthermore, while this article is being written, securities reform legislation is pending and may create an express right of action under Section 10(b) of the Exchange Act that may change the law in this area. Part V of this article will trace the developments pushing most customer-broker litigation into arbitration and will discuss the implications of proposed securities legislation.<sup>5</sup>

The author's conclusion, explicated in Part VI of this article and based upon the logical conclusion of Supreme Court antifraud doctrine, is that the shingle theory is no longer a sound basis for civil liability to private parties

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2. See *infra* pp. 1273-80.

3. See *infra* pp. 1280-89.

4. See *infra* pp. 1290-93.

5. See *infra* pp. 1293-95.

under the antifraud provisions. Nevertheless, the Court may retreat from this conclusion because of its general policy view that the purpose of the federal securities laws is to police the securities industry <sup>6</sup>

## II. The Shingle Theory

### A. Generally

A broker-dealer does not have the same relationship to all of its customers. If a firm exercises actual or *de facto* control over a customer's account because of a customer's trust and confidence, the broker may owe a fiduciary obligation to the customer.<sup>7</sup> In many situations, a broker-dealer deals with its customers at arm's length, and a fiduciary relationship may not exist. Some older cases stated, however, that broker-dealers impliedly represent that they will deal fairly with their customers, and, therefore, unfair dealing is a breach of this implied representation and a violation of the antifraud provisions.<sup>8</sup> This implied representation arises from the mere act of hanging up a shingle and going into business as a broker-dealer, and, therefore, it is known as the "shingle theory" <sup>9</sup>

This theory was developed in administrative proceedings brought by the Securities and Exchange Commission (SEC) against broker-dealers and then was affirmed by the courts. Accordingly, there was no question of liability in damages to customers who were defrauded. Charges brought by the SEC included violations of Sections 17(a) of the Securities Act,<sup>10</sup> 10(b) of the Ex-

6. See *infra* pp. 1295-97

7 See *Hughes v. SEC*, 174 F.2d 969, 974-76 (D.C. Cir. 1949) (noting broker's duty of disclosure); *In re Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 896 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

8. See, e.g., *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring) (noting implied warranty in shingle theory cases); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *In re United Sec. Corp.*, 15 S.E.C. 719, 727 (1944).

9. *LOSS & SELIGMAN*, *supra* note 1, at 879.

10. See 15 U.S.C. § 77q(a) (1988), which provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates

change Act<sup>11</sup> and Rule 10b-5 thereunder, and 15(c)(1) of the Exchange Act<sup>12</sup> and Rule 15c1-2 thereunder. The courts felt that the SEC's theories went beyond the common law, but considered the business of selling securities peculiarly in need of regulation for the protection of investors and further believed that Congress had given the SEC the authority to so regulate broker-dealers.<sup>13</sup>

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or would operate as a fraud or deceit upon the purchaser.

11. See 15 U.S.C. § 78j(b) (1988), which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

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

12. See 15 U.S.C. § 78o(c)(1)-(2) (1988), which provides:

(1)(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, [and] (B) no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. (D) The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

(2)(A) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation, [and] (B) no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. (D) The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

13. See *Hughes v SEC*, 174 F.2d 969, 975 (D.C. Cir. 1949).

The notion that the SEC created the shingle theory pursuant to its statutory authority to regulate broker-dealers and, in doing so, went beyond common-law principles may not be valid, however. The federal securities laws as they apply to broker-dealers are based upon a complicated scheme of audited self-regulation by the New York Stock Exchange, Inc. (NYSE), other national stock exchanges, the National Association of Securities Dealers (NASD), and other self-regulatory organizations (SROs).<sup>14</sup> These SROs impose a variety of obligations upon broker-dealers under the rubric of just and equitable principles of trade<sup>15</sup> or rules of fair practice.<sup>16</sup> Such standards of fair dealing are industry principles of custom and usage that form the basis of common-law duties.<sup>17</sup> The shingle theory is based upon these industry standards of fair dealing to a greater extent than upon any SEC regulation, although over the years the SEC has encapsulated certain fair dealing obligations into its rules.

### B. Variations

The shingle theory is not based upon the law of agency because a broker-dealer may act as either agent or principal. Indeed, a securities firm is required to disclose to customers the capacity in which it is acting.<sup>18</sup> But in dealing with customers, the broker-dealer necessarily has superior knowledge about certain matters. The essence of the shingle theory is a prohibition against overreaching or taking unfair advantage of this superior knowledge. Very importantly, the broker-dealer has knowledge of current

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14. Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 203-07 (1995); Roberta S. Karmel, *Securities Industry Self-Regulation — Tested By the Crash*, 45 WASH. & LEE L. REV. 1297, 1297-99 (1988).

15. Under NYSE Rule 476(a), 2 N.Y.S.E. Guide (CCH) ¶ 2476 (1995), the NYSE can discipline a member, member organization, allied member or member organization, or person otherwise subject to the jurisdiction of the Exchange who is adjudged guilty, among other things, of violations of the Exchange Act, the constitution or rules of the NYSE, any agreements with the NYSE, "fraud or fraudulent acts," or "conduct or proceeding inconsistent with just and equitable principles of trade."

16. Article III, § 1, NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2151 (1995), provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." The NASD's Rules of Fair Practice further set forth various components of the shingle theory including suitable recommendations to customers and a 5% markup policy. Article III, §§ 2, 4, NASD Rule of Fair Practice, NASD Manual (CCH) ¶ 2152, 2154 (1995).

17. Cf. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 10.6 (2d ed. 1990).

18. See 17 C.F.R. § 240.10b-10 (1995).

market prices of securities traded. Accordingly, an important aspect of the shingle theory is that a broker-dealer makes an implied representation that prices charged to customers will bear a reasonable relationship to current market prices.<sup>19</sup> This also may be expressed as a duty to charge fair prices.<sup>20</sup>

This duty to deal fairly has numerous variations that can be expressed as implied representations or duties. Because a broker-dealer impliedly represents that he will execute only authorized transactions, effecting unauthorized transactions is a breach of duty.<sup>21</sup> Because a broker-dealer impliedly represents that transactions will be consummated promptly, it is a breach of duty to use customer funds for other purposes.<sup>22</sup> Because a broker-dealer impliedly represents that he has a reasonable basis for investment recommendations, it is a breach of duty to fail to investigate the securities that he recommends for sale.<sup>23</sup>

These and similar obligations have been formulated into rules by the SEC pursuant to either Section 10(b) of the Exchange Act or Section 15(c) of the Exchange Act — the general antifraud provision specifically applicable to broker-dealers.<sup>24</sup> Two additional theories of broker-dealer liability to customers deserve special mention because they are the basis of many civil damage cases as well as SEC and SRO disciplinary proceedings. These theories are suitability and churning. Often, both theories are raised in the same case, and it is often unclear whether liability is predicated upon the shingle theory or breach of fiduciary duty.

SRO rules include obligations to "know your customer" and make investment recommendations that are suitable to each customer's financial circumstances and needs.<sup>25</sup> This precept may have originated in SRO efforts to protect member firms rather than customers, but it is now a clear ethical standard for the protection of investors.<sup>26</sup> Whether this standard has been

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19. *In re Duker & Duker*, 6 S.E.C. 386, 389 (1939); see Article III, § 4, NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2154 (1995).

20. *SEC v First Jersey Sec., Inc.*, 890 F Supp. 1185, 1196 (S.D.N.Y. 1995).

21. *Eichler v SEC*, 757 F.2d 1066, 1070-71 (9th Cir. 1985).

22. Similarly, doing business while insolvent is a violation of the shingle theory. *SEC v C.H. Abraham & Co.*, 186 F Supp. 19, 21 (S.D.N.Y. 1960).

23. *Hanly v. SEC*, 415 F.2d 589, 595-96 (2d Cir. 1969); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,365, at 88,728 (1977).

24. See 17 C.F.R. §§ 240.10b-10, 15c1-1 to 15c1-9, 15c2-1 to 15c2-12 (1995).

25. NYSE Rule 405, 2 NYSE Guide ¶ 2405 (1994); Article III, § 2(a), NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2152 (1995).

26. LOSS & SELIGMAN, *supra* note 1, at 898-901.

raised to the level of a principle of law depends upon whether the obligation to make suitable recommendations is a duty that has been incorporated by the antifraud provisions<sup>27</sup> or whether a customer can claim that unsuitable recommendations were tantamount to fraud and that all elements of a fraud action can be factually demonstrated.<sup>28</sup>

The suitability doctrine can arise in several contexts.<sup>29</sup> The most common is when a salesperson makes a recommendation to a customer that he knows or should know would be unsuitable for that customer's financial circumstances and needs. Another context is when a broker-dealer does not make an affirmative recommendation, but nevertheless sells the customer an unsuitable security. In both of these circumstances, the broker-dealer may not have made any misrepresentations to the customer, so there is a question of whether the securities salesperson or firm had a duty to investigate the customer's financial situation and then speak out.

In *Brown v. E.F. Hutton Group, Inc.*,<sup>30</sup> the Second Circuit held that an unsuitability claim is a subset of the ordinary Section 10(b) fraud claim in which a plaintiff must allege material misstatements or omissions, indicating an intent to deceive or defraud in connection with the purchase or sale of a security.<sup>31</sup> Further, the plaintiff must prove that (1) the securities purchased were unsuited to the buyer's needs, (2) the defendant knew or reasonably believed that the securities were so unsuited, (3) the defendant recommended or purchased the securities anyway, (4) the defendant made material misrepresentations (or owed a duty to disclose material information) relating to the suitability of the securities, and (5) the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.<sup>32</sup>

In *O'Connor v. R.F. Lafferty & Co.*,<sup>33</sup> the Tenth Circuit similarly found a need for the plaintiff to prove scienter, or at least recklessness, but ana-

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27. See *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 680-81 (9th Cir. 1980) (finding no congressional intent to provide private action for violation of stock exchange rules); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600-01 (2d Cir. 1978) (dealing with jury instruction concerning effect of NASD rule violation on finding of Rule 10b-5 violation); *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 141-43 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969).

28. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993); *O'Connor v. R.F. Lafferty Co.*, 965 F.2d 893, 897 (10th Cir. 1992).

29. See Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 448-54 (1965).

30. 991 F.2d 1020 (2d Cir. 1993).

31. See *Brown*, 991 F.2d at 1031.

32. *Id.*

33. 965 F.2d 893 (10th Cir. 1992).



lyzed the elements of a claim for unsuitability differently. The court viewed unsuitability as fraud by conduct and therefore similar to churning. It therefore adopted three elements to establish unsuitability based on fraud by conduct in a Rule 10b-5 case, namely: The plaintiff must prove that (1) the broker recommended (or, in the case of a discretionary account, purchased) securities that are unsuitable in light of the investor's objectives, (2) the broker recommended or purchased the securities with an intent to defraud or with reckless disregard for the investor's interests, and (3) the broker exercised control over the investor's account.<sup>34</sup>

Churning is excessive trading in a customer's account, in disregard of the customer's investment objectives, for the purpose of generating commissions.<sup>35</sup> Unlike suitability, churning long has been considered a violation of the antifraud provisions.<sup>36</sup> Control over the customer's account, either in the form of a trading power or by reason of the broker-customer relationship, is necessary.<sup>37</sup> Therefore, churning involves a fiduciary relationship and perhaps does not require any application of the shingle theory to make the antifraud provisions applicable. Nevertheless, the line demarcating churning from suitability often is blurred.

The lack of theoretical clarity between the shingle theory and a fiduciary duty theory is demonstrated by *In re E.F. Hutton & Co.*,<sup>38</sup> in which a customer placed an open limit order in Genex stock at 17⅞.<sup>39</sup> While the broker-dealer was holding the customer's order, the broker-dealer sold 4,755 shares of Genex from its own inventory at 17¼ and 17½. Subsequently, the price declined, and the customer's order was never executed. The SEC held that the broker-dealer violated its fiduciary duty to the customer by failing to give his limit order priority over its own proprietary position. The Commission's theory was that when the broker-dealer accepted the limit order it became the customer's agent, and absent an explicit agreement to the contrary, an agent is a fiduciary. But this theory would transform almost every transaction between broker-dealers and customers into one governed by fiduciary duty — a result that goes beyond the shingle theory. The

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34. *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992).

35. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820 (9th Cir. 1980).

36. Norman S. Poser, *Civil Liability for Unsuitable Recommendations*, 19 Rev. Sec. & Comm. Reg. (Standard & Poor's) 67, 67-68 (Apr. 2, 1986).

37. *Taylor v. Bear Stearns & Co.*, 572 F. Supp. 667, 671 (N.D. Ga. 1983).

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

39. *In re 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).

dissenting commissioners in this case took issue with this fiduciary duty analysis. They urged a remand for an inquiry into the facts surrounding this transaction and whether the dealings between the broker-dealer and customer were in accord with industry practice — an inquiry that would be more consonant with the shingle theory

Some of the disagreement over the *Hutton* case focused on the sophistication of Hutton's customer. The shingle theory would appear to apply primarily to unsophisticated customers who fall victim to salespersons who take unfair advantage of them. Yet, the securities markets are increasingly institutionalized. This raises a question as to whether the shingle theory is appropriate in analyzing the relationship between broker-dealers and customers in all situations.

Financial regulators and plaintiffs' lawyers apparently believe that the shingle theory is alive and well, even as to institutional clients. In the derivatives marketplace, huge losses by supposedly sophisticated corporate clients, institutions, and municipalities have generated a blizzard of litigation against banks and broker-dealers, charging lack of suitability and failure to disclose the risks of derivatives trading, including pricing and valuation methods.<sup>40</sup> While none of these suits has been tested at the circuit court or Supreme Court level, financial regulators required Bankers Trust Co. to agree to conduct its business in leveraged derivatives transactions (LDTs) in a manner that seeks to reasonably ensure that each LDT customer has the capability to understand the nature, material terms, conditions, and risks of any LDT entered into by the customer.<sup>41</sup> Additionally, Bankers Trust Co. agreed to make sufficient disclosures to customers about LDTs so they could understand such terms, conditions, and risks, as well as LDT pricing and valuation.<sup>42</sup>

This order against Bankers Trust Co. essentially presumes that the bank had a duty to sell derivatives at fair prices and to at least inquire whether the derivatives were suitable, although the undertakings by the bank are framed in terms of disclosure to customers. Although there was some question as to whether the derivatives involved were securities — the Commodity

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40. See generally Dominic Bencivenga, *Derivatives Litigation*, N.Y. L.J., Mar. 16, 1995, at 5; Lauren A. Teigland, *Derivatives Disputes and Disappointments: The 'Sad' Phenomenon of Derivatives Litigation*, 64 Banking Rep. (BNA) 703 (Apr. 3, 1995); *Unsuitable: It Is Wrong to Protect Companies and Professional Investors from the Consequences of Their Own Actions*, *ECONOMIST*, Dec. 3, 1994, at 18.

41. *Written Agreement Between Bankers Trust and Federal Reserve Bank of New York*, 63 Banking Rep. (BNA) 895 (Dec. 12, 1994).

42. *Id.*

Futures Trading Commission (CFTC) does not have a suitability rule — the SEC and CFTC brought similar cases that also were settled.<sup>43</sup> Regulators denied that Bankers Trust Co. was being subjected to a new or enhanced suitability standard, but the derivatives industry has adopted such a new standard in response to this litigation.<sup>44</sup> Ironically, the United States Supreme Court has been moving in a contrary direction, possibly undermining the legal underpinnings of the shingle theory

### III. Key Cases Interpreting the Antifraud Provisions

#### A. Rule 10b-5 Before 1975

The Securities Act and the Exchange Act contain an elaborate scheme of remedies for injured investors.<sup>45</sup> Nevertheless, an implied right of action for damages under Rule 10b-5 was first recognized in 1946<sup>46</sup> and later was confirmed by the United States Supreme Court in 1971 with virtually no discussion.<sup>47</sup> Impatience with specified remedies under the securities laws in the 1960s and early 1970s led to provisions that led to an expansive recognition of implied rights of action by the courts. Indeed, by 1977 Professor Loss observed that

[c]ivil liability has become a jungle as the lush growth of the "implied" actions — not only under rule 10b-5 but also under the proxy rules, the tender offer provisions of 1968, the Federal Reserve credit rules and

43. Order Exempting Certain Brokers and Dealers from Broker-Dealer Registration, Exchange Act Release No. 35,135, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,476, at 86,107 (Dec. 22, 1994); *In re BT Sec. Corp.*, Securities Act Release No. 7,124, Exchange Act Release No. 35,136, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477, at 86,109 (Dec. 22, 1994); Steven Lipin & Jeffrey Taylor, *Bankers Trust Settles Charges on Derivatives*, WALL ST. J., Dec. 23, 1994, at C1, C22.

44. The SEC Order stated: "This matter does not involve any finding or conclusion relating to the suitability of the derivative products described herein for Gibson." *In re BT Sec. Corp.*, Securities Act Release No. 7,124, Exchange Act Release No. 35,136, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,477, at 86,109, 86,110 n.2 (Dec. 22, 1994). *But see* Anne Schwimmer, *Legal Eagles Put Pen to Paper to Head Off Derivatives Suits*, INVESTMENT DEALERS' DIG., Dec. 12, 1994, at 7 (noting addenda to swap agreements that highlight suitability issues); *Industry Reps Tell Senate Banking No Derivatives Legislation Necessary*, 64 Banking Rep. (BNA) 101 (Jan. 16, 1995).

45. *See* Securities Act, §§ 11, 12(1), 12(2), 15 U.S.C. § 77k, l(1), l(2) (1988); Exchange Act, §§ 9(e), 16(b), 18, and 29(b), 15 U.S.C. § 78i(e), p(b), r, cc(b) (1988).

46. *See* Kardon v National Gypsum Co., 69 F Supp. 512, 513-14 (E.D. Pa. 1946).

47. *See* Superintendent of Ins. v Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

section 36 of the Investment Company Act — has dwarfed, upstaged, outshone, and made wide end runs around, the express civil liability provisions.<sup>48</sup>

In this environment, it generally was assumed that the antifraud provisions could be interpreted broadly to cover broker-dealer breaches of duty to a customer under the shingle theory. Cases prosecuted by the SEC based on the shingle theory were affirmed.<sup>49</sup> In addition, civil cases for damages brought by customers against broker-dealers were successful in imposing liability under the shingle theory.<sup>50</sup>

A reversal of this trend began in 1975 with *Blue Chip Stamps v Manor Drug Stores*.<sup>51</sup> This case affirmed the implication of private rights under Rule 10b-5, although Justice Rehnquist commented that this was a judicial oak that has grown from little more than a legislative acorn.<sup>52</sup> In *Blue Chip Stamps*, the Court concluded that a Rule 10b-5 plaintiff must be a purchaser or seller of securities.<sup>53</sup> More important than the holding was the fact that this was the first Supreme Court decision to interpret Rule 10b-5 restrictively, rather than liberally. In addition to interpreting the securities laws narrowly, the Court based its reading of the Exchange Act on public policy grounds. The Court viewed implied claims with disfavor and expressed the opinion that litigation in fraud cases had a unique propensity to be vexatious.<sup>54</sup>

### B. The Antifraud Provisions Since 1975

After 1975, the Supreme Court generally read Section 10(b) of the Exchange Act in a way that curtailed litigation pursuant to Rule 10b-5. In particular, the Court did so in cases involving negligence or fiduciary duties and in cases where the defendant was not a primary tortfeasor, but rather a more peripheral actor. Nevertheless, in cases involving broker-dealers, the Court generally declined to narrow the scope of the antifraud provisions.

48. Louis Loss, *Introduction: The Federal Securities Code — Its Purpose, Plan, and Progress*, 30 VAND. L. REV. 315, 315 (1977).

49. See *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring) (noting SEC's reliance on shingle theory in case and companion case); see also *Berko v. SEC*, 297 F.2d 116 (2d Cir. 1961); *Kahn v. SEC*, 297 F.2d 112 (2d Cir. 1961).

50. *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042 (11th Cir. 1987).

51. 421 U.S. 723 (1975).

52. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

53. *Id.* at 749-55.

54. *Id.* at 739.

In *Ernst & Ernst v Hochfelder*,<sup>55</sup> the Court concluded that knowing or intentional conduct was a required element of a Rule 10b-5 case. In so deciding, the Court invalidated the third clause of Rule 10b-5 insofar as it purports to cover fraudulent conduct not committed with scienter, or specific intent to deceive.<sup>56</sup> This case is important to the question of whether the shingle theory remains viable because it suggests that in customer-broker litigation the customer must prove scienter.

Whether there can be specific intent to deceive a customer when there is a breach of an implied representation is an interesting question. It can be argued that the failure to disclose an intended breach of a fiduciary duty is a Rule 10b-5 fraud.<sup>57</sup> However, if a representation of fair dealing is implied by the law rather than made expressly, how can a tortfeasor have the requisite intent not to honor that representation? If the scienter requirement of Rule 10b-5 is met by an extreme departure from ordinary standards of care,<sup>58</sup> and SRO suitability or other fair dealing precepts are regarded as an ordinary standard of care, then scienter could be found in an omission to disclose unfair dealing.

Shingle theory cases seem to be close to cases involving an alleged breach of fiduciary duty, but in *Santa Fe Industries, Inc. v Green*,<sup>59</sup> the Court declined to read Section 10(b) of the Exchange Act as covering breaches of fiduciary duty by corporate directors. The Court expressed the view that such actions were covered by state corporation law and that the federal securities laws were aimed at preventing deception and manipulation in the stock markets.<sup>60</sup> This refusal to use Rule 10b-5 to supplant state directorial fiduciary duty law was reaffirmed in *Schreiber v Burlington Northern, Inc.*,<sup>61</sup> in which the Court refused to apply the tender offer rules to hold as "manipulative" an allegedly abusive defense mechanism utilized by a target in a tender offer.<sup>62</sup> Whether the Court would extend this line of cases to broker-dealer breaches of fiduciary duty is an open question.

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55. 425 U.S. 185 (1976).

56. *Ernst & Ernst v Hochfelder*, 425 U.S. 185, 193 (1976).

57. See *Goldberg v. Meridor*, 567 F.2d 209, 221 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

58. See *Sundstrand Corp. v Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.) (outlining standard of recklessness as sufficient to meet Rule 10b-5 requirements), *cert. denied*, 434 U.S. 875 (1977).

59. 430 U.S. 462 (1977).

60. *Sante Fe Indus., Inc. v Green*, 430 U.S. 462, 477-78 (1977).

61. 472 U.S. 1 (1985).

62. *Schreiber v Burlington N., Inc.*, 472 U.S. 1, 12-13 (1985).

In *Chiarella v. United States*,<sup>63</sup> the court overturned a criminal conviction under Rule 10b-5 against a printer who traded on inside information on the ground that silence cannot be actionable unless there is a duty to speak and that the printer owed no general duty to the marketplace.<sup>64</sup> A broker-dealer's duty to speak under the shingle theory and to advise a customer that the firm is overreaching could be distinguished from the general duty to disclose to the marketplace that was rejected in *Chiarella*.<sup>65</sup>

In *Dirks v. SEC*,<sup>66</sup> another insider trading case, the Court declined to impose a general duty to the marketplace upon a securities industry professional who obtained information about a massive issuer fraud from a non-client.<sup>67</sup> The Circuit Court had suggested that a securities industry professional might have disclosure duties by reason of professional status,<sup>68</sup> but the Supreme Court held that fiduciary duty depended upon the existence of a special confidential or fiduciary relationship.<sup>69</sup> In the case of a broker-dealer and a customer, such a special relationship exists where the customer reposes trust and confidence in the firm or a particular salesperson. In arm's length dealer transactions with sophisticated customers, however, the existence of such a special relationship may be less clear.

It is interesting that in one post-1975 case in which the Court declined to narrow antifraud liability, *Bateman Eichler, Hill Richards, Inc. v. Berner*,<sup>70</sup> fraudulent activity by a broker-dealer was at issue.<sup>71</sup> Investors sued a securities broker who had misrepresented the discovery of gold in Surinam by an oil and gas company, claiming that this was inside information.<sup>72</sup> The Supreme Court rejected a defense of *in pari delicto* on the grounds that a private action may be barred only when the plaintiff bears at least equal responsibility for the violations and when preclusion of the suit would not interfere significantly with effective enforcement of the securities laws.<sup>73</sup> The Court reasoned that insiders and broker-dealers who selectively disclose

63. 445 U.S. 222 (1980).

64. *Chiarella v. United States*, 445 U.S. 222, 225-37 (1980).

65. *Id.* at 227-28.

66. 463 U.S. 646 (1983).

67. *See Dirks v. SEC*, 463 U.S. 646, 665-67 (1983).

68. *See Dirks v. SEC*, 681 F.2d 824, 841 n.21 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

69. *See Dirks*, 463 U.S. at 655 n.14.

70. 472 U.S. 299 (1985).

71. *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 301 (1985).

72. *See id.* at 301-02.

73. *See id.* at 310-11.

material, nonpublic information commit a broader range of violations than do tippees. Consequently, the public interest will be advanced if the tippees can bring suit.<sup>74</sup> This case does not necessarily indicate that the Court would impose a fiduciary duty on a broker-dealer's salespersons to customers solely by virtue of their status as securities professionals. However, in cases involving such primary targets of securities regulation, the Court has been less quick to curtail civil liability. The Court continued to interpret the securities laws broadly in *Herman & MacLean v Huddleston*,<sup>75</sup> where it held that facts giving rise to express civil liability against a public company under the federal securities laws also could form the basis for a Rule 10b-5 action<sup>76</sup> and in *Basic Inc. v Levinson*,<sup>77</sup> where the Court affirmed a broad materiality standard as against a public company.<sup>78</sup> Where defendants have been secondary tortfeasors, however, the Court has been very reluctant to extend liability. In *Central Bank v First Interstate Bank*,<sup>79</sup> the Court, in a 5-4 split, held that no private right of action should be implied under Rule 10b-5 against persons who aid and abet a securities fraud.<sup>80</sup>

It is difficult to extrapolate from these cases a lesson concerning the continued viability of the shingle theory. Since 1975, the Court has interpreted Rule 10b-5 narrowly, but it nevertheless views this rule as an important public policy tool for policing the public securities markets and securities industry professionals. Although the Court has declined to impose a general duty to the marketplace on anyone, when participants in a securities transaction have a relationship that could give rise to fiduciary duties, the Court has been willing to use Rule 10b-5 to impose a duty to speak. In the relationship between a broker-dealer and a customer, a duty to speak would validate the shingle theory in many cases. However, if the Court should hold that the relationship between salesperson and customer is a type of fiduciary relationship best left to state law, it could invalidate the application of Rule 10b-5 to cases involving overreaching only.

The requirement that scienter be proven in any Rule 10b-5 case is a possible barrier to use of Rule 10b-5 to cover breach of an implied representation of fair dealing. Yet, it could be argued that the necessary education and

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74. See *id.* at 314 (noting, essentially, that tippee's culpability is substantially equal to his tippers' culpability).

75. 459 U.S. 375 (1983).

76. See *Herman & MacLean v Huddleston*, 459 U.S. 375, 382-83 (1983).

77. See 485 U.S. 224 (1988).

78. See *Basic Inc. v Levinson*, 485 U.S. 224, 230-32 (1988).

79. See 114 S. Ct. 1439 (1994).

80. See *Central Bank v First Interstate Bank*, 114 S. Ct. 1439, 1447-48 (1994).

training that salespersons and other securities industry personnel must have in order to be employed as securities industry professionals gives them knowledge of the duty of fair dealing.<sup>81</sup> Therefore, the type of overreaching that has led to liability under the shingle theory in past cases is at least reckless behavior that has been held to satisfy the scienter requirement in most circuits.<sup>82</sup>

### C. Implied Claims Under Provisions Other Than Rule 10b-5

One of the Court's stated reasons for curtailing civil liability under Rule 10b-5 is that claims under Section 10(b) of the Exchange Act have been implied by the courts, and, therefore, judicial self restraint should be exercised in developing the parameters of such an action. The first securities law section under which the United States Supreme Court recognized an implied claim was not Section 10(b) of the Exchange Act, but rather was Section 14(a) of the Exchange Act<sup>83</sup> — which prohibits fraud in proxy solicitations. In *J.I. Case Co. v Borak*,<sup>84</sup> the Court recognized an implied cause of action for rescission or damages stemming from the use of a false and misleading proxy statement.<sup>85</sup> The Court reasoned that, because Section 14(a) was intended principally to protect investors, the availability of judicial relief must be implied to achieve that result.<sup>86</sup> Also, private enforcement of the proxy rules was necessary to supplement the activities of the SEC and to further the congressional purpose of protecting investors from fraudulent proxy materials.<sup>87</sup>

In a more recent case, *Virginia Bankshares, Inc. v Sandberg*,<sup>88</sup> the Court reaffirmed implied actions under the proxy rules in an action by share-

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81. See Exchange Act, § 15(b)(8), 15 U.S.C. § 78o(b)(8) (1994) (requiring that all broker-dealers registered with SEC join NASD); see also NASD By-laws, Schedule C, NASD Manual (CCH) ¶ 1785 (1994) (requiring that all persons associated with member of NASD must pass certain qualification and testing requirements).

82. See *Rolf v Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir.) (concluding that, at least where fiduciary duty is owed to defrauded party, reckless behavior satisfies scienter requirement), *cert. denied*, 439 U.S. 1039 (1978); *Bozsi Ltd. Partnership v Lynott*, 676 F Supp. 505, 511 (S.D.N.Y. 1987) (stating that proof of reckless conduct generally satisfies scienter requirement).

83. 15 U.S.C. § 78n(a) (1994).

84. 377 U.S. 426 (1964).

85. See *J.I. Case Co. v Borak*, 377 U.S. 426, 432 (1964).

86. See *id.*

87. See *id.*

88. 501 U.S. 1083 (1991).



holders for damages.<sup>89</sup> In that case, the Court held that a false statement of reasons, opinion, or belief is a statement "with respect to material facts" that is actionable and that such statements may be misleading.<sup>90</sup> Although the case involved an expression of views by a public company with regard to a proposed merger, the holding could cover stock recommendations by a securities salesperson and provide the basis for an application of the shingle theory under the antifraud provisions.

The general test for determining whether a private right of action should be applied under a federal statute was enumerated in a nonsecurities law case, *Cort v Ash*.<sup>91</sup> In this case, the Court set forth a four-part test to determine whether a private action for damages should be implied: (1) Is the plaintiff one of the class of persons for whose special benefit the statute was enacted? (2) Is there any indication of legislative intent, explicit or implicit, to create such a remedy or to deny one? (3) Is an implied remedy consistent with the underlying purposes of the legislative scheme? and (4) Is the cause of action one traditionally relegated to state law so that a federal claim would be inappropriate?<sup>92</sup>

Almost immediately, the Court began applying the *Cort* test to various provisions of the federal securities laws in order to deny liability. In *Piper v Chris-Craft Industries, Inc.*,<sup>93</sup> the Court held that a tender offeror does not have standing to bring a private action for damages under Section 14(e) of the Exchange Act<sup>94</sup> against either a competing tender offeror, the target company, or an investment banker.<sup>95</sup> The Court observed that implying a private remedy would not be necessary to effectuate Congress's purposes in enacting Section 14(e).<sup>96</sup> That provision was intended for the especial benefit of shareholders of target companies and not for those the statute was designed to regulate.<sup>97</sup> Further, the Court backed away from its rationale in *Borak*, stating that the SEC's institutional limitations alone cannot justify the creation of a new cause of action not contemplated by Congress.<sup>98</sup>

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89. See *Virginia Bankshares, Inc. v Sandberg*, 501 U.S. 1083, 1087 (1991) (referring to existence of § 14(a) private action).

90. *Id.* at 1091-95.

91. 422 U.S. 66 (1975).

92. *Cort v Ash*, 422 U.S. 66, 78 (1975).

93. 430 U.S. 1 (1977).

94. 15 U.S.C. § 78n(e) (1994).

95. See *Piper v Chris-Craft Indus., Inc.*, 430 U.S. 1, 35 (1977).

96. See *id.* at 29-35.

97. See *id.* at 41.

98. See *id.*

Then, in *Touche Ross & Co. v Redington*,<sup>99</sup> the Court found no right of action on behalf of creditors of a failed brokerage firm against an auditor for alleged misstatements in a required annual report of the broker's financial condition. The Court held, among other things, that Section 17(a) of the Exchange Act,<sup>100</sup> pursuant to which the report was required to be filed with the SEC, was not for the especial benefit of customers of the firm.<sup>101</sup> The Court emphasized the lack of expressed congressional intent to create a new cause of action.<sup>102</sup> It is noteworthy that this case involved allegations of negligence against a secondary tortfeasor.

In cases involving regulated securities industry entities, the Court has been more inclined to imply causes of action under federal statutes. In *Transamerica Mortgage Advisors, Inc. v Lewis*,<sup>103</sup> a case charging an investment advisor with fraud, the Court held that a provision of the Investment Advisors Act<sup>104</sup> — to the effect that contracts made in violation of that statute are void<sup>105</sup> — not only evidenced a congressional intent for courts to imply an equitable cause of action for rescission, but also for an injunction against continued operation of the contract and restitution.<sup>106</sup> Also, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v Curran*,<sup>107</sup> the Court upheld, in a 5-4 decision, an implied right of action against a securities firm under the Commodity Exchange Act.<sup>108</sup> The Court reasoned that, when Congress enacted this statute in 1974, implied rights of action for fraud were routinely recognized in the lower federal courts.<sup>109</sup>

Two issues are relevant to whether customers of broker-dealers can prosecute damage actions under the shingle theory: whether private claims can be implied under antifraud provisions other than Section 10(b) of the

99. 442 U.S. 560 (1979).

100. 15 U.S.C. § 78q(a) (1994).

101. See *Touche Ross & Co. v Redington*, 442 U.S. 560, 578 (1979).

102. See *id.* at 570-73.

103. 444 U.S. 11 (1979); see also *Daily Income Fund, Inc. v Fox*, 464 U.S. 523 (1984).

104. 15 U.S.C. §§ 80b-1 to 80b-21 (1994).

105. 15 U.S.C. § 8b-15(b) (1994). Section 29(b) of the Exchange Act, 15 U.S.C. § 78cc(b) (1994), contains a similar provision. See *Mills v Electric Auto-Life Co.*, 396 U.S. 375, 387 (1970) (noting that § 29(b) is counterpart to § 215(b)).

106. See *Transamerica Mortgage Advisors, Inc. v Lewis*, 444 U.S. 11, 24 (1979).

107. 456 U.S. 353 (1982).

108. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v Curran*, 456 U.S. 353, 381-82 (1982).

109. See *Curran*, 456 U.S. at 379.

Exchange Act, and whether breach of SRO rules is a basis for a Rule 10b-5 action. The Supreme Court has not decided whether claims can be implied under either Section 17(a) of the Securities Act or Section 15(c)(1) of the Exchange Act, both of which could be the basis for liability under the shingle theory. Cases decided in the lower courts are not entirely consistent, but seem to point away from the implication of such causes of action.

In *In re Washington Public Power Supply System Securities Litigation*,<sup>110</sup> the Ninth Circuit declined to imply a claim against 200 sellers of defaulted municipal bonds under Section 17(a) of the Securities Act.<sup>111</sup> The Court found no evidence of congressional intent for creating such a civil action even though the plaintiffs might be members of the class for whose especial benefit the statute was passed.<sup>112</sup> Although there are older Second and Seventh Circuit cases that concluded that a private right of action could be implied under Section 17(a),<sup>113</sup> the more recent trend is to the contrary, even in those circuits.<sup>114</sup>

Authority concerning whether a private right of action can be implied under Section 15(c)(1) of the Exchange Act is sparse. In *Roberts v Smith Barney, Harris Upham & Co.*,<sup>115</sup> a district court declined to imply such a claim on the ground, among others, that Section 10(b) was a broader section intended to subsume possible claims under section 15(c)(1).<sup>116</sup> In view of recent Supreme Court cases, this rationale may no longer be valid.

Whether an action for violation of SRO rules can be the sole basis for a Rule 10b-5 claim is problematic. In two cases from the 1960s, the Second and Seventh Circuits recognized actions for violations of the "know your

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110. 823 F.2d 1349 (9th Cir. 1987).

111. *In re Washington Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349, 1353 (9th Cir. 1987).

112. *See id.*

113. *See Kirshner v United States*, 603 F.2d 234, 241 (2d Cir. 1978) (finding § 17 sufficiently broad to imply private right of action); *Sanders v John Nuveen & Co.*, 554 F.2d 790, 796 (7th Cir. 1977) (assuming there could be an implied claim if scienter existed).

114. *See Finkel v Stratton Corp.*, 962 F.2d 169, 174-75 (2d Cir. 1992) (concluding that there is no private right of action under § 17(a)); *Sears v Likens*, 912 F.2d 889, 893 (7th Cir. 1990) (holding that § 17(a) does not imply private right of action); *see also* LOSS & SELIGMAN, *supra* note 1, at 1069-71.

115. [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,293, at 96,474 (D.C. Mass. 1986).

116. *Roberts v Smith Barney, Harris Upham & Co.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,293, at 96,474 (D.C. Mass. 1986); *see also* Corbey v Grace, 605 F Supp. 247, 250-51 (D. Minn. 1985) (noting that protections provided by § 15(c)(1) are all subsumed within provisions of § 10(b)).

customer rule," an important concept under the shingle theory.<sup>117</sup> However, following recent Supreme Court decisions curtailing civil liability and requiring such elements as scienter in Rule 10b-5 cases, more recent decisions have suggested that breach of an SRO rule will not suffice for a Rule 10b-5 claim unless the elements of such a cause of action can be proven.<sup>118</sup> Nevertheless, SRO rules may be considered in measuring a broker-dealer's duty of care.<sup>119</sup>

Much of the Supreme Court's hostility to expansive interpretations of Rule 10b-5 have been due to a reluctance to hold aiders and abettors liable for the wrongs of primary tortfeasors. With respect to broker-dealers, the controlling person provisions of the Securities Act and the Exchange Act impose liability upon them for violations of their employees in actions under the express civil liability provisions.<sup>120</sup> For a number of years, the circuits were split on whether liability also could be imposed under a theory of *respondeat superior*.<sup>121</sup> However, after the Supreme Court's decision in *Central Bank v. First Interstate Bank*,<sup>122</sup> there is a serious question as to whether liability against a broker-dealer employer can be predicated on a *respondeat superior* theory

117 *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 410 F.2d 135, 142 (7th Cir.) (holding that violation of NYSE Rule 405 is actionable, as rule's purpose is in accord with federal statute), *cert. denied*, 396 U.S. 838 (1969); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 182 (2d Cir.) (stating that when rule creates duty unknown to common law, federal liability is more likely to be implied), *cert. denied*, 385 U.S. 817 (1966).

118. See *In re Verifone Sec. Litig.*, 11 F.3d 865, 870 (9th Cir. 1993) (holding that breach of disclosure rule cannot serve as evidence of material misstatements or omissions); *Spicer v. Chicago Bd. of Options Exch., Inc.*, 977 F.2d 255, 266 (7th Cir. 1992). But see *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989) (holding that private cause of action can be implied for violations of Rule 405).

119. See *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 200 (3d Cir. 1990) (noting that violations of NASD rules may be probative in demonstrating course of conduct amounting to fraud); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981) (stating that rules are useful tools to measure reasonableness of excessiveness of broker's behavior).

120. See 15 U.S.C. § 77o (1994) (imposing liability on controlling persons); 15 U.S.C. § 78t(a) (1994) (same).

121. Compare *Campbell v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,082, at 91,413 (N.D. Ill. 1985) (finding prima facie claim established for secondary liability of corporation for agent) and *Plunkett v. Dominick & Dominick, Inc.*, 414 F. Supp. 885, 889 (D. Conn. 1976) (holding that *respondeat superior* doctrine was sufficient to survive motion to dismiss) with *Altshul v. Paine Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 595 (S.D.N.Y. 1981) (finding *respondeat superior* inapplicable against firms where alleged agent was, in effect, agent of plaintiffs).

122. 114 S. Ct. 1439 (1994).

*IV Possible Shingle Theory Liability Under Sections 12(2)  
and 17(a) of the Securities Act and Section 15(c) of the Exchange Act*

The federal securities laws contain an elaborate scheme of remedies for injured investors. Section 12(1) of the Securities Act provides that any person who offers or sells a security in violation of the registration provisions of Section 5 shall be liable to the person purchasing the security from him.<sup>123</sup> Section 12(2) provides that any person who offers or sells a security by means of a prospectus or oral communication that contains an untrue fact or fraudulent omission shall be liable to the person purchasing the security from him.<sup>124</sup> Section 11(a) of the Securities Act provides that any person who acquires a security pursuant to a registration statement containing an untrue statement of a material fact or an omission of a material fact may sue every signer of the registration statement, every director or partner, every consenting expert, and every underwriter.<sup>125</sup> In addition, controlling persons are made liable under Sections 11 and 12 by reason of the operation of Section 15 of the Securities Act.<sup>126</sup>

In *Pinter v Dahl*,<sup>127</sup> the Supreme Court narrowed the category of possible defendants in Section 12(1) of the Securities Act.<sup>128</sup> The Court found that only those who solicit a buyer of securities may be regarded as "sellers" for purposes of Section 12(1).<sup>129</sup> *Pinter* has been interpreted to apply in cases arising under Section 12(2)<sup>130</sup> and to eliminate the liability of collateral participants in securities frauds such as lawyers who prepare false and misleading disclosure documents.<sup>131</sup>

In *Gustafson v Alloyd Co.*,<sup>132</sup> the Supreme Court's penchant for restricting civil liability under the securities laws resulted in a draconian limitation on the parameters of Section 12(2).<sup>133</sup> *Gustafson* involved the sale of all of the issued and outstanding stock of Alloyd Co. by three shareholders to

123. See 15 U.S.C. § 77l(1) (1994).

124. See 15 U.S.C. § 77l(2) (1994).

125. See 15 U.S.C. § 77k(a) (1994).

126. See 15 U.S.C. § 77o (1994).

127. 486 U.S. 622 (1988).

128. *Pinter v Dahl*, 486 U.S. 622, 642-47 (1988).

129. *Id.* at 647.

130. *Wilson v Santune Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989).

131. See *id.* at 1126-27.

132. 115 S. Ct. 1061 (1995).

133. See *Gustafson v Alloyd Co.*, 115 S. Ct. 1061, 1072-73 (1995).

a limited number of purchasers.<sup>134</sup> Prior to *Gustafson*, several circuits had embraced the view that Section 12(2) does not apply to secondary market transactions.<sup>135</sup> However, in *Gustafson*, the Court went much further and held that Section 12(2) does not apply to private placements.<sup>136</sup> This raises a serious question as to whether Section 11 liability attaches to secondary market transactions.<sup>137</sup> Further, it appears that, in shingle theory cases not involving the sale of a registered security, customers defrauded by a brokerage firm have recourse only under implied causes of action.

If no liability can be implied under Section 10(b), the only other likely antifraud provisions are Section 17(a) of the Securities Act and Section 15(c) of the Exchange Act.<sup>138</sup> *Aaron v SEC*<sup>139</sup> involved an action brought by the SEC for an injunction against a broker-dealer's managerial employee for negligently supervising sales personnel who were making false representations about an issuer whose securities the firm was recommending.<sup>140</sup> In *Aaron*, the Supreme Court addressed whether scienter is required in an action under Section 17(a) of the Securities Act.<sup>141</sup> After *Ernst & Ernst v Hochfelder*,<sup>142</sup> there had been some debate as to whether the SEC was required to prove scienter in its cases, even if private parties had to prove scienter in actions under Rule 10b-5. The dissent in *Aaron* adopted the view that the SEC should not have to prove scienter under either of these antifraud provisions,<sup>143</sup> but the majority took another tack.

The Court distinguished Section 17(a)(1), holding that actions under this provision require proof of scienter, from Sections 17(a)(2) and (3), finding that proof of scienter is not required under these provisions.<sup>144</sup> According to the Court, the plain language of the statute draws a distinction between

134. *Id.* at 1064.

135. *First Union Discount Brokerage Servs., Inc. v Milos*, 997 F.2d 835, 843-44 (11th Cir. 1993); *Ballay v Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 691 (3d Cir.), *cert. denied*, 502 U.S. 820 (1991).

136. *Gustafson*, 115 S. Ct. at 1072-73.

137. See Judith Welton & Elizabeth Lynch, *After 'Gustafson' Does Section 11 Apply Only to IPOs?*, N.Y. L.J., Apr. 21, 1995, at 1, 4.

138. For the relevant text of § 17(a) of the Securities Act and § 15(c) of the Exchange Act, see *supra* notes 10 and 12, respectively.

139. 446 U.S. 680 (1980).

140. See *Aaron v SEC*, 446 U.S. 680, 682 (1980).

141. See *id.* at 686.

142. 425 U.S. 185 (1976).

143. *Aaron*, 446 U.S. at 703-04.

144. See *id.* at 695-96.

deceptive conduct and conduct that operates as a fraud.<sup>145</sup> The Court reasoned that "device," "scheme," and "artifice" in Section 17(a)(1) all connote knowing or intentional practices, but that Section 17(a)(2), which prohibits anyone from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact," is devoid of any suggestion of a scienter requirement.<sup>146</sup> Similarly, Section 17(a)(3), which makes it unlawful for any person "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit," focuses on the effect of particular conduct on investors rather than upon the culpability of the tortfeasor.<sup>147</sup>

As a matter of statutory interpretation, the contrast the Court makes between Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act is a fascinating exercise in the arcane because Rule 10b-5 is phrased similarly to Section 17(a). Because Section 10(b) is phrased differently, however, and simply prohibits "any manipulative or deceptive device or contrivance"<sup>148</sup> in contravention of the SEC's rules, the Court essentially invalidated the second and third clauses of Rule 10b-5; the Court held that deception or manipulation was required for a Rule 10b-5 action, but not for a Section 17(a)(2) or (3) action. This raises the interesting question of whether scienter is required in an action under Sections 15(c)(1) or (2) of the Exchange Act, which are phrased a little differently than either Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act.<sup>149</sup>

Section 15(c)(1) prohibits broker-dealers from inducing securities purchases or sales by means of "any manipulative, deceptive, or other fraudulent device or contrivance."<sup>150</sup> Section 15(c)(2) further prohibits broker-dealers from engaging in any "fraudulent, deceptive, or manipulative act or practice, or mak[ing] any fictitious quotation[s]."<sup>151</sup> Section 15(c)(1)(D) gives the SEC rulemaking power to define what devices or contrivances are manipulative, deceptive, or otherwise fraudulent.<sup>152</sup> Section 15(c)(2)(D) gives the SEC power to prescribe means reasonably

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145. *See id.*

146. *See id.*

147. *See id.* at 696-97

148. For the text of § 10(b), see *supra* note 11.

149. Compare *supra* note 12 (providing text of § 15(c)(1)-(2)) with *supra* note 10 (outlining text of § 17(a)) and *supra* note 11 (delineating text of § 10(b)).

150. See *supra* note 12 (providing text of § 15(c) of Exchange Act).

151. *See id.*

152. *See id.*

designed to prevent such acts and practices that are fraudulent, deceptive, or manipulative.<sup>153</sup>

The SEC drafted a broad definition of broker-dealer fraud in Rule 15c1-2 that includes "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," as well as "any untrue statement of a material fact and any omission to state a material fact."<sup>154</sup> In addition, the rules under Section 15(c) prohibit in detail specific practices that lead to overreaching of customers and form components of the shingle theory.<sup>155</sup> Although the Supreme Court could invalidate these various rules using *Ernst & Ernst v Hochfelder*<sup>156</sup> as a precedent and interpret Sections 15(c)(1) and (2) as narrowly as Section 10(b), one would hope that the Court would give some deference to the SEC's expertise and authority to regulate the securities industry and not effect such a wholesale excision of prohibited broker-dealer conduct from the statute and the regulations.

Because it is unlikely that private damage actions would be implied under either Section 17(a) of the Securities Act or Sections 15(c)(1) or (2) of the Exchange Act, the opportunities for the Supreme Court to address these issues in the context of a shingle theory case are slim. Nevertheless, equitable remedies might be implied under *Transamerica Mortgage Advisors, Inc. v Lewis*.<sup>157</sup> Even in cases in which the conduct of a broker is so egregious that a Rule 10b-5 case would be established, compulsory securities industry arbitration agreements assure that most such cases will not be litigated in the courts.

## V Collateral Developments

### A. Securities Industry Arbitration

Disagreements between member firms of the NYSE and between member firms and their employees must be submitted to NYSE arbitration.<sup>158</sup> Such arbitration facilities are of long standing, dating back to 1872,<sup>159</sup> and were designed to maintain public confidence in the NYSE by keeping

153. *See id.*

154. 17 C.F.R. § 240.15c1-2(a)-(b) (1995).

155. *See id.*

156. 425 U.S. 185 (1976).

157. 444 U.S. 11 (1979).

158. N.Y.S.E. Constitution, art. XI, § 1, 3 N.Y.S.E. Guide (CCH) ¶ 1501 (Nov 1994).

159. *See* PHILIP J. HOBLIN, JR., *SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, CASES 1-2* (2d ed. 1992).



disputes between members confidential. It also is customary for securities firms to require their customers to sign predispute arbitration agreements.

The validity of predispute arbitration agreements was questionable until 1987 when the Supreme Court held that an Exchange Act provision prohibiting the waiver of substantive obligations under the statute did not invalidate such agreements.<sup>160</sup> This decision seriously undermined an earlier contrary holding under the Securities Act,<sup>161</sup> but in 1989 the Supreme Court overruled that contrary holding.<sup>162</sup> Accordingly, today most disputes between customers and broker-dealers are determined in arbitration facilities maintained by the NYSE or other SROs.<sup>163</sup>

One of the Supreme Court's reasons for permitting predispute arbitration clauses to be enforced, despite the superior bargaining power of broker-dealers and the investor protection questions raised, is that the SEC's oversight of SROs serves to ensure the adequacy of their arbitration procedures and facilities from a customer protection perspective.<sup>164</sup> Somewhat perversely, however, the circuits have ruled that a customer may elect to arbitrate disputes before the American Arbitration Association.<sup>165</sup> Securities class actions, however, may not be arbitrated.<sup>166</sup>

As a result of these developments, customers have brought relatively few court cases against broker-dealers since 1987, a time during which the Supreme Court's doctrinal development of Rule 10b-5 has been changing rapidly. Further, breach of SRO standards is an appropriate claim in an SRO arbitration. In an important recent case, the Supreme Court held that punitive damages could be awarded in an SRO arbitration involving customers and broker-dealers.<sup>167</sup> This case again demonstrates that the Supreme Court has less solicitude for broker-dealers than for other defendants in securities law actions.

160. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 228 (1987).

161. *Wilko v. Swan*, 346 U.S. 427, 434-35 (1953).

162. *Rodriguez de Quijas v. Shearson/American Express Inc.*, 490 U.S. 477, 480 (1989).

163. Constantine N. Katsoris, *Should McMahon Be Revisited?*, 59 BROOK. L. REV. 1113, 1114 (1993).

164. *Shearson/American Express Inc.*, 482 U.S. at 233-34.

165. See *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Georgiadis*, 903 F.2d 109, 113 (2d Cir. 1990); *PaineWebber, Inc. v. Rutherford*, 903 F.2d 106, 108 (2d Cir. 1990).

166. N.Y.S.E. Rule 600(d), 2 N.Y.S.E. Guide (CCH) ¶ 2600 (Nov. 1992); N.A.S.D. Code of Arbitration Procedure § 12(d), N.A.S.D. Manual (CCH) ¶ 3712; Katsoris, *supra* note 163, at 1122.

167. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1219 (1995).

### B. Securities Reform Legislation

The currently pending Private Securities Litigation Reform Act of 1995 would add an express right of action to the Exchange Act and, thus, replace the implied actions previously brought under Rule 10b-5.<sup>168</sup> To some extent, this legislation would codify the cases discussed in this article, but additional changes to the law would be made. Very importantly, the pending legislation would make "recklessness" a requisite for an action under Rule 10b-5.<sup>169</sup> In crafting this legislation, Congress has focused primarily on curtailing litigation against public companies and accountants, but securities industry representatives have played a role in this effort.<sup>170</sup>

How much, if any, attention has been given to the future of the shingle theory in cases between broker-dealers and customers is not apparent. Because most of these cases are likely to be arbitrated, this is perhaps an issue of more theoretical than practical interest, especially because arbitration is a business forum, not a court of law, and arbitrators need not follow legal precedent.<sup>171</sup> Nevertheless, legal standards under the securities laws are important in SRO arbitrations.<sup>172</sup>

### VI. Analysis and Conclusion

The shingle theory requires that broker-dealers deal fairly with their customers. It embodies the notion that broker-dealers impliedly represent

168. H.R. 1058, 104th Cong., 1st Sess. (1995). House Bill 1058 passed the House of Representatives on March 8, 1995. The Senate amended H.R. 1058 to contain provisions from the parallel Senate bill, S. 240, 104th Cong., 1st Sess. (1995). On June 28, 1995, the Senate passed the amended version of H.R. 1058.

169. See John C. Coffee, Jr., *Securities Litigation Reform: An Agenda for the Senate*, N.Y.L.J., Mar. 23, 1995, p. 5, col. 1 (discussing bill generally). The standard for recklessness as an extreme departure from ordinary standards of care that was set forth in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), cert. denied, 434 U.S. 875 (1977), could be relevant in a shingle theory case.

170. See Jane Fritsch, *Securities-Bill Staff Has Ties to the Industry*, N.Y. TIMES, May 25, 1995, at A1.

171. See DANNY ERTEL & RALPH C. FERRERA, BEYOND ARBITRATION § 2.14, at 44 (1991) (citation omitted); Panel Discussion on Non-Attorney Representation (Dec. 5, 1994), in *New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 63 FORDHAM L. REV. 1495, 1608 (1995).

172. See James A. Fanto, *Justice Blackmun and Securities Arbitration: McMahon Revisited*, 71 N.D. L. REV. 145, 163-65 (1995). Compelled arbitration between broker-dealers and their customers has been controversial because of the customer protection issues involved. *Id.* at 165. However, SEC oversight of SROs and their arbitration facilities tends to ensure that there will be accountability to customers, *id.* at 161 n.72, and that shingle theory concepts will remain applicable.

that they will deal fairly, but this implied representation is really a legal fiction. At bottom, the shingle theory rests on the premise that a broker-dealer has fiduciary obligations to its customers. When a broker acts as an agent, such an obligation is generally consonant with an agent's common-law duties. However, the shingle theory arose in cases in which a securities firm was acting as a dealer or a principal, and not as an agent, selling stock to customers from inventory at unfair prices.<sup>173</sup> In suitability and other types of shingle theory cases, it is equally likely that a broker-dealer has been selling stock as a dealer rather than acting as a broker. Because securities firms operate in this dual capacity, their legal relationship with customers is confused if the courts insist on forcing the relationship between broker-dealers and customers to fit into the common-law categories of agent, fiduciary, or arm's-length bargainer.

The SEC and the SROs have gone beyond the common law in formulating the shingle theory and in applying it to both agency and principal transactions. The question addressed by this article is whether the Supreme Court would do the same in actions for damages by customers against their broker-dealers under Rule 10b-5 or other antifraud provisions under the Securities Act or the Exchange Act.

As a theoretical matter, the answer would seem to be "no." First, the only section of the statute pursuant to which aggrieved customers currently can sue is Section 10(b) of the Exchange Act. The Court apparently will not apply Section 12(2) of the Securities Act to secondary market transactions, and most lower courts do not believe that there are implied claims under either Section 17(a) of the Securities Act or Section 15(c)(1) of the Exchange Act. Second, actions under Rule 10b-5 require scienter or at least recklessness and, further, are not available for breaches of state law fiduciary duty.

In the more egregious shingle theory cases, alleging at least recklessness is not an insurmountable problem. However, the shingle theory is more like a common-law duty than a statutory standard. In the case of the duty of directors to shareholders, the Supreme Court has refused to incorporate state corporation law into Rule 10b-5. Would it treat the relationship between broker-dealers and customers differently? One could argue that the main purposes of the federal securities laws were to regulate the securities markets, to regulate the securities industry, and to create the SEC to be the policeman of Wall Street. Further, since the 1975 Amendments to the Exchange Act, all SRO rules or rule changes, as well as SRO disciplinary cases, are approved or disapproved by the SEC. A holding that the shingle

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173. See *supra* note 19 and accompanying text.

theory is not a federal standard for broker-dealers but rather a state law fiduciary duty standard would therefore be highly anomalous. Yet, the Supreme Court is generally hostile to securities fraud actions for damages, and most lower courts recently have held that plaintiffs must plead all standard elements of a Rule 10b-5 action for a shingle theory case (for example, a suitability case) to remain in the federal courts.

The likelihood of the Supreme Court grappling with these issues is remote because most cases between broker-dealers and customers now are relegated to arbitration. Further, securities reform legislation could substitute a specific right of action under Rule 10b-5 for the current implied right of action, thus generating years of litigation to determine the parameters of this new type of case.

If the federal courts refuse to recognize shingle theory cases under the federal antifraud rules, there would be an increase in such litigation in the state courts. However, compelled SRO arbitration makes such a development unlikely. Because arbitration decisions are not like court decisions and the law applied is often unclear, the burden of developing the law under the shingle theory is placed upon the SROs and the SEC in disciplinary proceedings.

