KEGS, CRUDE, AND COMMODITIES LAW: ON WHY IT IS TIME TO REEXAMINE THE SUITABILITY DOCTRINE

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I. INTRODUCTION

It's a clear sign the world has changed when thieves steal beer kegs not for the beer but for the stainless steel, and duffers hit the links not to play golf but to steal the aluminum cups from the golf course. Commodities have come of age. The media now follows oil and gold prices with all the breathless enthusiasm formerly reserved for high tech stocks. The debate over “peak oil” has

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1 The increasing price of scrap metal resulted in over 250,000 beer kegs “wobbling” out of circulation in the U.K. in 2005, joined by all 800 of the aluminum railway carts at Belgium’s main railway station, 25,000 manhole covers in Beijing, aluminum cups from the Royal Johor Country Club in Malaysia, miles of idle rail track in Germany and crossbeams from bridges in the U.S. Joel Millman, Metal Is So Precious that Scrap Thieves Now Tap Beer Kegs, WALL ST. J., Mar. 14, 2006, at A1. Copper prices have also made copper wiring in air conditioning units and copper pipes in plumbing tempting targets. Sarah Schaefer Munoz & Paul Glader, Copper & Robbers: Homeowners’ Latest Worry; Thieves Target Wires, Pipes, Air Conditioners as Price of Hot Commodity Soars, WALL ST. J., Sept. 6, 2006, at D1.

2 See, e.g., Barbara Hagenbaugh, Gold Prices Celebrate Uncertainty, Raising Oil Prices, USA TODAY, Apr. 7, 2006, at 3B; Madlen Read, Silver and Gold Prices Each Hit 20-Year Highs, PHILA. INQUIRER, Apr. 19, 2006, at C4; Christopher Wang, Stock Market No Match for Rising Oil, Gold Prices, PITTSBURGH POST, Apr. 18, 2006, at A9.
entered the mainstream, and the debate over the impact of China and India’s increasing consumption of oil, steel, copper, and other commodities continues.

Neither are the commodities futures markets. They have grown enormously. From 1999 to 2004, the number of contracts traded more than doubled, increasing from approximately 500 million to 1.225 billion. During the same period, the number of options contracts traded more than doubled, increasing from approximately 123.5 million to 271 million. Futures investments are increasingly marketed to small, as well as institutional, investors. Investment advisers now advocate allocating a portion of individual investor portfolios to commodities.

The means for investing in commodities futures have increased. Mutual funds have joined “the commodities boom” by offering funds which purchase derivatives tracking commodities. Exchange traded funds (“ETFs”) and exchange traded notes (“ETNs”) now track various commodities indices. Individual investors also have greater options for participating directly in the futures markets. Individual investors can now purchase “mini-gold futures” and futures contracts based on home prices in ten cities. Day traders have turned to the futures markets and joined “thousands of other individual investors betting on the global currency markets.” Individual investors form the

6 Id. at 104.
7 Laise & McKay, supra note 4.
8 Id.
10 Laise & McKay, supra note 4; John Spence, ETF Boom Expands with Exchange-Traded Notes, WALL ST. J., Aug. 5-6, 2006, at B4.
11 Id.
fastest growing segment of the $2 trillion-a-day foreign exchange market, investing in accounts as small as $250 with leverage ratios of up to 400-to-1.\textsuperscript{14}

With this increased focus on and participation in the commodities futures markets has come increased fraud. Boiler room operations are not limited to securities markets and have caused millions of dollars of losses in the commodities options markets\textsuperscript{15} and foreign currency markets.\textsuperscript{16} Since late 2000, the Commodities Futures Exchange Commission ("CFTC") has pursued fraud cases involving the currency markets and over 23,000 investors who have lost approximately $350 million.\textsuperscript{17} From 1999 through 2004, the total number of CFTC actions seeking injunctions grew from 20 to 44 and defendants named in those actions from 61 to 177.\textsuperscript{18} In administrative cases, the CFTC assessed approximately $27 million dollars in civil monetary penalties in 1999 compared with $133 million in 2004.\textsuperscript{19} In civil cases, the numbers rose from approximately $60 million in 1999 to $170 million in 2004.\textsuperscript{20}

While the growing futures markets and fraud have received growing attention, commodities law, by and large, has not. Congress has debated expanding the authority of the CFTC to "clamp down on fraud in the natural-gas mar-

\textsuperscript{14} Karen Richardson & Peter A. McKay, \textit{A Risky Money Game: Currency Trading Spreads to the Little Guy; How 'Leverage' Leaves Investors Teetering}, \textit{WALL ST. J.}, Oct. 28-29, at B1; John Partridge, \textit{Investors Roll the Dice on Foreign Exchange; Rapid Retail Customer Increase in Market, GLOBE & MAIL}, Dec. 6, 2005, at B18 (explaining that in January 2002, the National Futures Association ("NFA") had seven active foreign exchange dealer-members holding $42 million in funds for clients. By September, 2005, there were thirty-one foreign exchange dealer-members holding approximately $795 million in funds for clients).

\textsuperscript{15} \textit{Jerry W. Markham, Commodity Regulation: Fraud, Manipulation and Other Claims} § 10.4 (2005). Boiler room operations have been defined as a temporary operation established to sell a specific speculative security. Solicitation is by telephone to new customers, the salesman conveying favorable earnings projections, predictions of price rises and other optimistic prospects without a factual basis. The perspective buyer is not informed of known or readily ascertainable adverse information; he is not cautioned about the risks inherent in purchasing a speculative security; and he is left with a deliberately created expectation of gain without risk.


\textsuperscript{18} 2004 \textit{Annual Report}, \textit{supra} note 5, at 40.


\textsuperscript{20} Id.
but the focus has been on institutional investors in the natural-gas derivatives markets, and there has been little debate about the anti-fraud provisions within or promulgated pursuant to the Commodities Exchange Act (CEA).

The same is true of the suitability doctrine and its role in U.S. commodities law. While the scope of the suitability requirements under U.S. securities law remains a perennial source of debate within academia and the securities industry, that debate has been all but silent as it relates to the futures market. In 1986 the CFTC and federal courts rejected arguments that the recommendation of unsuitable futures transactions transactions violated the anti-fraud provisions of the CEA. Since then, an unspoken, growing divide has arisen separating the black letter law that there is no suitability requirement under federal commodities law and the reality that futures transactions continue to be recommended to unsuitable investors. The CFTC, its administrative law judges, and the National Futures Association ("NFA") continue to confront suitability issues.

The increased focus on commodities futures markets, increased participation in those markets, and increased levels of fraud all suggest the time is ripe to reexamine the suitability doctrine and its role in U.S. commodities law. Part II of this Article provides background. The suitability doctrine has its roots in U.S. securities law and is debated in the context of securities transactions. This section examines the suitability doctrine under U.S. securities law and provides a point of comparison. Part III of this Article examines the suitability doctrine under U.S. commodities law: its proposal, rejection, and resurrection in disguised form. Examination of the rules and regulatory decisions of the CFTC and NFA shows that suitability issues are now addressed indirectly and inadequately. Part IV discusses the possibility of a more suitable rule. Scholars have suggested the imposition of objective suitability standards. This Article urges consideration of the imposition of a uniform suitability standard for individual or retail investors in futures markets similar to that covering the securities futures products now jointly regulated by the CFTC and the Securities Exchange Commission ("SEC"). Finally, Part V offers some closing thoughts about the discrepancy between securities and commodities law and the disparity between commodities law and practice.

22 See infra Part III.B citing, inter alia, Phacelli v. Conticommodity Servs., Inc., No. 80-385-80-704, 1986 WL 68447 (Sept. 5, 1986); Nobrega v. Futures Trading Group, Inc., No. 98-R161, 1999 WL 450858, at *9 (July 1, 1999) ("The Commodities Exchange Act's antifraud provisions have been definitively interpreted by the Commission as not including a general duty to inquire into a customer's suitability to trade futures.").
23 See infra Part III.B-C.
24 See infra Part IV.
25 This paper does not address suitability issues involving institutional investors, a topic covered elsewhere. See Jerry W. Markham, Protecting the Institutional Investor - Jungle Predator or Shorn Lamb?, 12 YALE J. ON REG. 345 (1995).
II. THE SUITABILITY DOCTRINE & SECURITIES LAW

A. What is the Suitability Doctrine?

A definition of suitability provides a logical starting point in thinking about the suitability doctrine under U.S. commodities law. Defining suitability, however, requires reference to securities law, and reference to securities law suggests the answer depends on where one looks. Scholars have provided a fairly uniform definition. Professor Poser has defined the suitability doctrine as a requirement that “a broker-dealer who makes recommendations to a customer recommend only those securities that he reasonably believes are suitable for the customer.”26 Professors Loss and Seligman have similarly defined suitability as “an obligation on the part of the dealer to recommend only securities that are suitable to the needs of a particular customer.”27

The variation comes when one looks at suitability rules. Suitability rules established by self regulatory organizations (“SROs”) have been around for decades. The National Association of Securities Dealers (“NASD”) adopted its first suitability rule as part of its ethical guidelines in 1939.28 Suitability rules began receiving widespread attention and increased application in the 1960s in response to boiler room operations, and in the intervening forty years they have assumed a variety of forms. NASD Rule 2310 currently states:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.30

26 Norman S. Poser, Broker-Dealer Law and Regulation § 3.03 (2001).
27 Louis Loss & Joel Seligman, Fundamentals of Securities Regulation § 9-C-3 (2004); see also Lewis D. Lowenfels & Alan R. Bromberg, Suitability in Securities Transactions, 54 Bus. Law. 1557 (1999) (“The suitability doctrine . . . may be broadly defined as a duty on the part of the broker to recommend to a customer only those securities which are suitable to the investment objectives and peculiar needs of a particular customer.”).
28 The NASD’s suitability rule was adopted in response to the Maloney Act of 1938, which authorized the SEC to register national securities associations subject to the condition that they adopt rules designed “to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade.” Kathleen C. Engel & Patricia A. McCoy, A Tale of Three Markets: The Law and Economics of Predatory Lending, 80 Tex. L. Rev. 1255, 1321 (2002) (internal quotation marks omitted).
29 Loss & Seligman, supra note 27, at § 9-C-3.
Brokers are to have “reasonable grounds” for believing their “recommendation is suitable,” and in establishing such reasonable grounds, brokers are to make reasonable efforts to obtain information including (1) the customer’s financial status, (2) the customer’s tax status, (3) the customer’s investment objectives, and (4) such other information used or considered to be reasonable in making recommendations to the customer. The Municipal Securities Rulemaking Board (“MSRB”) has adopted a similar rule, while the New York Stock Exchange (“NYSE”) states that every member must:

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

The “eleventh commandment of Wall Street” was designed to protect NYSE members from dishonest or insolvent customers and imposes no express suitability requirement, but it has become much more. It is now interpreted as to “protecting investors from being induced to purchase securities whose risks they can ill afford,” and NYSE examiners have informally defined the “essential facts” relative to every customer as “any information which affects the customer’s ability to accept risk.” The NYSE rule by definition applies to “every customer” and “every order” and, as a result, is not limited to “recommendations.”

Perhaps more significant for the purposes of examining commodities futures regulation, the NASD, NYSE, Chicago Board of Options Exchange, and other securities markets have all adopted expanded suitability rules for transactions involving greater risk. For options, index and currency warrants,
and securities futures products regulated by the SEC, the NASD prohibits any member from recommending a contract, unless there are "reasonable grounds" to believe, after reasonable inquiry, that the recommended transaction is "not unsuitable" for such customer. Moreover, according to NASD Rule 2860(19),

[n]o member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making a recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

While NASD Rule 2310 provides a general suitability rule requiring "reasonable efforts" to obtain a "reasonable basis" for believing a recommendation is suitable for the customer, NASD Rule 2860(19), the suitability rule for options transactions, requires reasonable grounds to believe the transaction is "not unsuitable" and a reasonable basis for believing the customer can understand and bear the risks. The NYSE offers similar rules for option and warrant transactions and poses additional information-gathering obligations, requiring members to obtain from options customers: customer's investment objectives, employment status, estimated annual income, estimated net worth, estimated liquid net worth, marital status, age, and investment experience.


[n]o member organization or member, allied member or employee of such member organization shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

Id.

A securities futures product is a legally binding contract between two parties to purchase or sell in the future a specific quantity of shares of the security or of the component securities of the narrow-based security index, at a certain price. NFA, NFA Rule 2-30(b): Customer Information and Risk Disclosure, available at http://www.nfa.futures.org/nfaManual/manualCompliance.asp (last visited May 24, 2006).

NASD, Rule 2860(19), supra note 39.


The SEC, in turn, has promulgated its own suitability rules. In 1962, the SEC adopted Rule 15c-2 requiring broker-dealers to determine the suitability of sales of equity funding programs. In 1967, the SEC adopted Rule 15b10-3, now abolished, requiring suitability determinations by broker-dealers who were not members of the NASD. In 1989, the SEC adopted what is now designated as Rule 15g-9 to address fraud in “penny stocks” markets. The rule prohibits broker-dealers from selling penny stocks unless they have first approved the purchaser’s account for transactions in penny stocks, obtain sufficient information from the purchaser to make an appropriate suitability determination, provide the purchaser with a written statement setting forth the basis of that determination, obtain a signed copy of the suitability statement from the purchaser, and receive a written agreement to the transaction from the purchaser. It is unlawful for a broker or dealer to approve an account for transactions in penny stocks unless the broker or dealer “reasonably determines,” based on information known or obtained concerning the person’s financial situation, investment experience, and investment objectives, and any other information known by the broker-dealer, “that transactions in penny stocks are suitable for the person, and that the person . . . has sufficient knowledge and experience in financial matters that the person . . . reasonably may be expected to be capable of evaluating the risks of transactions in designated penny

“Chapters I-XXVII” hyperlink) (last visited Mar. 3, 2007); Rule 30.52 Special Requirements for Stock Index Warrants, Currency Index Warrants and Currency Warrants available at http://wallstreet.cch.com/CBOE/Rules/ (follow “Chapter XXX” hyperlink) (last visited Mar. 3, 2007). CBOE Rule 9.9 provides: every member who recommends to a customer any option contract “shall have reasonable grounds for believing that the recommendation is not unsuitable for such customer” and no member shall recommend an opening transaction in any option contract unless the person making the recommendation “has a reasonable basis for believing at the time of making the recommendation that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.”

44 SEC Rule 15c2-5, Disclosure and Other Requirements When Extending or Arranging Credit in Certain Transactions, 17 C.F.R. § 240.15c2-5 (2006) (It shall constitute a “fraudulent, deceptive, or manipulative act or practice” for any broker or dealer to offer or sell any security in connection with an offer to extend any credit unless such broker or dealer before any transaction is entered into “[o]btains from such person information concerning his financial situation and needs, reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person, and retains in his files a written statement setting forth the basis upon which the broker or dealer made such determination.”); Lowenfels & Bromberg, supra note 27, at 1583.

45 Lowenfels & Bromberg, supra note 27, at 1583-84.


Finally, in 1994, the SEC proposed suitability rules under the Investment Advisors Act of 1940. Setting aside the various rules and formulations, whether one looks to the SRO rules or the SEC rules, it is clear that the suitability doctrine plays an important role, especially when the securities transactions are deemed to present a higher risk. Whether it is options, warrants, securities futures, or penny stocks, brokers-dealers are required to have reasonable grounds for believing the recommended transactions are suitable or "not unsuitable" for the customer, based on a reasonable inquiry into the customer's investment objectives, financial situation, and needs, and a determination that the customer has the knowledge and experience to evaluate the risks and the financial means to bear the risk.

B. Suitability, the SEC, and the Federal Courts

Courts have, of course, rejected the violation of SRO rules as independent grounds for a private cause of action against the broker, but the rules continue to inform judicial determinations of negligence and breach of fiduciary duty in civil suits. Courts have also rejected a private right of action for violation of the SEC penny stock rules set out above, but both the SRO and SEC suitability rules impact SRO and SEC regulatory action. The SEC analyzes suitability issues under the anti-fraud provisions of the federal securities law and the SEC rules promulgated pursuant thereto. The SEC held early on that a violation of the suitability doctrine could violate SEC Rule 10b-5 based on the shingle theory, a theory "whereby it is presumed that a broker-dealer that hangs out a shingle and solicits customers makes an implied representation of fair dealing." In 1969, the Second Circuit explicitly endorsed this: "A securities dealer occupies a special relationship to a buyer of securities and that by his position implicitly represents he has an adequate basis

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49 These rules have not been adopted. Lowenfels & Bromberg, supra note 27, at 1584.
50 See, e.g., Spicer v. Chicago Bd. of Options Exch., Inc., 977 F.2d 255, 259 (7th Cir. 1992); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1419 (11th Cir. 1983). See also Poser, supra note 26, § 3.03[A][1].
51 Poser, supra note 26, § 3.03[A][1] and 3.03[C]; Lowenfels & Bromberg, supra note 27, at 1585.
52 Uhre v. Emmett A. Larkin Co., 205 F. Supp. 2d 475, 481 (D. Md. 2002) ("In simple terms, § 15(g) sets forth the requirements for transactions in penny stocks. It does not create a private right of action in favor of anyone.").
53 Lowenfels & Bromberg, supra note 27, at 1580-81.
54 Id.; Roberta S. Karmel, Is the Shingle Theory Dead?, 52 Wash. & Lee L. Rev. 1271, 1271 (1995). See also In re Alexander Reid & Co., 40 S.E.C. 986, 1962 SEC LEXIS 514, at *11 (Feb. 8, 1962) ("A broker-dealer in his dealings with customers impliedly represents that his opinions and predictions respecting a stock which he had undertaken to recommend are responsibly made on the basis of actual knowledge and careful consideration."); Markham, supra note 15, § 10.1 ("The shingle theory is simply a belief that because a broker in effect hangs out his shingle as a professional, the broker should not make investment recommendations to customers that are unsuitable for the individual to whom the advice is being given."); Lowenfels & Bromberg, supra note 27.
for the opinions he renders . . . . He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation."

While subsequent Supreme Court decisions narrowly interpreting civil liability under the Exchange Act have called into question the continued viability of the shingle theory, nothing has called into question the continued viability of the suitability doctrine. In 1999, the SEC examined the conduct of registered representatives at Olde Discount Corp. and stated unequivocally:

Making unsuitable recommendations to customers without disclosing the unsuitability of those solicited investments, in breach of an affirmative duty to disclose arising from a fiduciary or similar relationship of trust and confidence, violate[s] Sections 10 (b) and 15 (c)(1) of the Exchange Act and Rules 10b-5 and 15c1-2."

The court found Olde's recommendation of "special venture stocks" to investors with conservative investment needs and objectives not suitable, and the Olde representatives "did not disclose this unsuitability to any of the customers in question." The Olde representatives exercised de facto control over some of the accounts and, as a result, had "an affirmative duty to disclose the unsuitable nature of the recommendations made to the customers."

A breach of the suitability doctrine and liability under the antifraud provisions of the federal securities law are not, however, dependent upon a breach of fiduciary duties or a finding of a relationship of trust and confidence. "A salesperson’s recommendations must be suitable for the client in light of the client’s investment objectives, as determined by the client’s financial situation and needs," and unsuitable recommendations violate the antifraud provisions of the securities laws where:

(i) the recommended securities were, or the level of trading activity was, unsuited to the customer’s need; (ii) the salesperson knew that his recommendations were unsuitable or acted with recklessness regarding their suitability and making them; and (iii) the salesperson made material representations or fail to disclose material information relating to the suitability of the securities or the level of trading, including the associated risks.

In In re Alacan, there was no suggestion of de facto control or a relationship of trust and confidence; to the contrary, the investors followed their investments and complained about unauthorized trades. The SEC found fraud because the registered representative repeatedly recommended "in and out trading" in highly speculative securities without disclosing the risks and in reckless

55 Hanley v. SEC, 415 F.2d 589, 596-97 (1969) ("By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation."). Id. at 597.
56 Karmel, supra note 54, at 1282-94.
58 Id. at *21.
59 Id. ("Olde acted with scienter, in the form of a reckless disregard for the suitability of investment recommendations made by its [registered representatives] to the firm’s customers, by focusing the firm’s training primarily [all] on aggressive sales techniques.").
61 Id. at *9.
62 Id. at *1-7.
disregard of the investment objectives of his customers. “Alacan took advantage of the fact that these customers were elderly and vulnerable in causing them to make risky investments and trade their accounts at frequencies that were unsuited to their needs.”

Where the investors are older, with modest financial profiles, unsophisticated, with conservative investment strategies, or pointedly inform the broker that the investment was to be used for medical expenses, the SEC will find the recommendation of speculative securities on margin unsuitable and a violation of the anti-fraud provisions of the federal securities laws. The violation occurs because the broker “misrepresented material facts to persuade his customers that there was no risk to purchasing on margin or, claiming that the price of the stock would rise substantially or that their accounts would not be subject to margin calls,” and, in doing so, the broker “failed to fulfill his responsibility to ensure that his customers, on a current basis, fully understood the risks involved and were both able and willing to take those risks.” In these cases, the SEC finds unsuitable recommendations fraudulent by pointing to misrepresentations regarding risk, or omissions or “failures,” to ensure the investor understood and could bear the risk.

In each of these cases, the investors’ decision regarding the suitability of the transaction is not dispositive. “Whether or not customers considered [the] purchase of the stock ... a suitable investment is not the test for determining the propriety of applicants’ conduct.” According to the SEC, the test is whether the broker “fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer’s financial situation and needs.”

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63 Id. at *9.
64 Id.; see also SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 9 (D.D.C. 1998) (“Securities dealers cannot recommend securities without a reasonable basis for the recommendation; if essential information is not known to a securities dealer, the dealer must inform investors that this information is unknown and must disclose the risks of such uncertainty.”).
66 Id.
67 In re Philips & Co., S.E.C. Release No. 5294, 37 S.E.C. 66, 1956 WL 54332, at *3 (Apr. 9, 1956). The SEC went on to find that “[t]he record shows that Bernheimer knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist.” Id.
68 Id.; In re Chase, S.E.C. Release No. 47,476, 79 S.E.C. Docket 225, 2003 WL 917974, at *4 (Mar. 10, 2003) (“The test for whether Chase’s recommendations were suitable is not whether Horvath acquiesced in them, but whether his recommendations were consistent with her financial situation and needs.”); In re Faber, S.E.C. Release No. 49,216, 82 S.E.C. Docket 453, 2004 WL 239507, at *6 (Feb. 10, 2004) (“A recommendation is not suitable merely because the customer acquiesces in the recommendation. Rather, the recommendation must be consistent with the customer’s financial situation and needs.”); In re Stein, S.E.C. Release No. 47,335, 79 S.E.C. Docket 1777, 2003 WL 431870, at *2 (Feb. 10, 2003)

A registered representative does not satisfy the suitability requirement simply by disclosing the risk of an investment that he or she has recommended. Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer’s financial profile.
In short, the SEC has sought to impose, both through its rule-making authority and in enforcement actions, a suitability requirement on securities professionals working with the retail investor. The latter has resulted in findings of unsuitability and fraud where the broker knew his recommendations were unsuitable and failed to disclose their unsuitability, failed to disclose the risk, and failed to ensure that the investors fully understood those risks.

The federal courts have been less expansive in their treatment of the suitability doctrine but nonetheless recognized a suitability requirement under federal law and civil liability for its breach. When confronted with suitability claims, the courts analyze them as a subset of fraud under the federal securities laws.

The first to do so was Clark v. Lamula Investors, Inc. in 1978.69 In Clark, a retired teacher sought to invest conservatively and her broker recommended convertible debentures, resulting in sizable losses.70 There was no evidence the defendant misrepresented anything. The plaintiff simply argued that the defendant knowingly recommended unsuitable securities.71 The jury found the debentures were unsuitable, the broker knew it, and he failed to inform the plaintiff about their ratings and the extent of risk.72 The Second Circuit found a violation of SEC Rule 10b-5: "Lamula engaged in an act, practice or course of business which operated as a fraud or deceit ... and omitted to state facts material to an informed purchase by her."73 Clark v. Kidder Peabody & Co., Inc. followed, finding "[t]he knowing recommendation of an unsuitable security states a cause of action for fraud under Section 10(b)."74 The second Clark decision found the "unsuitable purchase itself is the proscribed act, not any representation connected with that purchase."75 In other words, liability for an unsuitable transaction requires neither a misrepresentation nor an omission.

The result is that it is now well accepted under federal securities law that broker liability for an unsuitable securities transaction can arise from either a recommendation of an unsuitable security and related misrepresentation or omission, under the "misstatement-omission theory," or fraud by conduct in the execution of the trade itself, under the "fraudulent conduct theory."76

Federal courts have analogized the latter to churning. In O'Connor v. R.F. Lafferty & Co., the plaintiff sought to invest conservatively in a discretionary account controlled by her broker, who successfully managed her account for a number of years and then unsuccessfully invested in oil and gas limited partnerships, stocks, and warrants.77 The plaintiffs alleged the purchase of those

69 583 F.2d 594 (2d Cir. 1978); Poser, supra note 26, § 3.03.
70 Id. at 597, 599.
71 Id. at 599.
72 Id. at 600.
73 Id.
75 Id.
77 965 F.2d 893, 895-96 (10th Cir. 1992).
investments acted as a fraud. The court looked to the elements of a churning claim for guidance and found the plaintiff must prove: (1) the broker recommended or in a discretionary account purchased securities that were 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. The court found that "the control element is essential" to establish causation and reliance, but it concluded in O'Connor that scienter was dispositive. There was no indication of an intentional or reckless attempt to defraud, and, hence, no liability.

Federal courts have analyzed suitability claims based on misrepresentation or omissions as a subset of SEC Rule 10b-5 misrepresentation claims. In Brown v. E.F. Hutton Group, Inc., the court held that the plaintiffs, four hundred unsophisticated investors in oil and gas limited partnerships, must prove:

1. that the securities purchased were unsuited to the buyer's needs;
2. that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs;
3. that the defendant recommended or purchased the unsuitable securities for the buyer anyway;
4. that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and
5. the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.

The court assumed that E.F. Hutton made oral assurances that the investments were low or no risk, but it found that any reliance on these assurances was not justified as a matter of law. "The disclosure of risks adequately informed the Limited Partners that the investment was not suitable. . . ."

While the courts examine whether the investor reasonably relied on the broker's recommendation and have rejected suitability claims where the investors did not read the disclosure documents, they continue to recognize that unsuitable recommendations can be fraudulent and violate federal securities law. As recently as 2005, the Southern District of New York in Louros v. Kreiccias applied the elements set out in Brown to deny summary judgment to an investment advisor who counseled a sophisticated investor, an attorney with an MBA and a degree in economics, into losing over $500,000. The court found evidence to infer that some of the defendant's options trading strategies were unsuited to Mr. Louros' objectives, the defendant knew it, and genuine
issues of material fact remained as to the plaintiff’s justifiable reliance. While the plaintiff signed account forms acknowledging the risks of options trading, the court found the standard options disclosure booklet and risk warnings said little about the specific risks, the “vertical bull spreads,” that caused the plaintiff’s loses. In other words, there was no explanation of the specific risks of the position the defendant created, and as a result, the plaintiff’s suitability claims remained.

Looking at both SEC enforcement actions and civil suits brought in federal courts shows that suitability requirements are firmly established, and that an unsuitable recommendation can be fraudulent. The fraud arises where the broker recklessly disregards the unsuitability of his recommendation and misrepresents its suitability, fails to disclose the risk, fails to ensure the customer understands the risks, or where the broker has de facto or legal control over the account and recommends and or causes to be purchased the unsuitable securities.

The principal distinction that arises is that the SEC focuses on the broker in an enforcement action and whether the investor thought the transaction suitable matters not. The courts in civil suits, in contrast, hold that what the investor thought or did not think is often dispositive; if the investor’s reliance on the broker’s recommendation was unreasonable, there is no relief from an unsuitable recommendation.

C. Suitability Rules and SRO Arbitration

Discussion of civil suits involving suitability claims in the federal courts based on federal securities law, however, offers an incomplete picture. Following the Supreme Court’s decisions in Shearson/American Express, Inc. v. McMahon and Rodriguez de Quijas v. Shearson/American Express, Inc., pre-dispute mandatory arbitration clauses have become the norm, and arbitration almost an exclusive forum for resolving investor-broker related disputes. Arbitration of suitability claims offers another standard, or standards. Arbitrators can decide cases based on a violation of SRO rules, federal law, state law, or equity.

87 Id. at 586.
88 Id. at 581, 591. A vertical spread is an option strategy that involves purchasing an option at one strike price while simultaneously selling another option of the same class at the next higher or lower strike price. Both options have the same expiration date . . . . The investor who buys a vertical spread hopes to profit as the difference between the option premium on the two option position widens or narrows.


State courts applying state security statutes have followed federal courts in recognizing a claim for fraud based on an unsuitable recommendation. See, e.g., Boettcher & Co. v. Munson, 854 P.2d 199, 208-09 (Colo. 1993); Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 180 (Minn. 1994).


90 Lowenfels & Bromberg, supra note 27, at 1593-94.
Arbitrators may balance the equities without rigid adherence to the legal formula set out above. The first page of the Securities Industry Conference on Arbitration’s Arbitrator’s Handbook quotes Domke on Aristotle:

Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators where appointed was that equity might prevail.92

While the arbitrator keeps “equity in view,” it is difficult to keep the arbitrator in view. The NASD has proposed changes to its arbitration rules that would allow investors to request written explanations in arbitration awards; however, arbitrators have not traditionally been required to provide a “reasoned award,” and most do not.93 We are left with the exceptions, those arbitrators who offer an analysis of the claims, and statistics.94 Both offer insight here.

Examining those arbitration awards that provide a factual or legal basis for the award shows that suitability issues are not treated uniformly. One need not look far to find awards that turn on the presence of written risk disclosures, as found in Brown v. E.F. Hutton.95 Arbitration panels have rejected SEC findings of sales practice abuses including unsuitable trading in speculative stocks, leaving the dissenting arbitrator to point out that the claimants, a retired factory worker and small business owner, had minimal resources and no ability to understand the risk disclosure or “special ventures authorization letter” provided.96

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93 NASD Rule 10330(e) currently requires awards to contain the names of the parties and counsel; a summary of the issues; the damages and other relief requested and awarded; a statement of any other issues resolved; the names of the arbitrator[s]; the dates the claim was filed and the award rendered; the location, number, and dates of hearing sessions; and the signatures of the arbitrators concurring in the award.

SEC, Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 Thereto, to Provide Written Explanations in Arbitration Awards Upon the Request of Customers, or of Associated Persons in Industry Controversies. 70 Fed. Reg. 41,065 (July 15, 2005); NASD Code of Arbitration Procedure, Rule 10330 Awards, available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited May 23, 2006). The NASD’s proposed rule would allow customers, or associated persons in industry controversies, to request a written explanation in the arbitration award. Under the proposed rule, an “explained decision” is one including “a fact-based award that states the reason(s) each alleged cause of action was granted or denied and will address all claims involved in the case . . . [t]he inclusion of legal authorities or damage calculations, however, will not be required.” Id.

94 “An arbitrator may make an award without explanation, but some summary [and] analysis of the parties’ respective duties to each other and themselves . . . may assist in their understanding and perception of the fairness of this arbitration system as a means of resolving disputes in the securities industry.” In re Wyman v. Guidry, N.A.S.D. Docket No. 01-05436, 2002 WL 32026658, at *1 (Apr. 9, 2002).

95 991 F.2d 1020, 1033 (2d Cir. 1993).

Arbitration panels, following O'Connor,97 have stated flatly that "[s]uitability is not a viable issue when the client controls the account," and that "a broker owes no fiduciary duty to a client who is both a sophisticated and independent investor."98 These decisions, however, are interspersed with arbitration awards and reasoning that clearly break with the courts in their analysis of suitability issues. They recognize liability for the breach of suitability duties where courts simply would not.

One often-cited example of this is In re Peterzell v. Charles Schwab & Co., where an arbitration panel imposed liability on a brokerage for its failure to stop a wealthy and sophisticated investor from unsuitable trading.99 In In re Peterzell, the arbitrators found that the claimant provided false information to the broker and continued to trade as losses mounted, yet concluded:

Suitability ... is an ongoing obligation and, although Charles Schwab initially met its suitability obligations, it failed to maintain any ongoing supervision of the Claimant's suitability. At some point in time, Claimant became unsuitable, even with his false representations.100

The panel found that Charles Schwab's compliance department should have realized Peterzell's losses were disproportionate to his claimed net worth and annual income, and it found them liable for a portion of Mr. Peterzell's losses.101

In re Peterzell does not stand alone. Arbitration panels have dispensed with any requirement that a broker act recklessly or with scienter in recommending an unsuitable securities transaction. In In re Crooks v. Hilliard Lyons, the arbitrator found the claimant to be an unsophisticated investor who relied on her broker and found the broker to be a "well-meaning, honest, hard-working customer interested registered representative." The registered representative had purchased the stock in question for her own and her husband's account as well as recommended it to others.102 The arbitrator found claimant's losses resulting from the purchase were:

[a] result of the omissions and commissions of Hilliard Lyons - even with [the] diligence and good faith - of the Manager ... for not requiring that Ms. Stavros and every registered representative be fully trained and continually educated so as to be knowledgeable and familiar with sound investment principles, including diversification and suitability ... .103

99 Lowenfels & Bromberg, supra note 27, at 1594.
101 Peterzell, 1991 WL 202358, at *2. The panel awarded as damages approximately 30% of the investor's loss.
103 Id. at *2.
The claimant was not advised of the risk accompanying placing a large portion of a small portfolio in a single high-risk stock, and the arbitrator awarded the claimant damages for the entire loss sustained. In other words, the arbitrator explicitly found "diligence and good faith" on the part of the registered representative and her supervisor, implicitly denied either recklessness or scienter, and yet awarded damages for the entire loss simply because the recommendation was unsuitable.

In In re Friesz v. Prime Charter Ltd., an arbitration panel found the investor to have a "philosophy of sophisticated and aggressive investing" and disclosed objectives including "short-term trading." He was actively involved in trading and acknowledged receipt of a letter from the Director of Compliance disclosing "significant transaction activity." The panel found no churning and no unauthorized trading, but it did find the broker liable for unsuitable recommendations. There is a "universal rule of conduct that an investment advisor must have reasonable grounds for believing that an investment recommendation is suitable for his customer," and here the broker was:


unable to articulate any sound analytical basis for soliciting and recommending as suitable such a large concentration of one position in Claimant's account. His research was limited to conversations with Metromedia's public relations personnel, street workers installing fiber network cables underground, and the occasional optimistic "buy" recommendation from an analyst... The Panel concludes that a concentration of this magnitude was unsuitable for Claimant's account.

Arbitration panels have found that even with an institutional investor there are instances when aggressive margin bond trading "per se would not be suitable." Others, such as In re Poole, have imposed liability for unsuitable recommendations of three mutual funds emphasizing that the broker "is a professional with specialized education, training, and experience that gives her power in relation to an inexperienced person like Claimant." As a professional entrusted with another's assets, the broker "had a duty to do no harm and to act in [the] the Claimant's best interest. The advice given should have fit the claimant's characteristics and life situation." In other words, arbitration panels have imposed liability for the unsuitable recommendation of three relatively conservative investments based on the shingle theory, a general fiduciary duty owed by a professional broker to an investor.

104 Id. at *3.
106 Id. at *4.
107 Id. at *5-7.
108 Id. at *6.
109 Id. at *6-7. The panel apportioned responsibility for claimant's loss 60% against the broker and 40% against claimant. Id. at *7. See also In re Meehan v. Schroder Wertheim & Co., N.A.S.D. Docket No. 96-00167, 1997 WL 460222 (July 7, 1997) (awarding damages for unsuitable recommendations that excessively concentrated the claimant's account in three speculative and/or high risk stocks).
112 Id.
What one finds are arbitration panels that have invoked the discretion afforded to them and imposed liability for the plain and simple reason that the brokers made unsuitable recommendations. While it is impossible to state the examples above are representative of a majority or minority position, they are consistent with scholars and practitioners finding that arbitration forums are on the whole more receptive to investor claims than the courts.\textsuperscript{113} "This shift in forum and in governing standards has eased meaningfully the customer's path to recovery and consequently has increased the customers leverage to compel a[ny] significant settlement."\textsuperscript{114}

The end result is that suitability requirements play an undeniably important role in broker-investor relations. The numbers make that clear. In 1998, the NASD warned broker-dealers that 95\% of all filings under NASD member's errors and omissions insurance policies were the result of unsuitability claims.\textsuperscript{115} Arbitration statistics from 2005 show suitability claims continue to play a leading role: out of approximately 6000 claims filed, the three most common "controversies involved in arbitration" were breach of fiduciary duty, 3514 cases; negligence, 2225 cases; and unsuitability, 1926 cases.\textsuperscript{116}

If one considers the arbitration awards and statistics, in conjunction with the SRO and SEC's enforcement actions and the courts' recognition of unsuitable recommendations as fraud under the federal securities law, the end result and inevitable conclusion is that the suitability doctrine plays a pivotal role in broker recommended transactions in federally regulated securities markets. The point here is that for the purposes of comparison, the suitability doctrine, in its various forms, is an indispensable part of the framework of securities law that governs disputes between individual investors and securities professionals.\textsuperscript{117}

III. THE SUITABILITY DOCTRINE AND COMMODITIES LAW

A. The Suitability Doctrine Under the Commodities Exchange Act (CEA)

This leads to the question, what about commodities law? The short answer is that, while the suitability doctrine has been described as "[o]ne of the most important doctrines under federal securities laws,"\textsuperscript{118} it does not exist under federal commodities law. "The courts and the Commodities Futures Trading Commission ("CFTC") are in accord that no cause of action exists under the Commodities Exchange Act ("CEA") for making an unsuitable recommendation to a customer."\textsuperscript{119}

\begin{thebibliography}{99}
\bibitem{113}Lowenfels & Bromberg, \textit{supra} note 27, at 1558.
\bibitem{114}Id.
\bibitem{115}Id. at 1557 (quoting Zarbh Urges Broker Dealers to 'Be on Guard' About Suitability, 30 \textit{SEC. REG. \\& L. REP. (BNA)} 810 (May 29, 1998)).
\bibitem{116}Each case can be coded to contain up to four different claims or "controversy types." NASD, Arbitration and Mediation - Dispute Resolution Statistics, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE\&nodeId=516\&ssSourceNodeId=12 (last visited May 15, 2006).
\bibitem{117}Lowenfels & Bromberg, \textit{supra} note 27, at 1557.
\bibitem{118}Id.
\bibitem{119}POSER, \textit{supra} note 26, § 3.03[D].
\end{thebibliography}
It did not start out that way. Congress created the CFTC in 1974,\textsuperscript{120} and in 1977 the CFTC announced proposed customer protection rules, including a comprehensive suitability rule covered by the anti-fraud provisions of the CEA.\textsuperscript{121} The proposed rule would have required each commodity professional\textsuperscript{122} obtain from the customer within a reasonable period of time before the transaction the "essential facts" about the customer's financial condition and trading objectives and have a "reason to believe that the recommendation or transaction was suitable for the customer."\textsuperscript{123} The suitability determination itself required two different judgments: (1) a determination that commodity trading in general was suitable for the customer in view of his trading objectives and financial condition, and, (2) a determination that the particular position recommended or the subject of a discretionary trade was suitable.\textsuperscript{124}

In proposing the rule, the CFTC emphasized that "futures commodity customers are often unaware of, or inattentive to, the substantial risk of loss in commodity [futures] trading."\textsuperscript{125} The CFTC stated that "[s]uitability and disclosure are separate concepts" and "disclosure alone does not sufficiently protect some customers."\textsuperscript{126} In addition to the proposed general suitability requirement, the CFTC specifically sought comment on adding objective suitability standards such as minimum net worth requirements.\textsuperscript{127} Much like the SEC's "shingle theory," the CFTC explained that the proposed rule was predicated on the principle that commodity professionals have a special skill, are presumed to understand the risks, including price volatility, liquidity, limit trading, and market requirements, and it should not be permitted to shift to the customer entirely the burden of assessing the risks of a trade.\textsuperscript{128}

\begin{footnotes}
\item[121] \textit{Poser}, supra note 26, § 3.03[D]; \textit{Markham}, supra note 15, § 10.2.
\item[122] The Commission uses the term "commodity professionals" to refer to all Commission registrants or "representatives" thereof, including any officer, partner, employee, or agent of a registrant. \textit{Proposed Standards of Conduct for Commodity Trading Professionals}, 42 Fed. Reg. 44,742 (Sept. 6, 1977).
\item[123] \textit{Id.} at 44,750. \textit{See also} \textit{Markham}, supra note 15, at § 10.3. When CFTC proposed its suitability rule, it did not start tabula rasa. The proposed rule was based on SEC Rule 15b10-3, a suitability rule adopted in 1967 and now repealed, covering over-the-counter broker-dealers not then required to become members of the NASD. \textit{See Poser}, supra note 26, § 3.03[A][2]; \textit{Louis Loss & Joel Seligman, Securities Regulation} 3853 (3d ed. 1991); Lowenfels & Bromberg, supra note 27, at 1583-84.
\item[125] These risks include the ability to purchase futures contracts on small margins resulting in a high degree of leverage; market prices subject to large rapid fluctuations resulting in substantially greater losses than the amount deposited as the original margins; and, daily price limits locking customers into losing positions. \textit{Id.} at 44,743.
\item[126] \textit{Id.} at 44,744. In other words, while "sunlight is said to be the best of disinfectants," there are some products that the light just does not penetrate well, and some people who even with good light don't see well, and the law intercedes in those cases. \textit{See Louis D. Brandeis, Other People's Money and How the Bankers Use It} 92 (Frederick A. Stokes Co. 1932) (1914) (stating "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light [is] the most efficient policeman . . . .").
\item[128] \textit{Id.}
\end{footnotes}
The proposed rules stopped at the starting gate. Industry fiercely opposed the suitability rule, and the CFTC retreated. In 1978, the CFTC announced it would not adopt the proposed suitability rule because it was unable "to formulate meaningful standards of universal application," and enacting a suitability rule would "merely have codified principles that are [already] implicit in the antifraud provisions" of the CEA and CFTC rules. Professor Markham has called this explanation "completely contrived," and, on its face, it is. It also stands in marked contrast to the SEC and the securities industry formulation of the suitability requirements discussed above, requirements that are separate and distinct from disclosure requirements.

Commodities investors were left with risk disclosure and various prohibitions against deception. The CEA proscribes deception in Section 4b prohibiting any member of a registered entity or agent in connection with any order to make any contract for any commodity in interstate commerce from attempting to cheat or defraud, willfully causing to be made any false report, or attempting to deceive by any means:

(i) to cheat or defraud or attempt to cheat or defraud such other person;

(ii) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(iii) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or 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 . . . .

The CFTC has supplemented this general anti-fraud provision with specific rules proscribing fraud in connection with commodity option transactions,

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129 Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,887 (July 24, 1978); Markham, supra note 15, § 10.3.

130 Markham, supra note 15, §10.3.


132 Markham, supra note 15, § 10.3.

133 See infra Part I.

134 It shall be unlawful . . . (i) to cheat or defraud or attempt to cheat or defraud such other person; (ii) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof; (iii) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or 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 . . . .


135 CFTC Fraud in Connection with Commodity Option Transactions, 17 C.F.R. § 32.9, (2006) (making it unlawful for any person: "(a) To cheat or defraud or attempt to cheat or defraud any other person; (b) To make or cause to be made any false report or statement. . . ; [or] (c) To deceive or attempt to deceive any other person by any means whatsoever, in or in connection with . . . any commodity option transaction."). See also CFTC Fraud in Connection with Commodity Option Transactions, 17 C.F.R. § 33.10 (2006).
fraud in connection with foreign futures and foreign options transactions, and fraud in connection with transactions in silver or gold bullion and coins.\textsuperscript{136}

Risk disclosures, disclosure documents that commodity professionals describe as "phone book size,"\textsuperscript{137} set forth basic information that must be provided to investors prior to opening an account for that investor. CFTC Rule 1.55 requires that all futures commission merchants ("FCMs")\textsuperscript{138} or introducing brokers ("IBs")\textsuperscript{139} provide a risk disclosure statement that includes the following language:

\begin{quote}
Risk Disclosure Statement

The risk of loss in trading commodities futures contracts can be substantial. You should, therefore, carefully consider whether such trading is suitable for you in light of your circumstances and financial resources.\textsuperscript{140}

The statement goes on to describe some of the specific risks, including the possibility of a total loss of funds invested and margin calls, and requires a signature acknowledging that the investor has received and understood the risk disclosure statement.\textsuperscript{141} CFTC rules for commodities options and leverage transactions disclosure contain similar warnings:

\textbf{BECAUSE OF THE VOLATILE NATURE OF THE COMMODITIES MARKETS, THE PURCHASE AND GRANTING OF COMMODITY OPTIONS INVOLVE A HIGH DEGREE OF RISK. COMMODITY OPTION TRANSACTIONS ARE NOT SUITABLE FOR MANY MEMBERS OF THE PUBLIC.}\textsuperscript{142}
\end{quote}

\hspace{1em}\textsuperscript{136} CFTC Fraudulent Transactions Prohibited, 17 C.F.R. 30.9 (2006); CFTC Fraud in Connection with Certain Transactions in Silver or Gold Bullion or Bulk Coins, or Other Commodities, 17 C.F.R. § 31.3 (2006).
\hspace{1em}\textsuperscript{138} The CEA defines a "futures commission merchant" ("FCM") as

\begin{quote}
[A]n individual, association, partnership, corporation, or trust that -- (A) is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility; and (B) in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.
\end{quote}


\hspace{1em}\textsuperscript{139} The CEA defines an "introducing broker" as

\begin{quote}
[\text{A}ny person (except an individual who elects to be and is registered as an associated person of a futures commission merchant) engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.
\end{quote}


\hspace{1em}\textsuperscript{140} CFTC Distribution of "Risk Disclosure Statement" by Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.55 (b) (2006).

\hspace{1em}\textsuperscript{141} Id. at 1.55(a)(1)(ii), (b).

\hspace{1em}\textsuperscript{142} CFTC Domestic Exchange-Traded Commodity Option Transaction Disclosure, 17 C.F.R. § 33.7(b) (2006) (emphasis in original); see also CFTC Leveraged Transactions Disclosure, 17 C.F.R. § 31.11 (2006).
The disclosure states that only persons who understand the disclosure statement and the risks involved should enter into such transactions.\textsuperscript{143}

Whether it is the general disclosure statement required by CFTC Rule 1.55 or the more specific disclosures for commodities options and leverage transactions, in each case the risk disclosure on its face explicitly shifts the burden of making a suitability determination to the customer. The only distinction between the two is formatting. The disclosure rule puts the investor on notice that suitability is an issue and then says to the investor: you decide whether the transactions are suitable for you, and you decide whether you understand them.\textsuperscript{144}

CFTC commentary, however, suggests that commodity professionals may be required to do more than simply provide the risk disclosure statement. In adopting regulations governing domestic exchange-traded commodities options, the CFTC described the risk disclosure statement as "only one element of the informational duty" of a futures commission merchant.\textsuperscript{145} According to the CFTC, commodity professionals must learn about the customer in order to provide sufficient risk disclosure and make "every reasonable effort" to see that options customers are informed as to the risks:

Thus, the FCM must acquaint itself sufficiently with the personal circumstances of each option customer to determine what further facts, explanations and disclosures are needed in order for that particular option customer to make an informed decision whether to trade options . . . .\textsuperscript{146}

The CFTC stated that while this requirement was not a "suitability" rule, before opening an option account the FCM has a duty to learn the personal circumstances of an option customer:

The procedures to be followed by the prudent FCM in ascertaining those personal circumstances may require an FCM to make an inquiry into an option customer's financial situation as well as an option customer's market sophistication for the purposes of determining to what extent risk disclosure above and beyond the disclosure statement itself might be advisable.\textsuperscript{147}

In short, when the CFTC adopted its exchange-traded commodities option regulations and disclosure requirements in 1981, it rejected a suitability rule but suggested in its discussion of risk disclosure that there is an implicit "know your customer" requirement in the disclosure regulation. This "know your customer" requirement in turn requires an assessment of the investor's finances, sophistication, an ability to understand the transaction, and an explanation tailored to the customer. In its interpretation of disclosure, the CFTC has imposed a requirement that the commodity professional make a suitability determination in order to provide a suitable explanation, without having that suitability deter-

\textsuperscript{143} 17 C.F.R. § 33.7(b) (2006).
\textsuperscript{144} Commodities investment advisors state up front that: "A trading plan needs a good foundation. The place to begin is with a complete review of your financial suitability for trading by determining your net worth and liquid assets. . . . You need to consider the nature and the amount of risk that you are willing to take." Diane Krueger, Developing a Trading Plan, FUTURES, Nov. 1, 2000, at 70.
\textsuperscript{146} Id.; see also MARKHAM, supra note 15, § 10.4.
\textsuperscript{147} Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. at 54,507.
mination determine whether the recommendation can reasonably be made in the first place.\textsuperscript{148}

B. Suitability, the CFTC, and the Federal Courts

The above CFTC risk disclosure and anti-fraud provisions form the basis for the CFTC's enforcement actions and for CFTC resolution of claims brought by investors.\textsuperscript{149} The CFTC differs from the SEC in that it offers investors the option of petitioning the CFTC for an award of damages arising from an alleged violation of the CEA or associated regulations.\textsuperscript{150} In its "reparations program" investors can file a complaint with the CFTC, and have an administrative law judge ("ALJ") hold a hearing and issue a decision containing findings of fact and conclusion of law.\textsuperscript{151} Both enforcement actions and reparations decisions show a similar progression.

Early on, the CFTC brought enforcement actions against commodities options boiler rooms, and the courts showed every indication of interpreting the anti-fraud provisions of the CEA broadly. "Just as the federal securities laws are intended to do, the 1974 Commodities Act amendments are meant to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the [commodities] industry."\textsuperscript{152} CFTC Rule 32.9, the rule regarding fraud in connection with commodities options, is "as broad as, if not broader than, Rule 10b-5," and the rule "should be read so as to affect the purposes of the Act and the policies of the Commission . . . [C]ases decided under the anti-fraud provisions of the securi-

\textsuperscript{148} According to Professor Markham, this interpretation "is, in effect, a 'modified' form of suitability designed to assure proper disclosure. But, it does not impose an obligation on a broker to make a subjective determination that an investment is appropriate for a particular customer." Markham, supra note 15, § 10.4.


\textsuperscript{150} 7 U.S.C. § 18 (a)(1)(A)-(B) (2000). The Commission may order an award of "actual damages proximately caused by such violation," as well as "punitive or exemplary damages equal to no more than two times the amount of such actual damages" if the action arises from any "willful and intentional violation in the execution of an order on the floor of a registered entity . . . ." The action must be brought "within two years after the cause of action accrues." Id. at § 18(a)(1)(A), (B).


\textsuperscript{152} Kelley v. Carr, 442 F. Supp. 346, 358 (W.D. Mich. 1977) (quoting SEC v. Capital Gains Bureau, 375 U.S. 180, 186 (1963) and explaining that "selling techniques that are aimed to snow the unsophisticated customer 'into parting with funds, often borrowed, which they could ill afford to invest even in far safer enterprises,' have no place in a regulated industry." (quoting SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1244 (S.D.N.Y. 1976))).
ties acts are instructive.” These decisions went on to impose injunctions summarily against commodity professionals who recommended, inter alia, commodities options “without regard to the suitability of the investment for the customers” or “without regard to the suitability to the needs of the customer.” CFTC administrative opinions similarly imposed sanctions and civil monetary penalties based in part on commodity professionals soliciting “as many prospective investors as possible without regard to the suitability of commodity options as an investment for prospective investors.”

Early reparations decisions held open the possibility of a suitability requirement. One decision found the claimant was a “college student with no income, extremely naïve . . . and from any ethical standpoint totally unsuited to leverage transactions.” Another decision found the claimant stated a cause of action based solely on lack of suitability and the respondents “breached their fiduciary duty by . . . urging complainant to purchase a dealer option at which time the respondents knew the complainant’s physical and mental condition.”

Other administrative law judges, however, sought to avoid the issue, noting in one instance that the claimant was an immigrant with limited English skills, a house painter by trade, with the salary of $12,000 and no understanding of futures markets, but that the “customer’s suitability need not be addressed” because of the respondent’s misrepresentations about “imminent profits.” Others simply found the transaction suitable or rejected outright the imposition of any suitability requirements.

Two decisions brought the issue to a head. In Hannay v. First Commodity Corporation of Boston, an administrative law judge found that the complainant

154 Crown Colony Commodity Options, Ltd., 434 F. Supp. at 918; Kelley, 442 F. Supp. at 350. See also Markham, supra note 15, § 10.4.
155 In re London Commodity House, Inc., CFTC Docket No. 77-4, 1977 WL 13535, at *2. Compare In re Anthony Luizzi, CFTC Docket No. 78-53, 1981 WL 26079 (Administrative complaint rejected by the CFTC seeking to revoke the registration of a floor broker based, inter alia, on recommendations to engage in commodity futures trading “knowing that such trading was unsuitable”).
160 In re Luizzi, 1981 WL 26079, at *2 (holding that “[n]either the Commission nor the courts have accepted a suitability standard within the anti-fraud scope of the Commodity Exchange Act. Significantly the Commission proposed but declined to adopt a suitability rule. The lack of objective standards of suitability and the corresponding risk of liability that the adoption of such an unclear and evanescent standard would present prevents us from finding that Luizzi violated the Act by accepting Mrs. Dwyer as a customer.”).
was made aware of the risks and was "on notice that he could lose his entire investment and more," and that the respondent "made a conscientious effort to trade this account in the best interests of his customer." In other words, there was risk disclosure and no attempt to defraud the customer. The ALJ went on, however, to ask "more fundamental questions":

Was it right, or was it legal, for respondents to solicit a 71 year old novice to invest 90 percent of his liquid assets in a commodity venture and charge this elderly customer 60% of his out-of-pocket investment in commissions? Was it right, or was it legal, for respondents to encourage, or fail to discourage, this elderly customer from exposing himself to enormous risk?

I think not.

The ALJ found respondent's recommendations unsuitable, a reckless breach of the fiduciary duty owed to the customer, and a violation of Section 4b of the CEA.

In Phacelli v. ContiCommodity Services, Inc., the ALJ similarly rejected all of complainant's claims, save suitability. The ALJ reviewed the CFTC's proposed suitability rule, the CFTC's earlier decisions, and its definition of fiduciary and concluded that "suitability is implicit in the antifraud provisions of the Act, and has not been abrogated." The ALJ found Phacelli, a fifty-seven-year-old disabled carpenter with a low fixed income, disability, and limited savings, unsuitable for commodities trading and entitled to compensation.

The CFTC took issue with both opinions in Phacelli v. ContiCommodity Services, Inc. On appeal, it held:

The Commission's adjudicatory opinions have consistently declined to read into Section 4b of the Act, a requirement that commodity professionals determine a customer's suitability to trade futures contracts. The courts have also recognized that no suitability requirement presently governs commodities futures trading. Based on commission precedent and the great weight of authority in the courts, we hold that a commodity professional does not violate Section 4b merely because he fails to determine whether a customer is suitable for commodity trading.

According to Phacelli, the CEA is not "indifferent" to the individual characteristics of the customer. Some courts have found "overreaching" equivalent to fraud, and, in analyzing reliance in fraud cases, courts have "long recognized" that "people who are exceptionally gullible, superstitious, ignorant, stupid, dim-witted, or illiterate have been allowed to recover when the defendant knew it, and deliberately took advantage of it." In Phacelli, however,

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162 Id. at *4. See also Phacelli v. ContiCommodity Servs., Inc., CFTC Docket No. 80-385-80-704, 1984 WL 47924.
164 Id. at *11.
165 Id. at *12-17.
166 Id. at *17.
167 Id. at *1.
168 Id. at *5-8.
169 Id. at *8.
170 Id. (quoting W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 751 (5th ed. 1984)).
there was no evidence of "overreaching" and no affirmative misrepresentation or omission giving rise to an analysis of the investor's reliance.\textsuperscript{171}

The CFTC found that the initial \textit{Phacelli} decision rested solely on the suitability of the recommendations, reversed, and dismissed the complaint.\textsuperscript{172} It found the initial \textit{Hannay} decision "may have intended to" award reparations based in part on a traditional fraud analysis and remanded for further proceedings.\textsuperscript{173} With \textit{Phacelli}, the CFTC explicitly rejected a suitability requirement under the CEA and offered, in its stead, recognition that some transactions may be unconscionable and, in fraud cases, that the reasonableness of the investor's reliance may depend on her characteristics as an investor.\textsuperscript{174}

With \textit{Phacelli}, the lines were drawn. Some ALJ decisions now routinely and summarily reject any claim smacking of suitability.\textsuperscript{175} Others now expansively interpret disclosure requirements and work very hard to "find a misrepresentation where they think the customer is unsuitable."\textsuperscript{176}

Immediately after \textit{Phacelli}, the basis for liability in \textit{Hannay} switched from suitability to material misrepresentations of the profitability of trading and the degree of risk.\textsuperscript{177} In \textit{Edwards v. Balfour Maclaine Futures, Inc.}, an ALJ, "conceding that this Commission has no suitability rule," nonetheless found "that respondent's acceptance of this septuagenarian as a customer suggests that these respondents have a callous, contemptuous view of the law and the disregard for the welfare of senior citizens with limited income and resources."\textsuperscript{178} The ALJ went on to hold that:

Disclosure of material facts is more than merely passing out forms to potential customers. Little more would be required in dealing with a sophisticated, experienced and relatively affluent person. However, in soliciting elderly, unsophisticated, and less affluent persons, as in the instant case, greater disclosure must be made.\textsuperscript{179}

In other words, the ALJ held, as the CFTC suggested in its comments on commodities options disclosure, that legally adequate disclosure requires consideration of the suitability characteristics of the customer and a tailored duty to explain.

\textsuperscript{171} \textit{Id.} at *8-9.
\textsuperscript{172} \textit{Phacelli}, 1986 WL 68447. at *9.
\textsuperscript{173} \textit{Id.}
\textsuperscript{174} \textit{Id.} \textit{See also} \textsc{Peter A. Alces, Law of Fraudulent Transactions} § 3:11 (2006) (citing U.C.C. § 2-302 and stating that it "provides that a court may adjust the term of the sales contract after the fact if there has been unconscionable overreaching by one of the parties" to a sales contract and that the courts have identified two types of unconscionability, procedural and substantive, and for the former considered factors including "age, education, intelligence, business acumen and experience of the parties; the relative bargaining power; the consciousness of the contract language; ... the oppressiveness of the terms; and the presence or absence of meaningful choice").
\textsuperscript{175} \textsc{Markham, supra note 15, § 10.7.}
\textsuperscript{176} \textit{Id.}
\textsuperscript{178} CFTC Docket No. 93-R005, 1993 WL 193896, at *1, \textit{rev'd}, 1994 WL 267438 (finding claims time barred).
\textsuperscript{179} \textit{Id.} at *3.
The CFTC affirmed a similar analysis in *Nobrega v. Futures Trading Group, Inc.* In *Nobrega*, the ALJ found the complainant was permanently disabled, being treated for depression and anxiety, and had begun investing in futures "to provide for his disabled daughter with major medical and education needs, while on a relatively limited disability income himself." The ALJ found that the claimant had informed his broker that he was counting on him in order to purchase a wheelchair lift for his disabled daughter, and the broker had breached his duty by merely repeating that profits were not guaranteed.

The ALJ acknowledged at the outset that the CEA has "been definitively interpreted as not including a general duty to inquire into a customer’s suitability to trade futures," but found the act was not indifferent to the individual characteristics of the customer. Nobrega was ignorant of the risks of trading and the issue was "simply whether Weisser, intentionally or recklessly, disregarded information that should have alerted him to Nobrega’s unrealistic profit expectations and lack of true appreciation of risk." The ALJ found, "[s]imply put, a broker has a duty to correct a customer’s erroneous beliefs about trading risks or expected profits when, as here, the broker becomes aware of those beliefs. Where, as here, reminders of previous warnings do not correct the customer’s delusions, the broker is responsible for taking additional action."

On appeal the CFTC reversed, but it did so without rejecting the ALJ’s legal analysis imposing a duty to correct a customer’s erroneous beliefs. The CFTC found that Nobrega was entitled to a rebuttable presumption that he would have relied on the information that should have been disclosed: "that options trading is too inherently risky to be a source of funds to pay for a medically-related need." In other words, the CFTC accepted the ALJ’s focus on Nobrega’s unsuitability for trading commodities options and imposed a duty to correct Nobrega’s misunderstanding of the risk. The CFTC stated unequivocally that commodity professionals must inform investors in like circumstances that "options trading is too inherently risky” to pay medical bills.

At the same time, other reparations decisions focus on suitability characteristics not to justify enhanced disclosure requirements, but as part of a science and reliance inquiry in the context of a misrepresentation analysis. The focus on the claimant’s suitability, or lack of suitability, however, remains the same.

In *Modlin v. Cane*, the complainant began trading after listening to an infomercial on CNBC and calling an advertised number. The ALJ found the

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182 *Id. at* *1-3.
183 *Id. at* *11-12.
184 *Id. at* *9-10.
185 *Id. at* *10.
186 *Id. at* *11.
187 *Nobrega*, 2000 WL 1460081, at *11 (finding that the damages were not proximately caused by the broker’s failure to inform Nobrega of the risk).
respondent fraudulently induced "an unsophisticated investor" to open and continue to trade two commodities futures accounts; the ALJ went on to examine whether Modlin justifiably relied on the broker:

Modlin has a high-school education and had never traded commodities before his dealings with Cane. Modlin clearly expressed to Cane his lack of knowledge about commodities and indicated that he intended to rely entirely on his broker if he opened an account. Cane took advantage of Modlin's naivete and ignorance. Under these circumstances, Modlin's reliance on Cane's reassurances and misrepresentations is clearly justifiable.

The CFTC affirmed the ALJ award emphasizing that the reliance was justifiable: the investor was unsophisticated and had a limited understanding of futures trading. The respondent, in turn, had fostered a relationship of trust and confidence and knew that the investor had no futures experience, limited investment experience, and could not evaluate the solicitation. The CFTC focuses here on claimant's suitability characteristics in making a determination as to the investor's reasonable reliance and the respondent's scienter.

This indirect focus on suitability comes up repeatedly. In Sanchez v. Crown, the complainant was a sixty-seven-year-old, semi-retired laborer with a high school education and an income under $10,000, who purchased unleaded gas commodity options after watching another infomercial. The ALJ found the respondent intentionally defrauded Mr. Sanchez by "providing a heavily lopsided picture of the relative risks and rewards of following ITG's trading advice and by pushing the purchase of deep-out-of-the-money options in order to generate excessive commission income." The ALJ rejected the respondent's justification for the transactions because the transactions "cannot be jus-

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189 Id. at *6-7.
190 Id. at *14.
191 Id. at *8-9.
192 Id.
193 See also Bruggeman v. Broadstreet Fin. Corp., CFTC Docket No. 01-R105, 2004 WL 433690, at *8 ("The intentional nature of Fisher's fraud is underscored by Fisher's knowledge that Bruggeman was an inexperienced and unsophisticated novice of modest financial means who relied on him to provide fair and reasonable trading advice, Fisher's knowledge that Bruggeman was investing retirement funds and thus understandably concerned about losses, and Fisher's knowledge that Bruggeman believed Siegel's false message that FSG only recommended safe trades . . . ."); Tymniak v. Murls Commodities, Inc., CFTC Docket No. 88-R36, 1989 WL 242101, at *1 (finding all complainants were immigrants, with "noted English language difficulty;" one was seventy-seven years of age and retired with an annual income of $9,000; one worked as a salesman with an annual income of $8,000 to $19,500; and one was employed as a production worker earning $14,000 annually; none with any training or education in finance or investments, none with any prior experience in futures or options transactions).
195 Id. at *20; see also New York Mercantile Exchange Rule 300.10(B), available at http://www.nymex.com/rule_main.aspx?pg=38#300.10 (last visited May 29, 2007) (defining a deep-out-of-the-money options as "an option whose strike price is more than X strike prices distant from the strike price closest to the price of the price of the underlying futures contract, when X equals two(2) plus the number of calendar months remaining to option expiration . . . .")
tified for Sanchez whose trading objective included, at a minimum, a reasonable chance of profit with a reduced risk tolerance.\textsuperscript{196}

The CFTC affirmed the award, noting that Sanchez had disclosed that he was poorly educated, had held menial jobs, was unemployed, and had little investment experience.\textsuperscript{197} The CFTC noted that the respondent emphasized profits, rushed him through the account opening, and failed to provide the full required risk disclosure statement, but again it emphasized:

Sanchez had not traded futures or options before and his investment experience was limited to buying and selling his residence and investing in a bank-sponsored mutual fund. He had little formal education and had not worked in jobs that exposed him to financial instruments and their risk. Accordingly, he had nothing in his own background to draw on to evaluate the risk. . . . Therefore, we find that Sanchez relied on the nondisclosure in opening his account.\textsuperscript{198}

In both the ALJ and CFTC opinions, liability is premised on non-disclosure and misrepresentation about risk, but both recite facts focused on suitability. The ALJ noted Mr. Sanchez’s lack of education, lack of assets, and lack of understanding and rejected the respondent’s arguments given Mr. Sanchez’s “trading objective” and “reduced risk tolerance.”\textsuperscript{199} The CFTC found that Mr. Sanchez had little investment experience, little education, and an inability to evaluate the risk, and, as a result, his reliance on the broker’s nondisclosure of the risk was reasonable.\textsuperscript{200} The CFTC is now highlighting traditional suitability factors in finding fraud based on a failure to disclose.

Not all decisions involve such clearly unsuitable investors, but a surprising number do involve suitability determinations. Since the \textit{Phacelli} decision, respondents have continued to argue and decisions have continued to find that the claimant “was suitable” for the trades recommended, and, as a result, there were no violations of the Act or regulations.\textsuperscript{201} ALJs have engaged in what one Commissioner has termed a “reverse suitability” analysis: despite the CFTC’s rejection of any implicit suitability requirements under the CEA, they consider the investor’s suitability in rejecting liability.\textsuperscript{202} Commissioner West has protested:

I find it inconsistent to apply a suitability standard after the loss to disqualify some customers from recovery of their losses. Doctors, lawyers, dentists and educated customers of all sorts may be the victims of fraud. A customer with a college degree should not be a free ride for those brokers who use fraud to solicit their customers.\textsuperscript{203}

\textsuperscript{196} Sanchez, 2003 WL 21196530, at *22.


\textsuperscript{198} Id. at *6.

\textsuperscript{199} Id.

\textsuperscript{200} Id.


\textsuperscript{203} Id. . See also In re Keith Gordon, CFTC Docket No. 90-19, 1993 WL 80512, at *4 (quoting ALJ opinion that although the suitability of the customers is not a consideration
The end result is that while the CFTC retreated from its proposed suitability rule in 1977, and definitively rejected in Phacelli its earlier suggestion that a suitability requirement is implicit in the CEA, suitability issues remain and a suitability determination made by the CFTC is commonplace. It happens, however, under the rubric of disclosure: it takes the form of enhanced disclosure requirements so that commodity professionals are required to provide unsuitable investors additional risk disclosure, explain the risks, and, in some cases, tell customers futures transactions are "too risky" for them. It also happens under the rubric of a fraud analysis that focuses on the elements of scienter and reliance: the more unsuitable the investor, the clearer the evidence of scienter on the part of the commodity professional presenting a lopsided picture of the risks and then reasonable reliance by the investor. Finally, it happens when ALJs reject claims based on the investor's sophistication.

The federal courts have not provided the same level of analysis, but almost uniformly and most summarily, they adopt the position of the CFTC holding that the anti-fraud provisions within the CEA do not impose a suitability requirement.204 As discussed above, in reviewing early CFTC enforcement actions, some courts upheld sanctions based, in part, on the commodity professionals' disregard of the unsuitability of the recommendations. In doing so, they suggested that CFTC anti-fraud provisions are "as broad as, if not broader than, Rule 10b-5," and "cases decided under the anti-fraud provisions of the securities acts are instructive."205 Later decisions, however, have specifically disavowed any suggestion that suitability requirements recognized under the Securities Exchange Act offer any support for the imposition of a similar requirement under this CEA.206 They have relied on what one court has described as a false syllogism: the CFTC considered adopting a suitability rule; it did not adopt such a rule; therefore, the CFTC rejected the notion that the CEA embraces the suitability doctrine — and that settles the matter.207

A federal district court in Bieganek v. Wilson offered more than this syllogism, noting that while the CFTC declined to adopt a general suitability rule in 1978, it did not reject application of the suitability doctrine finding it already implicit in the CEA.208 Biegnak did not, however, differ in result. It found that the CFTC had retreated from its stance in 1978 and the legislative history did not "specifically" support recovery on a suitability theory: "Lacking any guidance from Congress, and clear signals from an administrative agency with expertise in the area, we decline to be the first court to hold that the CEA implicitly imposes a suitability rule on brokers."209 Other courts have followed

here, ""somewhat in mitigation . . . the customer witnesses at least had reasonable educations and some of investment background.").

204 Markham, supra note 15, at § 10.8.
208 Id.
209 Id. at 774.
suit and simply "determined that there is no suitability rule under the Commodity Exchange Act."\textsuperscript{210}

The end result is that under the CFTC's purview, ALJs couch suitability issues in terms of enhanced disclosure requirements and a misrepresentation analysis. The CFTC acknowledges that disclosure can require admonitions to the investor that commodities trading is "too risky," but there is no suitability requirement. The federal courts have simply followed suit.\textsuperscript{211}

\section*{C. Suitability and the National Futures Association}

The National Futures Association (NFA) is a self-regulatory organization, authorized as a "registered futures association" pursuant to the CEA.\textsuperscript{212} It is the counterpart to the NASD, overseeing the 4200 firms and 55,000 associates in the futures industry.\textsuperscript{213}

In 1985, while Phacelli was pending, the CFTC wrote the NFA inquiring of "any efforts NFA may be pursuing with respect to professional conduct standards, including but not limited to practices commonly referred to as suitability or 'know-your-customer rules'."\textsuperscript{214} The CFTC followed this in 1986, in Phacelli, finding that "[e]ven if a suitability requirement could be grounded in some other provision of the Act . . . we believe that the fashioning of a workable requirement and creation of the guidelines that would determine its scope and practical impact on commodity professionals and customers would be better done on an industry-wide generic basis than through the reparations process."\textsuperscript{215}

That year, the NFA adopted NFA Rule 2-30: Customer Information and Risk Disclosure.\textsuperscript{216} The rule added for the first time a "know your customer"

\begin{thebibliography}{9}
\bibitem{211} State courts have reached similar results. See, e.g., Puckett v. Rufench, Bromagen & Hertz, Inc., 587 So. 2d 273, 279 (Miss. 1991) ("[A] commodities broker in a non-discretionary account only owes his customer the duty to properly execute trades as directed by him, and has no further duty to call upon his own professional skill and prudence as to the wisdom of any of his customer's trades."); Sherry v. Diercks, 628 P.2d 1336, 1341 (Wash. Ct. App. 1981) ("A broker whose client maintains a nondiscretionary account has no common law duty to ascertain the suitability of a customer to make investments.").
\bibitem{213} Id.
\bibitem{214} Letter from John A. Webb, Secretary of CFTC, to Joseph H. Harrison Jr., General Counsel and Secretary NFA (Feb. 1, 1985), quoted in MARKHAM, supra note 15, §10.9.
\end{thebibliography}
requirement. Pursuant to this rule, each Member "shall exercise due diligence" to "obtain information about its futures customers who are individuals and provide such customers with disclosures of the risks of futures trading." The information to be obtained includes: (1) the customer's name, address, and principal occupation or business; (2) estimated annual income and net worth; (3) approximate age; and (4) an indication of previous investment futures trading experience.

This requirement, in and of itself, is hardly remarkable. The rule, however, establishes a separate set of requirements for transactions involving securities futures products and is accompanied by two interpretive notices, both of which are remarkable.

A June 1, 1986 interpretive notice makes clear that while NFA Rule 2-30 is a "know your customer rule," it is not like the NYSE know your customer rule: "it does not require the Member or Associate to make a final determination that a customer should be barred from futures trading on suitability grounds." The interpretive notice, as much as anything, sets out the NFA's argument for why a suitability rule is not appropriate for the futures markets: "The futures industry differs from the securities industry." While different types of securities have varying degrees of risk and serve different investment objectives, futures contracts in general are highly volatile and it "makes little sense to presume that a certain futures trade may be appropriate for a customer while others are not. An appreciation of the risks of futures trading must be gained and a determination of its appropriateness made at the time each customer makes a decision to trade futures in the first place." Based on these two observations, the NFA concludes:

The futures industry has traditionally met this need through risk disclosure designed to encourage the customer to make an informed decision as to whether futures trading is suitable for that customer. The Risk Disclosure Statement and the Options

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218 NFA, Rule 2-30, Customer Information and Risk Disclosure, supra note 218.

In addition, Members that are not also members of NASD Regulation, Inc. and their Associates must obtain the following information from each customer who is an individual if the customer trades securities futures products: (5) whether the customer’s account is for speculative or hedging purposes; (6) the customer’s employment status (e.g., name of employer, self-employed, retired); (7) the customer’s estimated liquid net worth (cash, securities, other); the customer’s marital status and number of dependents; 9) such other information used or considered to be reasonable by such Member or Associate in making recommendations to the customer.

Id.

219 Id.

220 NFA's Interpretive Notice (June 1, 1986), supra note 219.

Rule 2-30 is a 'know your customer' rule; however, it does not require the Member or Associate to make the final determination that a customer should be barred from futures trading on suitability grounds. Some "know your customer" rules in the securities industry (New York Stock Exchange Rule 405, for example) have been construed in that manner; these interpretations do not applied to Rule 2-30.

221 Id.

222 Id.
Disclosure Statement mandated by CFTC Regulations... each are designed to bring the suitability issued to the customer’s attention.\textsuperscript{223} 

In its interpretive notice, the NFA offers tradition as the rationale for dismissing an independent suitability requirement, and it adds reliance on the CFTC. As discussed above, when the CFTC declined to adopt its proposed “suitability” rule, it stated that it was unable “to formulate meaningful standards of universal application.”\textsuperscript{224} While Professor Markham found this excuse contrived, the NFA found it persuasive:

NFA found the same difficulty, and for that reason the Rule is premised on NFA’s conclusion that the customer is in the best position to determine the suitability of futures trading if the customer receives an understandable disclosure of risks from a futures professional who “knows the customer.”\textsuperscript{225}

What the NFA offers is tailored risk disclosure. According to the NFA, the CFTC risk disclosure documents provide the minimum required:

[T]he decision with respect to what additional disclosure, if any, should be given to the customer is best left to the Member. . . . There may be some customers for whom the additional disclosure will portray futures trading as too risky for that customer . . . [W]ho those customers are cannot be made except on a case-by-case basis, because no objective criteria can be established that will apply to all customers.\textsuperscript{226}

In June, 1999, Daniel Roth, then vice president and now president of the National Futures Association, testified before Congress and concluded that despite the NFA’s explicit rejection of a suitability rule, the NFA’s “know your customer” rule and a suitability rule are functionally equivalent. According to Mr. Roth, because futures and options contracts all involve substantial risk, “[t]he more appropriate focus in the futures industry is on whether the customer should be trading futures at all.”\textsuperscript{227} As part of this inquiry,

NFA’s rule requires the Member firm obtain the same type of information about the customer that suitability rules require. If the customer has no business trading in these markets, the firm has to tell him exactly that. In short, the differences between suitability rules and our Know Your Customer Rule are not significant and the basic type of protection afforded by each is the same.\textsuperscript{228}

The second, July 1, 2000, interpretive notice reiterates that the NFA’s “know your customer rule” may require a member provide additional risk disclosure including informing a prospective customer that futures are too risky:

The heart of Rule 2-30 is the requirement that Members obtain certain basic information from the customer concerning his financial background, analyze that information and ensure that the customer has received adequate risk disclosure . . . . [S]ome customers may require risk disclosure in addition to that specifically prescribed . . .

\textsuperscript{223} \textit{Id.}
\textsuperscript{225} \textit{Id.}
\textsuperscript{226} NFA’s Interpretive Notice (June 1, 1986), \textit{supra} note 219.
\textsuperscript{228} \textit{Id.}
[T]here may be instances where, for some customers, the only adequate risk disclosure is that futures trading is too risky for that customer.\textsuperscript{229}

Where an associated person ("AP")\textsuperscript{230} solicits a couple without prior investment experience who informed the AP that they could not afford the minimum investment, additional risk disclosure is required.\textsuperscript{231} Where an AP solicits a seventy-seven-year-old who stated that he and his wife were in ill health and one of his reasons for investing in futures was his desire to earn money to pay for his medical expenses, additional risk disclosure is required.\textsuperscript{232}

The catch with NFA Rule 2-30 is that, according to the NFA, the need for additional risk disclosures does not result in additional liability. From the outset, the NFA sought explicitly to foreclose civil liability arising from its newly enacted "known your customer" rule.

NFA's enactment of the Rule 2-30 should not be construed to expose Members to increased potential liability for damages in customer litigation or reparation proceedings. [It is a] business conduct standard [that does not] create a private right of action . . . . [It is] not an anti-fraud rule . . . to the extent that personal information about a customer is germane to the issues in a reparation or arbitration case, it is undoubtedly already beingen considered even in the absence of a formal rule requiring Members to obtain it.\textsuperscript{233}

The July 1, 2000 interpretive notice describes the two objectives of the rule as defining "high standards of commercial honor and just and equitable principles of trade" and providing "a useful tool to combat any unscrupulous firms attempting to take advantage of unsophisticated investors."\textsuperscript{234} The intent was, in response to CFTC inquiries, to provide an enforcement tool against those who take advantage of unsophisticated investors, but not a civil remedy.

To conclude that the NFA rejected suitability, argued to Congress that its "know your customer rule" was the functional equivalent of a suitability rule, tried to preclude additional civil liability, and that's that, however, is premature.

In December 2000, Congress enacted the Commodities Futures Modernization Act ("CFMA"). The CFMA amended the Commodities Exchange Act to, inter alia, clarify the Act's application to off-exchange trading in foreign currency futures and options. Thereafter, the NFA adopted Requirements for Foreign Currency Futures or Options Transactions and followed with an Inter-


\textsuperscript{230} The CFTC Glossary defines "Associated Person" (AP) as "[a]n individual who solicits or accepts (other than in a clerical capacity) orders, discretionary accounts, or participation in a commodity pool, or supervises any individual so engaged, on behalf of a Futures Commission Merchant, an Introducing Broker, a Commodity Trading Advisor, a Commodity Pool Operator, or an Agricultural Trade Option Merchant." CFTC Glossary, supra note 138.

\textsuperscript{231} NFA's Interpretive Notice (Staff, Nov. 30, 1990; revised July 1, 2000), supra note 231.

\textsuperscript{232} Id.

\textsuperscript{233} NFA, Rule 2-30 Interpretive Notice (June 1, 1986), supra note 219.

\textsuperscript{234} NFA Rule 2-30 Interpretive Notice, Customer Information and to Risk Disclosure (Staff, Nov. 30, 1990; revised July 1, 2000), supra note 231.
pretive Notice titled “Forex Transactions with Forex Dealer Members.” The Rule and Interpretive Notice apply only to retail customers and are intended to “provide adequate protection for retail customers without imposing undue burdens on NFA Members.” The Interpretive Notice again focuses on the NFA “know your customer” rule:

Members and Associates have a duty to acquaint themselves sufficiently with the personal and financial circumstances of each [retail] forex customer to determine what further facts, explanations and disclosures are needed in order for the customer to make an informed decision on whether to enter into forex transactions. The Regulatory Guide provides examples:

* [I]f a customer does not have experience trading forex, you must determine what additional information the customer needs to make an informed decision on whether to enter into forex transactions. In some circumstances (e.g., if the customer is living on social security or is looking for a safe investment), you may even have to tell the customer that forex trading is too risky for that particular customer.

Again, NFA members have a duty to know their customers and in some circumstances a duty, framed as a disclosure requirement and not a suitability requirement, to tell their customers that “forex trading is too risky.”

The 2000 CFMA also authorized securities futures products, futures contracts on single securities, and certain indices. Unlike other futures, however, the CFMA provides that securities futures products are both securities and futures, regulated by both the CFTC and SEC. As a result, the “NFA

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Id.

At a minimum, the Member soliciting the [retail] customer to engage in forex transactions with a Forex Dealer Member should obtain the customer’s name, address, principal occupation or business, current estimated annual income and net worth, approximate age, and an indication of the customer’s previous investment and trading experience. Members and their Associates need to ensure that each [retail] customer they solicit has received adequate information concerning the risks of forex transactions so that the customer can make an informed decision as to whether forex transactions are appropriate for the customer.

Id.

237 Id.

238 NFA, RETAIL FOREX TRANSACTIONS: A REGULATORY GUIDE, supra note 237, at 5.

239 NFA, SECURITIES FUTURES PRODUCTS: A REGULATORY GUIDE (2004), available at http://www.nfa.futures.org/compliance/publications/sfp/sfp_web.pdf. Indices regulated both as futures and securities are “narrow-based indices” such as an index allowing an investor to trade on a specific market sector. It does not include “broad-based indices” such as the Dow Jones Industrial Average, Nasdaq, NYSE Composite, or the S & P 500, which trade on futures exchanges and are regulated only by the CFTC. Id. at 1-2. Narrow-based securities indices are defined further in 7 U.S.C. § 1a(25) (2000).

240 NFA, SECURITIES FUTURES PRODUCTS: A REGULATORY GUIDE, supra note 241, at 1. A securities futures product is defined by the Commodities Exchange Act as “a security future or any put, call, straddle, option, or privilege on any security future.” 7 U.S.C. § 1a(32) (2000). A “security future” is defined as “a contract of sale for future delivery of a single
became a national securities association for the limited purpose of regulating ... members ... registered as brokers or dealers in securities futures.\textsuperscript{241} The NFA, which had made clear that Rule 2-30 was not a "suitability" rule, added a "suitability" rule for securities futures products.\textsuperscript{242} It revised Rule 2-30 to expressly incorporate suitability requirements modeled after the NASD suitability rule for options discussed above.\textsuperscript{243}

If the customer trades securities futures products, NFA members must "exercise due diligence" to learn additional "essential facts," including the customer's investment objectives, employment status, estimated liquid net worth, marital status, and number of dependents, and such other information considered reasonable in making recommendations to the customer.\textsuperscript{244} For non-discretionary accounts, no commodity professionals shall recommend to a non-institutional customer securities futures products "without making reasonable efforts to obtain current information regarding the customer's financial status and investment objectives."\textsuperscript{245}

No commodity professional shall recommend securities futures products "without reasonable grounds for believing that the recommendation or strategy is not unsuitable for the customer on the basis of the customer's current investment objectives, financial situation and needs, and any other information known . . . ."\textsuperscript{246} Finally, no commodity professional shall recommend a securities futures transaction unless the person making the recommendation has a reasonable basis for believing that the customer has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction and is financially able to bear the risks of the recommended transaction.\textsuperscript{247}

According to NFA Rule 2-30, members must approve or disapprove the customer's account for securities futures transactions in writing and forward the background and financial information upon which the customer's account has been approved to each customer, unless the information has been obtained in writing from the customer.\textsuperscript{248}

The end result is that commodity professionals now are subject to a suitability rule when they recommend securities futures products, much like the one found in the securities industry regulating options transactions. Commodity professionals now are subject to, maintain records for, and ensure compliance security or of a narrow-based security index, including any interest therein or based on the value thereof," excepting certain securities exempted under Section 3 (a)(12) of the Securities Exchange Act of 1934 and certain contracts or transactions excluded under the Commodities Exchange Act and the Commodities Futures Modernization Act. Id. § 1a(31).\textsuperscript{249}

\begin{itemize}
\item \textsuperscript{241} NFA, SECURITIES FUTURES PRODUCTS: A REGULATORY GUIDE, supra note 241, at 1.
\item \textsuperscript{242} Id. at 7, 8.
\item \textsuperscript{243} Id. at 8; Testimony of Daniel J. Roth, supra note 229.
\item \textsuperscript{244} NFA, SECURITIES FUTURES PRODUCTS: A REGULATORY GUIDE, supra note 241, at 7; NFA Rule 2-30 Customer Information and Risk Disclosure, supra note 218, at (c).
\item \textsuperscript{245} NFA Rule 2-30 Customer Information and Risk Disclosure, supra note 218, at 2-30(j)(3).
\item \textsuperscript{246} Id. at 2-30(j)(4).
\item \textsuperscript{247} Id. at 2-30(j)(5); see also NFA, SECURITIES FUTURES PRODUCTS: A REGULATORY GUIDE, supra note 241, at 8.
\item \textsuperscript{248} NFA Rule 2-30 Customer Information and Risk Disclosure, supra note 218, at 2-30(j)(4)-(5).
\end{itemize}
with two different sets of standards, depending on which futures product is recommended.

D. Arbitration and the National Futures Association

The National Futures Association, like other SROs also maintains an arbitration forum for resolution of futures-related disputes, and NFA Arbitration, like NASD Arbitration, is now the primary forum for dispute resolution. According to the Procedural Guide for NFA Arbitrators, the NFA provides an award form and "[t]he award is to state the result and should not include reasons for the decision." The instructions precluding arbitrators from providing reasoned awards obviously limits their review.

The NFA Arbitration Manual does, however, discuss suitability, stating that neither the CEA nor the CFTC impose suitability requirements and the NFA has adopted a "know your customer" rule instead of a suitability rule.

The rule clearly recognizes, however, that the information obtained from some customers will show that they need a greater explanation of the risks involved in futures trading and that for some customers the only adequate risk disclosure is to tell them that futures trading is too risky for them. Once that has been done, each customer is free to make the decision whether to trade futures or commodities options.

Like other NFA pronouncements, the NFA Arbitrators Manual states that there is no suitability rule, but there are cases where commodity professionals must advise their customers that futures trading is too risky for them, i.e. that it is unsuitable for them. Like other NFA pronouncements, the manual recognizes that there are times when investors simply are not suited to trading in futures and that a commodities professional should inform the customer of that fact, but it does not impose liability based on a commodity professional's recommendation of an unsuitable futures transaction.

IV. A More Suitable Rule

The first, and most obvious, conclusion to be drawn from an examination of the suitability doctrine under U.S. securities law and U.S. commodities law is that the CFTC may decline to adopt a suitability rule, decree that suitability is implicit in the CEA, then decree suitability is not implicit in the CEA, and the courts may accept that, but suitability problems will not go away. Commodity professionals have continued to argue that the futures transactions in

249 The NFA has argued that the CFTC reparation program has "outlived its usefulness." According to the NFA, in 2002, the CFTC processed 80 cases while 136 cases were filed with the NFA's arbitration program. Testimony of Daniel J. Roth, President and Chief Executive Officer National Futures Association, Before the Subcommittee on General Farm Commodities and Risk Management of the U.S. House of Representatives Committee on Agriculture (June 19, 2003), available at http://www.nfa.futures.org/news/newsTestimony.asp?ArticleID=1115.


252 Id.
question were suitable for sophisticated, affluent claimants. Claimants who are not sophisticated, affluent investors have continued to emphasize their age, lack of education, means, and understanding of the transactions that were recommended. The CFTC and NFA have continued to struggle with what to do when the investor was clearly not suited for futures transactions.

At the CFTC's urging, the response of the NFA has been to promulgate a "know your customer" rule, reject any suggestion of a suitability requirement, and argue before Congress that the basic types of protection afforded by each are the same. This raises the question, are they? Is the NFA "know your customer" rule the functional equivalent of a suitability rule, or a different animal all together?

An examination of the rules and interpretations suggests that the NFA's "know your customer" rule functions differently from a suitability rule. The fact that the NFA rule simply requires a commodity professional to obtain information from the customer prior to initiating trading, while a traditional suitability rule requires a broker to have a reasonable basis for believing that the recommendation the broker is about to make is suitable for the customer, does not, in and of itself, preclude the NFA rule from offering the same basic type of protection. After all, the NYSE has a structurally similar rule, and this rule has been interpreted as protecting investors from being induced to purchase unsuitable securities.

As discussed above, however, the NFA explicitly rejected any parallel analogy to the NYSE rule and, instead, suggested in interpretive notices, member guidelines, and its arbitration manual that the rule may require additional disclosure. "There may be some customers for whom the additional disclosure will portray futures trading as too risky for that customer." The CFTC in its interpretation of "the informational duty" of a commodity professional selling commodities options said the same thing: "the FCM must acquaint itself sufficiently with the personal circumstances of each option customer to determine what further facts, explanations and disclosures are needed in order for that particular option customer to make an informed decision." Administrative law judges after Phacelli have said the same thing: little more than passing out disclosure forms may be required with some investors, but "in soliciting elderly, unsophisticated, and less affluent persons . . . greater disclosure must be made."

In each case, what the NFA and CFTC are suggesting, through their interpretation of the NFA rule and CFTC disclosure requirements, is that the commodity professional make a suitability determination not to determine whether or not a recommendation can be made, but to determine the amount of explanation required.

253 See Testimony of Daniel J. Roth, supra note 227.
254 Markham, supra note 15, § 10.1.
255 See supra Part III.C.
256 NFA's Interpretive Notice, supra note 217.
In each case, this NFA and CFTC requirement, even if strictly applied, results in a different transaction chronology. Under a suitability rule, the broker is required to obtain customer information and, based on that information, determine whether or not to make a recommendation. Under the NFA rule, the commodity professional can make the recommendation, close the sale, and then with a new investor obtain information about the investor and thereafter, if necessary, suggest that futures trading is "too risky for that customer." The disclosure comes after the infomercial, after the hard sell, after the investor is convinced that that the transaction will win. Under the current rule, a commodity professional can solicit an entirely unsuitable customer, recommend an entirely unsuitable product, and then think about disclosure.

A second difference arises when one looks beyond the initial transaction. The NFA has argued that because securities brokers have a range of products to recommend with varying degrees of risk, a suitability rule may be appropriate. In contrast, because futures and options contracts all involve substantial risk, "there is little or no basis for assuming that a trade in soy bean futures contracts would be appropriate for a particular customer but that a heating oil contract would not. The more appropriate focus in the futures industry is on whether the customer should be trading at all."^259

The NFA rule focuses on the account rather than the transaction. With this focus, the rule requires an initial explanation of the risks, but it does not require, for either regulatory or civil liability purposes, that the commodity professional have a reasonable basis for each recommended transaction. In contrast, the NASD suitability rules are directed to the transaction: no member "shall recommend to any customer any transaction" without reasonable grounds to believe the transaction is not unsuitable.^260 The result is that the object, and thus the scope, of the NFA's "know your customer" rule and the securities industry's suitability rules are different.

Their interpretation by the courts, respective regulatory bodies, and arbitration panels also show they are applied differently. There are areas of overlap. When the federal courts examine the suitability of recommendations for securities transactions and find that an unsuitable recommendation may constitute fraud under a "misstatement or omission theory," they are suggesting that there was a misrepresentation regarding suitability or risk or that there was a failure to disclose adequately the lack of suitability or risk.^261 The unsuitable recommendation is fraudulent because of the misrepresentation or omission.

The CFTC, in its administrative hearings, conducts a similar analysis. It avoids the word "suitability," but it ties the investor's lack of suitability with the level of disclosure required and finds fraud in a misrepresentation as to risk or an omission of material facts relating to the risk that ultimately made the transaction unsuitable.^262 In other words, there are times when the commodity professional should have disclosed the transaction was "too risky," but did not, and this omission constitutes fraud. The CFTC reaches the same place through

^259 Testimony of Daniel J. Roth, supra note 227.
^260 NASD Rule 2860(19), supra note 39; see also supra note 41 and accompanying text.
^261 See supra note 76 and accompanying text.
^262 See supra notes 178-88 and accompanying text.
an analysis that sidesteps independent consideration of the suitability of the recommendation.

As set out above, the suitability doctrine under federal securities law is not, however, coterminous with the "misrepresentation or omission theory" recognized by the courts. The courts have also recognized that, under certain circumstances, the making of an unsuitable recommendation by itself constitutes fraudulent conduct. The courts have recognized under the "fraudulent conduct theory" that where the broker exercises control, de facto or otherwise, over the investor's account and recklessly recommends an unsuitable transaction, there is fraud.

The courts and the CFTC, in rejecting a suitability requirement as implicit in the CEA, have rejected the possibility that the making of an unsuitable recommendation, by itself, constitutes fraudulent conduct. In doing so, it cuts off half the equation. The two theories, "misrepresentation or omission theory" as opposed to the "fraudulent conduct theory," have a distinct focus and cover different conduct. A commodity professional may, by an objective standard, fully disclose the risk and yet fail to gain the understanding of the investor. Under these circumstances, the broker's de facto or legal control over the investor's account and reckless disregard of the unsuitable nature of the recommendation is dispositive. Under these circumstances, the focus is on the broker's conduct rather than the disclosure received by the investor.

The courts and CFTC's rejection of the suitability doctrine under commodities law is not simply a rejection of the "fraudulent conduct theory" of liability under federal securities law. If one turns to the SEC and SRO enforcement actions, one sees that the rejection of the suitability doctrine also eliminates all those actions that focus on the broker's conduct and the unsuitable recommendation itself, regardless of whether the broker exercised control over the investor's account. Where the SEC says flat out that a "salesperson's recommendation must be suitable for the client in light of the client's investment objectives" and whether the customers consider the purchase of the stock suitable "is not the test for determining the propriety of the applicant's conduct," the CFTC and the NFA state the opposite in their mandated risk disclosures. "You [the customer] should . . . carefully consider whether such trading is suitable." It gives no indication that suitability is anything other than the responsibility of the customer.

If one turns to arbitration, again, one sees that the CFTC and NFA rejection of the suitability doctrine eliminates actions that focus on the recommendation. Decisions such as In re Peterzell, which explicitly recognized that suitability is an ongoing obligation, have no place if one looks only at whether

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263 See supra notes 74-75 and accompanying text.
266 CFTC, Rule 1.55 Risk Disclosure Statement, 17 C.F.R. § 1.55(b) (2006); see supra note 140 and accompanying text.
267 See supra Part III (discussing disclosure requirements).
an investor has any basis for trading in the futures market in the first place. Similarly,

decisions such as *In re Crooks* and *In re Friesz*, which did not find scienter,
did not find misrepresentations, did not find churning or unauthorized trading, but
did find the broker lacked "any sound analytical basis" for "recom-
mending as suitable such a large concentration of one position in Claimant's
account," are eliminated.\(^\text{268}\) The ongoing duties owed by a broker to the inves-
tor under the shingle theory type of reasoning found in *In re Poole* are elimi-
nated.\(^\text{269}\) Even if these arbitration decisions do not represent a majority
position, they are the visible tip of an iceberg that gives substance to suitability
rules that require plain and simple that brokers have a reasonable basis for
believing their recommendation is suitable for the investor.

If one accepts that the "know your customer" rule in the futures markets
and its interpretation requiring commodity professionals offer a tailored expla-
nation of the risk of commodities trading is not the functional equivalent of the
suitability rules found in the securities industry, the next question is whether
there is a need for a suitability rule and recognition of suitability requirements
under the CEA. An examination of the same rules, interpretations, enforce-
ment, and civil actions suggest that the answer is yes.

There is a question of equity. While investors are now precluded from
claiming damages resulting from the commodity professionals' unsuitable rec-
commendations, ALJs have continued to apply suitability criteria after the loss
to disqualify customers from recovery. This "reverse suitability" analysis viol-
ates basic notions of fairness: "What's sauce for a goose is sauce for a gan-
der."\(^\text{270}\) If suitability arguments seeking to deny liability are accepted, fairness

demands consideration of suitability claims seeking to impose liability.

At the same time, one must ask whether there is a cost to denying the
existence of a suitability requirement and analyzing suitability issues as evi-
dence of scienter and reasonable reliance, but not analyzing suitability issues as
suitability issues.

In *Baker v. Yarusso*, the claimant was a former steelworker, an unmarried
father with two dependent children, in debt, unemployed, and brain-dam-
aged.\(^\text{271}\) He saw an infomercial, called a toll free number and was encouraged
to trade futures.\(^\text{272}\) In analyzing Mr. Baker's claim, the ALJ noted the
respondent's

blatant disregard of Baker's desire to limit his investment, by Yarusso's recom-
modation that Baker begin trading before he had any money, by Yarusso's recom-
modation that Baker buy too many options, and by Yarusso's knowledge of Baker's patent
lack of sophistication, inability to understand the basic matters such as the mechanics
of trading options, and dire financial condition.\(^\text{273}\)

\(^\text{268}\) *In re Friesz*, N.A.S.D. Docket No. 02-02443, 2004 WL 1125843, at *7 (May, 7 2004);
(Oct. 27, 2000). *See supra* notes 102-109 and accompanying text.


(quoting JONATHAN SWIFT, POLITI CONVERSATION (1738)).


\(^\text{272}\) *Id.* at *2. He bounced his first check trying to open an account. *Id.* at *4.

\(^\text{273}\) NASD, Rule 2310, available at http://nasd.complinet.com/nasd/display/display.html?
rbid=1189&record_id=1159000499 (last visited Mar. 3, 2007). *See also* NASD, IM-
The ALJ analyzed the claimant's investment objectives, inability to understand the transactions and limited financial means, finding that the broker knew these facts and acted with scienter in misrepresenting the risk and failing to disclose the commissions. Baker was compensated for his losses. Is not the more basic question, however, what was the broker doing soliciting Baker to trade futures options in the first place? Is not the problem the fact that the broker solicited an unemployed, brain damaged, former steelworker to trade commodities futures, rather than the broker's failure to disclose the commissions charged and give a balanced presentation of the potential profits and risks? Is there a problem with obscuring the issue, so long as the injured party is compensated, or does everything come out in the wash?

Even when the result is equitable, if the legal reasoning is flawed the process suffers. Legal reasoning that obscures the issues but reaches the desired result, obscures other issues: the CFTC and NFA rejected a suitability rule because they were unable "to formulate meaningful standards of universal application" and instead adopted "an additional disclosure" standard that must be made on a "case-by-case basis." In other words, they summarily rejected a proposed reasonable basis requirement because they were unable to formulate universal standards, in favor of a disclosure standard dependant on the individual characteristics of the investor.

The NFA and some scholars have offered an explanation that all futures contracts are risky as an additional rationale for rejecting a suitability requirement: that all futures contracts are risky. There is "no basis for assuming that a trade in soybean futures contracts would be appropriate for a particular investor."


274 Id. at *2-*4.
275 Id. at *5.
276 The CFTC cases discussed above present the same question. In Sanchez v. Crown, the CFTC premised liability on inadequate risk disclosure, including the respondents' failure to fax the entire risk disclosure document to Mr. Sanchez. CFTC No. 02-R50, 2003 WL 21196530, at *8, *22 (May 16, 2003). Isn't the basic problem, however, that respondents solicited the purchase of $32,000 of out-of-the-money unleaded gas options from a 67 year old with $40,000 in assets, a high school education, and no understanding of commodities options? See generally supra notes 194-98 and accompanying text.
277 NFA's Interpretive Notice, supra note 219.
278 "Commodities futures, unlike securities, cannot ordinarily be purchased for conservative goals, such as income or long-term growth. They are inherently speculative.... Thus, it may be argued that a suitability rule is not only unnecessary but may also be misused by investors as a way of recouping fair market losses." Poser, supra note 26, at § 3.03[D].
customer but that a heating oil contract would not. In doing so, they reject the obvious: that a broker may have a reasonable basis for believing that an investor is suited to trading in futures markets and still have no basis for recommending a specific trade. The CFTC, futures exchanges, and brokerage in their rules all recognize that not all futures contracts are alike. It is not simply a matter of saying if you are suitable for soybeans, you are suitable for heating oil. Deep-out-of-the-money option contracts, for example, carry far higher commission and inherently greater risk. The CFTC has also acknowledged, as far back as 1977, the simple fact that the risk of loss depends on the size of the trade. "Thus, in recommending to a customer the purchase of 10 futures contracts of a particular commodity the professional would be required to have a reasonable basis for believing that the risk of loss from an adverse price movement could be absorbed by the customer without undue hardship. If the professional thought the risk of buying 10 contracts was too great, the proper recommendation might be to purchase fewer contracts." The CFTC proposed, as a result, two separate suitability determinations: one determining suitability for trading futures in general, and one determining the suitability of the particular position recommended. In short, not all futures transactions are the same, and any argument that they are provides scant support for concluding that there is no need for a suitability rule in the futures industry.

Even if it were true that all futures contracts are the same because they are all inherently risky, this is an argument for, rather than against, the imposition of a suitability rule. The NASD, NYSE, and other SROs all examined options and warrant trading, found them especially risky, and imposed expanded suitability requirements on its members. The SROs provide extensive risk disclo-

279 Testimony of Daniel J. Roth, supra note 227. "Futures contracts in general are recognized as highly volatile instruments. It therefore makes little sense to presume that a certain futures trade may be appropriate for a customer while others are not." NFA's Interpretive Notice, supra note 219; Poser, supra note 26, at § 3.03[D] (see note 280 for pertinent excerpt).

280 See Sanchez, 2003 WL 21196530 at *21, *6 n.9. An "out of the money" option is one "which has no intrinsic value. For calls, an option whose exercise price is above the market price of the underlying future. For puts, an option whose exercise price is below the futures price." NYMEX Glossary, http://www.nymex.com (follow "Glossary" hyperlink) (last visited Mar. 3, 2007). A "deep-out-of-the-money option" is defined as "an option whose strike price is more than X strike prices distant from the strike price closest to the price of the underlying futures contract, where X equals two (2) plus the number of calendar months remaining to option expiration, provided, however, that the Exchange may impose additional criteria as appropriate." NYMEX Rule 300.10(B) Sales of Deep-Out-Of-The-Money Options, available at http://nymex.com/rule_main.aspx?pg=37#300.10 (last visited Mar. 3, 2007). For deep-out-of-the-money option contracts each member commission merchant "shall, in regard to all sales of deep-out-of-money options, provide the customer with a full explanation of the nature of such option prior to any transaction." NYMEX Rule 300.10(A) Sales of Deep-Out-Of-The-Money Options, available at http://nymex.com/rule_main.aspx?pg=37#300.10 (last visited June 14, 2006). CFTC Rule 33.4(b)(2) imposes separate rules relating to deep-out-of-the-money options because of "the potential for misleading and deceptive practices in the sale of such options." CFTC, Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. 54,500, 54,505 (Nov. 3, 1981).

281 CFTC, Proposed Standards of Conduct for Commodity Trading Professionals for the Protection of Customers, supra note 122, at 21,929.

282 See supra note 124 and accompanying text.
sure designed to encourage the customer to make an informed decision regarding options transactions, but they also recognize that this risk disclosure does not preclude or alleviate the necessity of an expanded suitability rule. The SEC requires broker-dealers to provide standardized risk disclosure documents prior to completing penny stock transactions in addition to and apart from expanded suitability rules imposed because penny stocks present special risks. The arguments for why futures markets do not need a suitability rule are not convincing.

There are also questions of efficiency. Is there an unnecessary cost in maintaining and enforcing two separate standards? Since the 2000 CFMA amendments, if a commodity professional recommends a securities futures products, there is an unambiguous suitability requirement that they have “reasonable grounds for believing that the recommendation or strategy is not unsuitable” and a “reasonable basis” for believing the customer can evaluate and financially bear the risks. At the same time, during the same interaction with the same customer, if the same commodity professional recommends a different futures product, the standard changes to “know your customer.” In terms of regulation and compliance there is efficiency to be gained in applying one common standard, as opposed to a distinct “know your customer” standard and a separate “suitability” standard depending what futures product is solicited.

In determining what standard to apply, Professor Markham has proposed an objective standard:

[C]onfusion could be avoided by simply imposing objective standards that would make them per se suitable for trading. Such an approach is neither novel nor unworkable. Almost every major brokerage firm has objective standards for determining whether a customer is suitable. For example, the firms may impose restrictions that exclude customers from commodity futures trading, at all, where they do not have, for example, a net worth, exclusive of insurance and home, of $100,000 or an income of $50,000 that is continuing in nature.

All in all, the situation is a confusing one – needlessly so ... if a suitability standard is now necessary, beyond a concept of disclosure, much of this confusion could be avoided by simply imposing objective standards that would make them per se suitable for trading. Such an approach is neither novel nor unworkable. Almost every major brokerage firm has objective standards for determining whether a customer is suitable. For example, the firms may impose restrictions that exclude customers from commodity futures trading, at all, where they do not have, for example, a net worth, exclusive of insurance and home, of $100,000 or an income of $50,000 that is continuing in nature.

The North American Securities Administrators Association (“NASAA”) has proposed similar objective guidelines for commodity pool

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283 17 C.F.R. § 15g-2 (2006); see also supra note 47 and accompanying text.
284 NFA Rule 2-30, supra note 218, at (3)-(5); see also supra note 218 and accompanying text.
285 Markham, supra note 15, at § 10.9; see also supra note 15 and accompanying text.
286 The NASAA is an organization of sixty-seven securities administrators in the fifty states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. NASAA History, http://www.nasaa.org/About_NASAA/NASAA_History/ (last visited Mar. 3, 2007).
programs.\textsuperscript{287} The sponsor "shall propose minimum income and net worth standards which are reasonable."\textsuperscript{288} Unless the state administrator determines the risks dictate otherwise, the participants "shall have: (a) a minimum annual gross income of $45,000 and a minimum net worth of $45,000; or (b) a minimum net worth of $150,000."\textsuperscript{289}

The NASAA commodity pool guidelines are, however, in addition to and not in lieu of a traditional suitability determination: the sponsor "shall make every reasonable effort to determine that the purchase of the program interests is a suitable and appropriate investment."\textsuperscript{290} The sponsor "shall ascertain" the minimum income and net worth standards are met; in keeping with the participants' investment objectives, the participant is able to bear the economic risk; and the participant understands the investment.\textsuperscript{291}

Objective standards do present a problem of "formulating meaningful standards of universal application." An elderly investor in retirement may meet a minimum net worth standard, or exceed it many times over, and still be grossly unsuited for trading in the futures markets. Similarly, there may be little reason to exclude from the markets a knowledgeable, younger investor with significant future earnings potential but limited assets. A requirement that the commodity professional make reasonable efforts to determine that the product is suitable in light of the participant's investment objectives, ability to bear the risk of loss and that she understands the transaction avoids this issue. There is no bright line rule, but recognition that many areas of the law do not lend themselves to bright line rules yet require rules all the same.\textsuperscript{292}

\textsuperscript{287} NASAA, Registration of Commodity Pool Programs, NASAA Statements of Policy (1990), available at http://www.nasaa.org/content/Files/Registration_of_Commodity_Pool_Programs.pdf. A commodity pool is "[a]n investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity futures or option contracts. Typically thought of as an enterprise engaged in the business of investing the collective or 'pooled' funds of multiple participants in trading commodity futures or options, where participants share in profits and losses on a pro rata basis." CFTC Glossary, supra note 138.

\textsuperscript{288} NASAA, Registration of Commodity Pool Programs, supra note 287, at III.A.2.

\textsuperscript{289} Id. at III.B. (emphasis omitted). These net worth requirements are lower than those originally proposed. "The major complaint with the guidelines issued for comment last year was the suitability rule – who could purchase a fund. The proposal was to require an investor have a minimum annual taxable income of $60,000 plus a net worth of $60,000 or a net worth of $225,000." Szala, supra note 137, at 66, 68.

\textsuperscript{290} NASAA, Registration of Commodity Pool Programs, supra note 287, at III.C.1. (emphasis omitted).

\textsuperscript{291} Id. at III.C.2(a)-(d).

\textsuperscript{292} Looking only at fraud cases under the CEA, courts have repeatedly rejected "bright-line" requirements for defining misleading statements before liability is triggered. CFTC v. R.J. Fitzgerald & Co., 310 F.3d 1321, 1330 (11th Cir. 2002). As with securities law, they have found a statement material "if there is a substantial likelihood that a reasonable investor would consider it important in making an investment." Saxe v. E.F. Hutton & Co., 789 F.2d 105, 111 (2d Cir. 1986) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (emphasis added)). They have defined puffery as alleged misstatements that are "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." Saxe, 789 F.2d at 111 (emphasis added). The intent to defraud may be inferred from a "totality of circumstances." In re Soybean Futures Litig., 892 F. Supp. 1025, 1045 n.20 (N.D.Ill. 1995). Injunctions against commodity professionals depend upon the likelihood of future violations which, in turn, "depends on the totality of the
Setting aside the difficulties of formulating objective suitability standards, there is an argument for simply unifying the standards now in place so that the "reasonable basis" suitability standard currently applied to commodity professionals soliciting securities futures products applies to all futures products. In doing so, all commodity professionals would be required to have "reasonable grounds for believing that the recommendation or strategy is not unsuitable for the customer," and all commodity professionals would be required to conform to the same standards currently in place for brokers of options, warrant, and other high risk transactions in the securities markets.

The real issue is liability. The NFA's first interpretive notice for its "know your customer" rule made clear that its rule "should not be construed to expose Members to increased potential liability for damages." The industry similarly "geared up" to fight the NASAA commodity pool guidelines, arguing that "higher suitability requirements and compensation stipulations put a severe strain on all parties in the pool." Brokers argued "[t]he industry has to take this to court, there's nothing to resolve with these jokers." Opposition to suitability rules within the securities industry has been at times every bit as sharp. The Midwest Stock Exchange (now the Chicago Stock Exchange) testified before Congress in 1964 that adoption of a suitability regulation, of all the recommendations, would be "the most harmful to industry and future liquidity of the marketplace . . . . To apply any penal provision or prohibition that cannot be clearly and comprehensively defined would leave an entire industry open to irresponsible lawsuits and unlimited liability." The securities industry has not, however, collapsed under the weight of suitability requirements. There are no reasoned arguments being made suggesting suitability rules have harmed the liquidity of the marketplace, and there is always the risk of irresponsible lawsuits. That risk must be measured against the risk of irresponsible solicitation of unsuitable futures transactions.

If, as argued, the current "know your customer" rule and disclosure requirements provide the same customer protection as a suitability rule, the extent of liability imposed on commodity professionals should not change with recognition of a suitability requirement. If, as argued here, the current disclosure regime is not coterminous with one that recognizes suitability as separate and distinct from disclosure, then liability would necessarily be greater, but also provide necessary deterrence.

293 NFA Rule 2-30, supra note 218, at (4).
294 NFA's Interpretive Notice, supra note 219.
296 Szala, supra note 137, at 68. "State administrators have been a major thorn in the industry's side for years." Id.
298 A literature search (suitability /liquidity in the Westlaw jlr [journals and law reviews] database) shows the debate regarding suitability and liquidity has centered around the investor's need for liquidity and not the effect of a suitability requirement on the liquidity of the markets.
V. Conclusion

A former director of the CFTC’s division of trading and markets described the futures markets as “the wild, wild, west, and they don’t want the government looking over their shoulder.”299 Professor Markham has described a “laissez-faire attitude” in the industry, where “futures traders believe they are the last bastion of free enterprise where no quarter is given or taken.”300 The question is whether a laissez-faire attitude in the futures markets and an ethic where no quarter is given or taken is appropriate in transactions between commodity professionals and individual investors, or whether commodity professionals should be held to the same standard as professionals in other financial markets.301

The CFTC and NFA arguments for distinguishing the securities markets from the futures markets and why a suitability rule is not necessary in the latter are problematic. NFA arguments for why its “know your customer” rule offers the same protection as a suitability rule are problematic, and the fact that commodity professionals continue to solicit permanently disabled, uneducated investors, semi-retired laborers with an income of under $10,000, as well as retired steelworkers with brain damage, is especially problematic. These are egregious examples, even a parade of horribles, but they are also part of a larger picture that shows a history of commodity professionals soliciting unsuitable investors that continues today.

The futures markets have boomed, more than doubling in size between 1999 and 2004.302 Its offerings, including financial products and foreign currency futures, have grown.303 Attention paid to futures markets has grown.304 The number of individual investors participating in those markets has grown.305 The instances of fraud have grown, with over $350 million dollars in losses in five years in the currency markets alone.306 The regulatory structure for the futures markets has not.

The NFA “know your customer” rule and the NFA and CFTC disclosure requirements do not replace a suitability standard or satisfy the need for one. Suitability is the elephant in the room that nobody talks about, but should.

300 MARKHAM, supra note 15, at § 10.2.
301 Futures trading “hasn’t been as heavily regulated as stock trading.” The CFTC has brought fewer cases and levied fewer fines than regulators like the SEC; however, “as this corner of Wall Street has grown in complexity and size over the years, there have been calls for greater regulation.” Craig, supra note 301, at C3.
302 See supra notes 5-6.
303 See supra notes 7-12.
304 See supra notes 2-4.
305 See supra notes 13-14.
306 See supra note 17.