15 *See infra* note 26 at 27.

16 *Powers Report,* at 109.

17 *See also*, ABA Model Rule § 1.16(b).

18 *See In re American Continental Corporation/Lincoln Savings and Loan Securities Litigation*, 764 F.Supp. 1424 (D. Ariz. 1992).

19 ABCNY Formal Opinion 2002-01.

20 *See, e.g.*, *U.S. v. Matthews*, 787 F.2d 38 (2d Cir. 1986); *U.S. v. Crop Growers Corp*., 954 F. Supp. 335 (D.D.C. 1997) (not a criminal act to fail to disclose in an SEC filing uncharged criminal conduct).

21 Coffee, *Understanding Enron: "It's About the Gatekeepers, Stupid"*, Business Lawyer (August 2002), at 1403, 1405.

22 148 *Cong. Rec.* S6552 (July 10, 2002).

23 *See, e.g.*, Ackman, *Enron's Lawyers: Eyes Wide Shut?*, Forbes.com, Jan. 28, 2002; and Koniak, *Who Gave Lawyers a Pass*, Forbes. com, August 12, 2002.

24 2002 WL 198018.

25 *Powers Report,* at 201-202.

26 Available at www.abanet.org/buslaw/corporateresponsibility.

27 Seventy percent of in-house corporate counsel in a recent survey reportedly responded that their employers would be better served if the law clearly defined instances of mandatory reporting, regardless of attorney-client privilege. *ACCA Survey,* ftn. 1.

28 For an excellent analysis of due diligence and disclosure obligations for securities underwriters, that takes into account post-Enron developments, *see* Chapman, "Underwriters' Due Diligence Revisited," *The Review of Securities & Commodities Regulation* (October 9, 2002).

29 295 F.3d 312 (2d Cir. June 27, 2002).

30 An excellent discussion of *Caiola* is found in McLaughlin, *Synthetic Options in the Second Circuit: "They Are Securities*," Futures & Derivatives Law Report, October 2002.

31 *Powers Report*, at 25-26.

32 *In Re: CFS-Related Securities Fraud Litigation*, No. 99-CV-825-K(J) (N.D. Okla. December 21, 2001).

33 Pitt, Remarks at the SEC Speaks Conference (Washington, D.C., February 22, 2002).

34 Lawyers who violate ethics and professional responsibility rules may be subject to a variety of remedies. The ABA Model Rules and state codes are not *per se* enforced but are looked to for guidance by courts and regulatory agencies. The NY Disciplinary Rules are court rules that are enforced by the Appellate Divisions of the New York Supreme Court. The SEC, CFTC and other federal and state agencies may also discipline lawyers who practice before such agencies and who violate their ethical or other requirements, and clearly the SEC will be looking very closely at the conduct of issuer's counsel from now on. Clients and third-parties may bring actions against lawyers, alleging that violations of ethical or professional responsibility provisions caused actual or prospective harm to the client or the third-party. Courts may disqualify lawyers from appearing in particular matters based on a prospective or actual violation of an ethics requirement. In the non-litigation context, a lawyer may be subject to disqualification in a specific matter. The disqualification is often self-imposed or may be the subject of an application made by an aggrieved party to a court or state bar association. A violation of an ethics or professional responsibility code may also constitute conduct in violation of a criminal law, a regulatory prohibition or may be a tort, subjecting the lawyer to additional actions and remedies.

The Kwiatkowski Decision: Implications for the Nature and Scope of Duties of Brokers and FCM's to their Customers

By Richard A. Rosen

Introduction

In *Kwiatkowski v. Bear, Stearns & Co., Inc.*[1] the United States Court of Appeals for the Second Circuit places significant limitations on the duties that brokerage firms and futures commission merchants owe to their retail customers. The decision, which reversed a post-trial ruling by a trial court that had taken an expansive view of the common law duties of financial services firms to customers, restores a more realistic balance between the competing interests of investors and their brokers and establishes a liability regime that allows firms to manage their risks.

The salient features of the Court's ruling are readily summarized: brokers ordinarily do not have an ongoing duty to provide nondiscretionary clients with investment advice; rather, their duties are circumscribed on a transaction-by-transaction basis. Those duties are to execute the client's trade orders diligently and competently, and to give honest and complete information when making a recommendation on a particular transaction. The negligence standard of reasonable care applies to the advice when given, and the duty ends when the transaction is completed. Providing advice does not trigger any ongoing duty to update, augment or modify that advice, or to provide continuing advice even if factual circumstances change, and the broker is not required to make continuing suitability and risk assessments. Internal firm policies and procedures, designed to protect the firm, do not provide a source for imposing more stringent duties of care on brokers than the law otherwise requires. Finally, special circumstances of the broker-client relationship may require a higher duty of care than that owed in the ordinary course, but those circumstances are limited to situations in which the broker, due to some incapacity or vulnerability of a particular client, effectively assumes control of the account, negating its nondiscretionary status.

©2002 Richard A. Rosen. Richard A. Rosen is a litigation partner and chair of the Securities, Futures and Derivatives Litigation practice group at Paul, Weiss, Rifkind, Wharton & Garrison. Mr. Rosen wrote the amicus brief submitted on behalf of the Securities Industry Association urging the Second Circuit to reverse the judgment in Kwiatkowski. *The assistance of Abigail Evans, a Paul Weiss litigation associate, in the preparation of this article is gratefully acknowledged.*

The *Kwiatkowski* ruling, although arising in the context of a customer's transactions in foreign currency futures and over-the-counter trades, appears to be equally applicable to transactions in securities, options or any other financial product. And although arising under New York law, the Court's willingness to draw on case law from other jurisdictions to support its analysis suggests that the case can and should be cited as good law in most U.S. jurisdictions.

The decision, by a unanimous panel, is particularly welcome at a time when the plaintiffs' bar is aggressively seeking to expand the scope of a firm's duties to retail customers, through suits in both federal and state courts and in arbitration proceedings.

Factual Background

In January 1991, Henryk de Kwiatkowski opened a nondiscretionary foreign currency futures account at Bear Stearns, with a position of 4000 Swiss Franc contracts traded on the CME. Bear Stearns served as FCM for futures contracts and as OTC dealer for forward contracts. Kwiatkowski signed all federally mandated risk disclosures documents. Bear Stearns daily sent large amounts of information to Kwiatkowski and his accountant, but did not solicit trades. Kwiatkowski spoke personally to his broker Albert Sabini many times a day, but made all final trading decisions himself.

Kwiatkowski consistently assumed long-term positions favoring the U.S. dollar against other currencies. Between 1991 and 1994, he amassed nearly $450 million in aggregate net cash profits from commodities trading, primarily because the dollar rose in value relative to other currencies. By the fall of 1994, his profits from trading foreign currency and other futures at Bear Stearns totaled over $219 million. Between December 1994 and early March 1995 however, Kwiatkowski lost those profits and about $7 million more when the dollar fell.

The Bear Stearns Executive Committee was heavily involved in monitoring the account[2] and Kwiatkowski had extraordinary access to senior management and senior economists. In November 1994, Sabini sent Kwiatkowski a report written by Bear Stearns economist Wayne Angell, expressing the view that the dollar was "close to a bottom or has actually bottomed." In late November or early December 1994, David Schoenthal, the head of Bear Stearns' foreign exchange department, recommended to Kwiatkowski that he move his position from the CME to the OTC market.[3] Kwiatkowski directed Bear Stearns to transfer half of his position to the OTC market, but kept the other half on the CME.

Starting in late December 1994, Kwiatkowski suffered enormous single-day losses on three days when the dollar fell sharply. On December 28, 1994, his position declined $110 million, but the dollar rebounded significantly on the next trading day. On January 9, 1995, Kwiatkowski lost $98 million, and shortly thereafter, he consulted Angell about the value of the dollar. According to Kwiatkowski, Angell opined that the dollar was undervalued. Kwiatkowski maintained his position, and on January 19, 1995, lost $70 million. When later asked why he did not liquidate after these losses, he testified, "I'm not a running type."

In February 1995, two salesmen in the Bear Stearns futures department wrote in a monthly global futures report that they were downgrading their outlook for the U.S. dollar to negative. Kwiatkowski later testified that he had neither seen nor heard of this report. The dollar continued to fall. By February 17, 1995, Kwiatkowski had lost over $37 million since October 1994, and he instructed Bear Stearns to meet his margin calls by liquidating positions rather than demanding more collateral. By March 2, 1995, these liquidations had reduced Kwiatkowski's position to 40,800 contracts. By the following morning, his account was undermargined, and Bear Stearns closed 18,000 contracts to meet the margin call.

On Friday afternoon, March 3, Kwiatkowski asked Schoenthal about the possibility of liquidating his remaining positions. Schoenthal told him that the markets were relatively illiquid at that time of the week, and also said that the market "may improve next week." There was also evidence that it was suggested that Kwiatkowski could sell in Australia or New Zealand over the weekend. During this conversation, Kwiatkowski decided not to liquidate the remainder of his position, but instead to await developments when the markets opened in Asia on Sunday afternoon and in the United States on Monday. When the markets further deteriorated over the weekend, Kwiatkowski authorized the liquidation of his position.

In total, Kwiatkowski lost $226 million in futures and forwards trading between October 1994 and March 1995. Kwiatkowski's expert testified that the advice Kwiatkowski received regarding liquidation was negligent, that Kwiatkowski would have reduced his loss by $116.5 million by closing his remaining positions on March 1-2, 1995, and that he would have saved $53 million if he had sold on Friday afternoon, March 3, 1995.

District Court proceedings and decision

Kwiatkowski contended at trial that Bear Stearns had improperly failed to advise him about his massive dollar-bullish investments. Specifically, he claimed Bear Stearns had breached duties: (a) to assess and advise him about the suitability and risks of his investment position, particularly as the dollar declined in early 1995; (b) to provide him with the dollar-bearish report of February 1995, particularly after Bear Stearns had earlier supplied a dollar-bullish economist's report and dollar-bullish opinions; and (c) to advise him by the middle of the week of January 30, 1995 to consider liquidating his position, and to advise him on Friday afternoon, March 3, 1995, to liquidate his remaining

positions immediately rather than suggesting that he wait to see if the markets rebounded over the weekend.

By the time the case was presented to the jury, there were no claims that Bear Stearns violated any statute or rule and no claims of fraud, misrepresentation, unauthorized trading, or unexecuted or improperly executed trades. Neither were there claims that Bear Stearns had breached any contractual obligation.

The claims that went to the jury were that Bear Stearns and Sabini breached a fiduciary duty and were negligent because they did not give Kwiatkowski certain advice that would have led him to reduce his loss. District Judge Victor Marrero instructed the jury that it could find Bear Stearns negligent if it found that Kwiatkowski established that "defendants had a duty to perform particular services,"[4] and that they had "failed to exercise the degree of care expected of a reasonable or prudent broker acting under the same circumstances."[5] The jury rejected the fiduciary duty claim against all defendants and the negligence claim against Sabini; it ruled for Kwiatkowski against Bear Stearns on the negligence claim, awarding him $111.5 million in damages. The district court added $53 million in prejudgment interest.

Bear Stearns filed a post-verdict Rule 50(b) motion, asserting that the "reasonable or prudent broker" instruction allowed the jury to impose advisory obligations that do not exist under the nondiscretionary customer agreement that governed its relationship with Kwiatkowski. Bear Stearns argued that the scope of a defendant's duty of care is a question of law and, as a broker on a nondiscretionary account, Bear Stearns had no legal duty to furnish Kwiatkowski with investment advice; rather, its sole duty was to "execute [Kwiatkowski's] transactions at the best prices reasonably available, and . . . to offer honest and complete information when recommending [a] purchase or sale."[6]

In a lengthy opinion rejecting the post-judgment motion, the district court ruled, in summary, that (i) a broker has a duty to do whatever a "reasonable" broker would have done under the circumstances, and it was for the jury to determine what reasonableness required; and that (ii) special circumstances could have imposed additional duties in this case, although the jury had not been instructed on, or asked to find, any such circumstances.

The court decided that the jury could have found that Bear Stearns failed to exercise due care in the handling of Kwiatkowski's account by failing to conduct an ongoing risk analysis and suitability review; failing to inform Kwiatkowski of any higher risks associated with his investments as market conditions adversely changed; conveying to Kwiatkowski encouraging market assessments at a number of critical times; failing to inform Kwiatkowski about two Bear Stearns analysts' forecast for the dollar; failing to inform Kwiatkowski of the increased risk profile of meeting margin calls by liquidating positions; and failing to liquidate his accounts with reasonable prudence and skill in March 1995.[7] The court stated:

> [T]he theory of liability and the corresponding legal duty in question here are not grounded on Bear Stearns' obligation to provide any particular item of investment advice or information, but on its failure to exercise the reasonable care and display the skill and standard of conduct expected of a prudent broker under the circumstances that prevailed here. The case thus does not turn necessarily on a brokerage firm's furnishing or omitting to furnish any given materials, but more generally on Bear Stearns' deficient performance as a broker in its dealings with Kwiatkowski and handling his account under the circumstances, as gauged by the degree of the firm's adherence to its internal procedures, industry rules and practices and general standards embodied in the concept of the legal duty of reasonable ca[r]e.[8]

The court noted that if the numerous cases rejecting any duty of a broker to give investment advice to a nondiscretionary account were controlling, this case "would be a 'slam dunk' for the broker here."[9] The opinion outlined three categories of reasons for disregarding these cases.

First, the court stated that the limited-duty cases related only to a broker's fiduciary duties. Where there is a negligence claim, the court explained, brokers are also subject to a "more expansive and more imprecise" duty of "reasonable care,"[10] the test of which is whether the broker "failed to exercise the degree of care expected of a reasonable or prudent broker acting under the same circumstances."[11] The court found that the trial record contained sufficient evidence of Bear Stearns' failures to advise Kwiatkowski about the dollar, or about the riskiness or personal suitability of his investments, on which a jury could base a finding that Bear Stearns' conduct had fallen short of this standard.

Second, the court cited "special circumstances" as justification of the imposition of a duty to furnish investment advice. Kwiatkowski "was not just another customer with a nondiscretionary account at a brokerage firm."[12] Rather, Kwiatkowski was "one of 'a select group of private investors' whose accounts were handled by the firm's Private Client Services Group" who had an "out of the ordinary" level of contact with firm officials and an account of exceptional and "probably unprecedented" size for an individual investor.[13] The court also noted as a special circumstance the "sheer size, placement and visibility of Kwiatkowski's foreign currency position," which "rendered him subject to distinct risks and vulnerabilities."[14] However, the court later stated that the size of Kwiatkowski's account was not relevant to the determination that Bear Stearns owed him a heightened duty of care, because Bear Stearns' conduct would have been no less wrongful had Kwiatkowski's account been modest in size.[15]

Third, the district court held that the jury could properly have found that Bear Stearns had a duty to: (a) assess the suitability of its nondiscretionary customers' commodity investments; (b) provide Kwiatkowski with the February 1995 global futures report because it had earlier provided complimentary information and opinions by Angell; (c) provide these materials on the theory that it became Kwiatkowski's "agent" when it executed his orders; or (d) rescue Kwiatkowski's position more effectively from the 1995 decline. The court determined that any of these findings would provide bases to decide that Bear Stearns had an affirmative duty to provide additional advice to Kwiatkowski.

The Second Circuit Reverses[16]

The Second Circuit interpreted its task as deciding "whether the facts of this case support the legal conclusion that Bear as a broker owed its nondiscretionary customer, Kwiatkowski, a duty of reasonable care that entailed the rendering of market advice and the issuance of risk warnings on an ongoing basis" and, if so, "whether a reasonable juror could find that Bear breached that duty."[17]

Duty of Care to Nondiscretionary Clients Arises on a Transaction-by-Transaction Basis

The Court decisively affirmed that brokers ordinarily do not have a duty to monitor a nondiscretionary account or to provide ongoing or unsolicited advice to a nondiscretionary client, who "by definition keeps control over the account and has full responsibility for transaction decisions."[18] A broker owes duties of diligence and competence in executing the client's trade orders on a transaction-by-transaction basis, and is obliged to give honest and complete information when recommending a purchase or sale. The broker's duties ordinarily end after each transaction is completed, the Court said. The broker does not have a duty to offer unsolicited information, advice or warnings, and the client may "enjoy the broker's advice and recommendations with respect to a given trade, but has no legal claim on the broker's ongoing attention."[19]

Giving Advice Does Not Trigger Ongoing Duty

The panel determined that providing advice to a client does not trigger an ongoing obligation on the part of the brokerage firm to provide advice in the future; nor does a broker have any obligation to provide its clients with constant updated financial or other information that may affect their investments. The Court recognized that it would be impossible for brokers continually to provide customers with all information potentially bearing on every investment in their customers' portfolios.

The fact that Bear Stearns executives may have provided Kwiatkowski with advice on which he relied did not trigger an ongoing duty to advise or monitor all potentially relevant data, the Court found. Rather, the services Bear Stearns provided Kwiatkowski were

> wholly consistent with his status as a nondiscretionary customer; Kwiatkowski bargained for the expertise of the Private Client Services Group, but simultaneously signed account agreements making clear that he was solely responsible for his own investments. Thus it was obviously contemplated that Kwiatkowski would receive a lot of advice from Bear's senior economists and gurus, and that this advice would not amount to Bear's entrustment with the management of the account.[20]

The Court drew on well-established case law to the effect that a broker does not assume a continuing obligation to provide advice to or keep its clients informed of news, research, or other developments which could influence further trading decisions by the client, absent an express contract to do so.[21] If there were such broad responsibilities, a customer could recover damages "merely by proving non-transmission of some fact which, he could testify with the wisdom of hindsight, would have affected his judgment had he learned of it."[22] Thus, the Court found that Bear Stearns could only be found to have become the "handler" of Kwiatkowski's account if, in its course of dealing with Kwiatkowski, it consented to undertake additional duties to furnish information and advice on which he came to rely. The Court determined that there was insufficient evidence to find that Bear Stearns affirmatively undertook any such duties.[23]

Duties Are Defined By Contract

The Court looked first to Kwiatkowski's nondiscretionary account contract for the basis of Bear Stearns' duties. The Court noted that Kwiatkowski's account was "at all times 'nondiscretionary,' meaning that Bear executed only those trades that Kwiatkowski directed."[24] The Court also discussed the relevant risk disclosure and security documents that Kwiatkowski signed when opening the account.[25]

The panel agreed with the district court that "a duty of reasonable care applies to the broker's performance of its obligations to customers with nondiscretionary accounts."[26] But the Court found no authority to support the proposition that "in the ordinary case, a broker may be held to an open-ended duty of reasonable care, to a nondiscretionary client, that would encompass anything more than limited transaction-by-transaction duties[,]"[27] concluding that "in the ordinary nondiscretionary account, the broker's failure to offer information and advice between transactions cannot constitute negligence."[28]

The Court stated that Kwiatkowski's theory of the case, that special features of Kwiatkowski's relationship to Bear Stearns rendered it an exception to the ordinary

nondiscretionary contract, would only prevail if there were circumstances that created a duty outside the contract:

> Kwiatkowski does not dispute that in the ordinary case, a broker's failure to offer ongoing, unsolicited advice to a nondiscretionary customer would breach no duty. Kwiatkowski's claim is viable, therefore, only if there is evidence to support his theory that Bear, *notwithstanding its limited contractual duties*, undertook a substantial and comprehensive advisory role giving rise to a duty on Bear's part to display the "care and skill that a reasonable broker would exercise under the circumstances."[29]

No Special Circumstances

The Court addressed Kwiatkowski's claim that his was not an ordinary account, and found that this was "true enough as far as it goes."[30] But the Court found no circumstances that created a special duty owed by Bear Stearns to Kwiatkowski. The Court noted that special circumstances exist where a vulnerable client is so dominated by his broker that a purportedly nondiscretionary account is in fact at least partially under control of the broker.[31]

The panel stressed that Kwiatkowski was hardly a disadvantaged or unsophisticated client to whom a special duty was owed and as to whom the broker effectively controlled the account. To the contrary, Kwiatkowski had engaged in hundreds of millions of dollars of speculative currency futures transactions, and experienced significant losses. He had a full-time accountant, an ex-partner from a major accounting firm, who monitored his account daily. When Bear Stearns advised him to move his positions from the CME to the OTC market, he moved only half, and there was other evidence of his rejecting Sabini's advice.[32]

Moreover, the Court rejected the suggestion that Kwiatkowski was not sufficiently warned of the risks associated with currency speculation, as Bear Stearns had issued the required federal risk disclosures and Kwiatkowski had a long career as a sophisticated investor accustomed to taking extraordinary market risks. Indeed, the Court concluded that Kwiatkowski's losses could not have been caused by Bear Stearns' failure to provide advice, even if a duty to provide such advice could be found, since "there was nothing that Bear could tell him about the risks that he did not know from experience."[33]

No Duty to Provide Ongoing Suitability and Risk Assessments; Internal Manuals and Industry Standards Do Not Establish the Standard of Duty of Care

The Court also found that Bear Stearns had no obligation to provide ongoing risk and suitability assessments.[34] Kwiatkowski argued that New York Stock Exchange Rule 405 (the "know your customer" rule) establishes a higher industry standard that obligates Bear Stearns to provide suitability determinations for commodities trades. As matter of law, Rule 405 does not apply to brokers acting as FCM's or OTC dealers; NYSE Rules do not apply to transactions in commodity futures. However, the Court noted that Sabini had testified that Bear Stearns adhered to the rule in commodities transactions.[35]

The Court agreed that broader industry guidelines and Bear Stearns' own internal policies could establish higher standards than would be applicable to Bear Stearns as a FCM for Kwiatkowski's CME trades under FTC and NFA regulations. But the Court observed that "deviation from industry or internal standards does not necessarily amount to the breach of a duty owed to Kwiatkowski,"[36] where no such duties were owed to him as a nondiscretionary client.

Furthermore, the Court stated that, "[a]s a policy matter, it makes no sense to discourage the adoption of higher standards than the law requires by treating them as predicates for liability. Courts therefore have sensibly declined to infer legal duties from their internal 'house rules' or industry norms that advocate greater vigilance than otherwise required by law."[37] The Court further noted that

> [i]t may be that noncompliance with internal standards could be evidence of a failure to exercise due care, assuming however a duty as to which due care must be exercised. But the assertion that Bear had an ongoing duty to exercise "due care" or "behave like a reasonable broker," breach of which could be evidenced by noncompliance with internal rules, cannot be squared with the cases holding that a broker's obligations to a nondiscretionary client arise and are satisfied transaction-by-transaction . . . there is no basis in this case for a more comprehensive duty on Bear's part to monitor Kwiatkowski's account between transactions.[38]

Thus the Court found that higher in-house or industry standards relating to ongoing risk analysis should not be used as swords in litigation, effectively punishing company and industry efforts to establish quality control standards for self-regulation.

Negligence standard still applies on transaction-by-transaction basis

The Court applied the common law negligence standard to Bear Stearns' actions surrounding Kwiatkowski's liquidation transactions in March of 1995, and found no negligence in its handling of these transactions. The Court noted that "there is no suggestion that Schoenthal failed to exercise reasonable care in forming or expressing [the] view [that the market 'may improve next week']; . . . Kwiatkowski had no reasonable basis for relying on it, if indeed he did; and the fact that Schoenthal turned out to be wrong does not imply negligence."[39]

Further, the Court found "no evidence that Bear knew better than Kwiatkowski whether the dollar would go up or down between Friday and Monday. Indeed, there can be no

such evidence; it is the nature of markets to go up and down. Schoenthal's advice on Friday afternoon was not that Sunday would be a better time to liquidate than Friday; his advice . . . was that the market 'may improve next week.'"[40] The Court noted that "[r]egarding trading advice, brokers cannot be liable for honest opinions that turn out to be wrong. Otherwise brokers would refuse to take discretionary accounts and would refuse to advise on nondiscretionary accounts."[41]

Comments and Recommendations

Although the dispute arose under and was governed by New York law, nothing in the decision turned on any peculiar or special feature of New York jurisprudence. The Court's analysis of the limits of common law duties of brokers and FCM's should be cited as persuasive in a dispute in any common law jurisdiction.

It is important not to misread the opinion to mean that the law of negligence is inapplicable to broker-client relationships. On a transaction-by-transaction basis, brokers are still bound by the negligence standard of reasonable care. However, the Court clearly recognized that because a wide range of factors can affect the market price of a futures contract, the imposition of any continuing duty to furnish all information likely to affect the market "would be so burdensome as to be unreasonable."[42]

Though this decision was made in the futures context, there is reason to believe that the same determination would be made in all brokerage contexts. The Court's determination that Bear Stearns had no duty to provide ongoing advice or risk and suitability assessments is consistent with widely prevailing brokerage industry standards and with fundamental principles of contract.

The Second Circuit's decision upholds the integrity of the nondiscretionary account contract. If a customer believes he would benefit from a high level of personal attention and advice, he can pay a financial advisor for updated market information and suitability assessments. Clients entering into nondiscretionary contracts should not be able to sue in tort on the basis of claims that would not support a breach of contract action. Otherwise, there is no distinction between the duties owed to investors with discretionary and nondiscretionary accounts, and the nondiscretionary contract is rendered meaningless.

Because of the Court's affirmation of the transaction-by-transaction duty of care in the ordinary course, the reasoning supporting the decision applies equally to less affluent, unsophisticated investors, absent any finding of "special circumstances." The Court was unequivocal in its determination that, in the ordinary course, the rendering of advice to a nondiscretionary client does not trigger an ongoing obligation to do so. However, given that the Court looked to the contract as the primary source of the broker's duties to the nondiscretionary client, it may be advisable to incorporate language in nondiscretionary customer agreements, or in a separate attached document, to the following effect:

> You understand that we are under no obligation to provide you with information or advice affecting your trading decisions. However, we may from time to time provide you with such information or advice, at your request or as a courtesy to you. You expressly acknowledge that you are solely responsible for all trading decisions made in your account, regardless of any information or advice you may or may not receive from us. You understand and acknowledge that our providing such information or advice does not impose on us any obligation to provide any continuing information or advice, to update or modify previously provided information or advice, or to provide you with conflicting information or advice of which we may be aware.

Conclusion

The Second Circuit recognized bedrock legal principles and long-standing industry practice limiting broker liability on nondiscretionary accounts. By confining the scope of duties of diligence, competence and reasonable care in providing services to nondiscretionary clients to a transaction-by-transaction basis, the Court has preserved the distinction between these arrangements and those in which clients pay for the professional advice of industry professionals. The Court also acknowledged that there may be special circumstances in which a nominally nondiscretionary client is owed an ongoing duty of care, but those circumstances only exist when the account has essentially been converted to a discretionary one by the broker's assumption of control. In the ordinary course under a valid nondiscretionary account contract, there is no ongoing duty to provide information or advice, or to perform ongoing risk assessments or suitability reviews. Brokers who meet their duty of care obligations on a transaction-by-transaction basis should prevail against any claim of negligence by a nondiscretionary client. ■

Notes

1 *Kwiatkowski* v. *Bear Stearns & Co., Inc.*, Docket No. 01-7112, 2002 WL 31086924 (2d Cir. Sep. 19, 2002).

2 In October 1994, Kwiatkowski instructed Sabini to sell short 65,000 contracts (approximate notional value: $6.5 billion) on the Deutsche mark, Swiss franc, Japanese yen, and British pound. To protect itself, Bear Stearns asked Kwiatkowski to deposit $300 million in cash and liquid securities as margin collateral—Kwiatkowski offered to deposit $500 million.

3 The OTC market is much larger than the CME, and Schoenthal said its size would allow Kwiatkowski to trade his large positions with less visibility and less chance of market impact. Kwiatkowski later testified that Schoenthal had told him that, if needed, Schoenthal could get him "out like that, on a dime" from an OTC position.

4 *Kwiatkowski* v. *Bear Stearns & Co., Inc.*, 126 F.Supp.2d 672, 687 (S.D.N.Y. 2000).

5 *Id.* at 688.

6 Docket No. 01-7112, 2002 WL 31086924 at *8.

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7 126 F.Supp.2d at 711-17.

8 *Id.* at 725.

9 *Id.* at 692.

10 *Id.* at 694.

11 *Id.* at 688.

12 *Id.* at 702.

13 *Id.*

14 *Id.* at 703.

15 *Id.* at 726.

16 On appeal, amicus briefs in support of Bear Stearns were filed by the Bond Market Association, the Futures Industry Association and the Foreign Exchange Committee, by the National Futures Association, and by the Securities Industry Association. The Public Citizen Litigation Group filed an amicus brief in support of Kwiatkowski.

17 Docket No. 01-7112, 2002 WL 31086924 at *7.

18 *Id.*

19 *Id.*

20 *Id.* at *12.

21 *See, e.g., Robinson* v. *Merrill Lynch*, 337 F. Supp. 107, 112 (N.D.Al. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972); *Puckett* v. *Rufenacht, Bromagen & Hertz, Inc.*, 587 So. 2d 273, 280 (Miss. 1991); *Walston & Co.* v. *Miller*, 410 P.2d 658, 661 (Ariz. 1966).

22 Docket No. 01-7112, 2002 WL 31086924 at *12, quoting *Robinson*, 337 F. Supp. at 112-13.

23 *Id.* at *11.

24 *Id.* At *2.

25 *Id.* At *2-3.

26 *Id.* at *10.

27 *Id.*

28 *Id.*

29 *Id*. At *11 (emphasis added).

30 *Id.* at *8.

31 *See Societe Nationale d'Exploitation Industrielle des Tabacs et Allumettes* v. *Salomon Bros. Int'l Ltd.,* 674 N.Y.S.2d 648, 649 (App. Div. 1st Dep't 1998) (no heightened duties without "the requisite high degree of dominance and reliance"); *Leib* v. *Merrill Lynch Pierce Fenner & Smith*, 461 F. Supp. 951, 954 (E.D. Mich 1978), *aff'd.*, 647 F.2d 165 (6th Cir. 1981) (no heightened duties with respect to nondiscretionary account unless "broker has usurped actual control," citing precedent involving 77-year-old widow); *Robinson*, 337 F. Supp. at 111- 13 (no "special circumstances" in case of physician whose commodities broker failed to advise him of material market information; no heightened duties "unless the customer is infirm or ignorant of business affairs").

32 Docket No. 01-711, 2002 WL 31086924 at *10.

33 *Id.* at *16. In his petition for panel rehearing and rehearing en banc, Kwiatkowski argued that the Court ignored evidence that Bear Stearns charged Kwiatkowski greater commission rates than were customary for ordinary nondiscretionary accounts; that its highest ranking specialists advised Kwiatkowski on a daily basis; that Kwiatkowski routinely relied on this evidence on an ongoing, not transaction-by-transaction, basis; and that Bear Stearns earned massive profits by delaying Kwiatkowski's final liquidations. The petition also contended that the Court created a new rule of law inconsistent with New York negligence law regarding brokers. On December 5, 2002, the Second Circuit denied the petition for rehearing and rehearing en banc.

34 *Id.* at *13.

35 *Id.* at *15.

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.* at *17.

40 *Id.*

41 *Id.*, quoting *Hill* v. *Bache Halsey Stuart Shields, Inc.*, 790 F.2d 817, 824-45 (10th Cir. 1986).

42 *Walston*, 410 P.2d at 661 (quoted in *Robinson*, 337 F. Supp. at 112).

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