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Blair H. Wallace

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## **A PROPOSAL TO REFINE THE SUITABILITY STANDARD BY QUANTIFYING RECOMMENDATION RISK AND CLIENT APPROPRIATE RISK LEVELS**

Unsuitable recommendation of securities is one of the most common and costly claims in the brokerage industry.<sup>1</sup>

Perhaps the clearest example of a suitability violation occurs where a broker recommends speculative securities to a customer whose financial situation clearly calls for conservative investments (for example, a retired person who needs the income from his investments for his living expenses and who has no reasonable expectation of being able to replace any substantial trading losses).<sup>2</sup>

The current standard for determining “unsuitability” is subjective: Whether the broker reasonably believed his recommendation to be suitable for his client when he made it. The enormous quantity of claims<sup>3</sup> suggests that such a subjective standard may not be satisfactory and that refinement of the applicable laws and rules may be necessary. Without a clear standard, brokers may not know whether their recommendations are suitable. Similarly, attorneys for claimants and respondents have difficulty assessing their own cases. An objective standard based on financial data currently available to brokers is a better solution and would better guide brokers in making recommendations to their clients. Such a standard would improve the ability of lawyers to assess their clients’ cases, thus reducing the quantity of claims filed by investors and increasing the amount of settlements when claims were filed.

Unsuitable recommendations are proscribed by securities industry self-regulatory organization<sup>4</sup> (SRO) rules which require that a broker “have reasonable grounds for believing that the recommendation [of a security] is suitable for such customer.”<sup>5</sup> The Second Circuit requires five elements to

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1. Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999).

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

*Id.*

2. NORMAN POSER, *BROKER DEALER REGULATION* § 3.03 (3d ed. 2005).

3. NASD.com, NASD Dispute Resolution Statistics, Summary Arbitration Statistics October 2006, [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=516&ssSourceNodeId=12](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12).

4. The Securities and Exchange Commission sanctioned and approved the self-regulatory organizations including the National Association of Securities Dealers and the New York Stock Exchange to propose, implement, and enforce rules of conduct for the securities industry.

5. NASD RULES OF THE ASSOCIATION R. 2310; NYSE RULES R. 405.

prove a claim of unsuitability under §10(b) of the Securities Exchange Act of 1934 (the '34 Act) and Rule 10b-5 promulgated thereunder.<sup>6</sup> Federal courts have required scienter in the recommendation of an unsuitable security, and that damages resulted from the investor's justifiable reliance on that recommendation.<sup>7</sup>

The current standard for proving unsuitability, under federal law and SRO Rules, requires proof that the broker lacked a reasonable belief that the recommended security was suitable for his client.<sup>8</sup> This standard is unsatisfactory because it is "nebulous and amorphous."<sup>9</sup> This lack of a clear standard causes problems of proof for claimants, rebuttal for respondents and fails to establish satisfactory prophylactic direction.<sup>10</sup>

This article proposes a standard which quantifies the amount of risk inherent in a broker's recommendation and compares that risk to the client's appropriate risk level, and that certain objectively determined levels of risk are presumptively suitable or unsuitable for brokers to recommend to clients based upon their risk profile.

Part I of this article discusses the development and current state of unsuitability claims under SRO and federal law. Part II suggests that the suitability standard should be objective and weigh the level of risk inherent in a broker's recommendation against the client's appropriate risk level. Part III proposes an objective standard for determining suitability: the comparison of Risk Quotient (RQ)<sup>11</sup> to Client Appropriate Risk Level (CARL);<sup>12</sup> and discusses brokers' and investors' responsibility to explain and understand risk; and investors' acceptance of market risk when they invest in securities.

Part IV of this article proposes that an RQ less than or equal to one (RQ ≤ 1.0) is presumptively suitable for any investor; that an RQ greater than or

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6. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993); 15 U.S.C. § 78a, et seq.

7. *Brown*, 991 F.2d at 1031.

8. *Id.*

9. Lowenfels, *supra* note 1, at 1557 ("The suitability doctrine, always somewhat nebulous and amorphous with respect to its content and parameters. . .").

10. Roger W. Reinsch, J. Bradley Reich and Nauzer Balsara, *Trust Your Broker?: Suitability, Modern Portfolio Theory, And Expert Witnesses*, 17 ST. THOMAS L. REV. 173, 173 (Winter, 2004) ("The issues in and surrounding suitability claims are complex, yet surprisingly little has been written on this topic."); Stuart D. Root, *Suitability—The Sophisticated Investor—and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 289 (1991) ("The problems of 'unsuitability'—what does it mean, how is it measured, who should bear the risk of determining suitability—are not new. But these problems will most certainly become more frequent and arcane as the architecture of investment securities and strategies becomes more exotic.").

<sup>11</sup> Risk Quotient (RQ) is a term proposed by the author in this article. It is a measure of the risk of a position or portfolio of equity securities where the numerator is the volatility or beta and the denominator is the percentage of equity, which recognizes the impact of leverage on risk.

<sup>12</sup> Client Appropriate Risk Level (CARL) is also a term proposed by the author in this article. It signifies the objectively determinable amount of risk appropriate for a client despite her subjective view or her broker's opinion.

equal to 2.0 ( $RQ \geq 2.0$ ) is presumptively unsuitable for any investor; discusses the impact of an objective standard for suitability claims; and concludes that a clear, well-defined standard is necessary for meaningful review of unsuitability awards. This article concludes that a clear, well-defined standard is necessary to avert a developing crisis where both claimants and respondents are bound to arbitrate, but have no meaningful review of awards available to them.

## I. SRO AND FEDERAL UNSUITABILITY CLAIMS

### A. SRO RULES PROHIBIT UNSUITABLE RECOMMENDATIONS AND MAY RESULT IN DISCIPLINARY ACTIONS AND SANCTIONS

Investors may bring a claim of unsuitability before an arbitration panel<sup>13</sup> under NASD Rule 2310<sup>14</sup> or under NYSE Rule 405.<sup>15</sup> “Although the NYSE does not have a general suitability rule, its ‘know your customer’ rule requires NYSE members to use ‘due diligence to learn the essential facts relative to every customer [and] every order.’”<sup>16</sup> The NASD, on the other hand, specifically addresses unsuitable recommendations:

#### Recommendations to Customers (Suitability)

(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.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer’s financial status;
- (2) the customer’s tax status;
- (3) the customer’s investment objectives; and

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13. Under NASD Rule 10302, a panel of three arbitrators hears cases that have claims of damages in excess of \$25,000, while amounts under \$25,000 are decided by a single arbitrator on the basis of pleadings, and are known as “paper cases.” NASD RULES OF THE ASSOCIATION R. 10302.

14. *Id.* R.2310.

15. NYSE RULES R. 405 (“Rule 405. Diligence as to Accounts. Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to (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. Supervision of Accounts (2) Supervise diligently all accounts handled by registered representatives of the organization.”).

16. POSER, *supra* note 3, § 3.03, at 3-89.

(4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.<sup>17</sup>

Additional NASD broker duties are found in the, so called, “Know Your Customer Rule” where, “Members’ responsibilities include having a reasonable basis for recommending a particular security or *strategy*. In addition, the know-your-customer requirement . . . requires a careful review of the appropriateness of transactions in *low-priced, speculative securities*, whether solicited or unsolicited.”<sup>18</sup> Thus, a broker is required to learn about the investor’s financial condition,<sup>19</sup> including the investor’s source of funds for the account, the investor’s goals for these funds, and the investor’s ability to sustain risk<sup>20</sup> before making *any* recommendation.

The Second Circuit has found that NASD Rules “prohibit[] the sale to a customer by a broker or dealer of unsuitable securities.”<sup>21</sup> In furtherance of this end, the NASD rules state that, “[i]n 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.”<sup>22</sup> Accordingly, to make a suitable recommendation,<sup>23</sup> a broker must

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17. NASD RULES OF THE ASSOCIATION R. 2310.

18. *Members Reminded to Use Best Practices When Dealing in Speculative Securities*, SPECIAL NASD NOTICE TO MEMBERS 96-32, May 9, 1996, at 233 (emphasis added); Lowenfels, *supra* note 1, at 1560.

Four months later, in response to protests from discount brokers, the NASD purported to “clarify” the above reference to “unsolicited transactions” by issuing Notice to Members 96-60: “A member’s suitability obligation under Rule 2310 applies only to securities that have been recommended by the member. It would not apply, therefore, to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member.”

*Id.*

19. NASD RULES OF THE ASSOCIATION R. 2310.

20. See generally DAVID E. ROBBINS, *SECURITIES ARBITRATION PROCEDURE MANUAL* § 5-5 (5th ed. 2003).

21. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600–601 (2d Cir. 1978).

22. See NASD RULES OF THE ASSOCIATION R. 2110. The rule also requires members and their brokers to “observe high standards of commercial honor and just and equitable principles of trade.” *Id.*

23. Because what constitutes a recommendation may also be the subject of a claim or defense, the NASD issued the following statement:

[A] broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as “solicited” or “unsolicited.” In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.

understand the risks inherent in the investment and believe that such risks are justified by the potential rewards in light of the investor's financial situation.<sup>24</sup>

Arbitration panels often cite the "speculative nature of a stock;"<sup>25</sup> when determining suitability. In recent years, that an investment was a "tech stock" or "technology stock;"<sup>26</sup> and most commonly that the investment was "high risk," "risky" or "volatile"<sup>27</sup> has been cited. Currently, only two available SRO arbitration awards cite considerations of objective statistical comparison between recommended securities and the broader markets.<sup>28</sup> The descriptions of the securities at issue in suitability claims are arbitrary, and "[n]o securities industry standard of conduct is more frequently cited,

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NASD NOTICE TO MEMBERS 96-60, Sept. 1996, at 474.

24. See *Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 597 (2d Cir. 1969).

[A Broker] cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.

*Id.*

25. On November 14, 2006 the following LexisNexis search produced 56 results, composed of NASD and NYSE reported awards and disciplinary decisions: "Source: Securities > Self-Regulatory Organizations (SRO) Materials > Combined NYSE & NASD materials," "Terms: 'speculative nature' w/50 suitab!."

26. On November 14, 2006 the following LexisNexis search produced 81 results, composed of NASD and NYSE reported awards and disciplinary decisions: "Source: Combined NYSE & NASD materials," "Terms: suitab! w/50 ('tech stock' or 'technology stock')."

27. On November 14, 2006 the following LEXIS search produced 2,842 results, composed of NASD and NYSE reported awards and disciplinary decisions: "Source: National Association of Securities Dealers (NASD) Arbitration Awards," "Terms: suitability & (risk! or volatil!)". Lowenfels, *supra* note 1, at 1575-1576 ("The SEC agreed that the broker's recommendations, taken as a whole, were unsuitable for the customer's account. The broker's firm, at one time or another, had been an underwriter for each of the eleven securities at issue. The vast majority of these companies had operating losses and no anticipation of paying dividends. In addition, at least seven of these companies had offerings that were characterized by the prospectus as involving substantial or a high degree of risk. The SEC wrote: . . . 'The concentration of high risk and speculative securities in Bradley's account, which were predominately underwritten by Paulson [broker's firm], was not suitable.'").

28. In the Matter of the DeNicola v. First Union Brokerage Services, Inc., 2004 NASD Arb. LEXIS 1072 (May 21, 2004) ("The objectivity of the use of the Beta analysis as a tool to assess past performance outweighs Mr. Lyman's essentially unsupported, subjective, if not speculative, approach to determining suitability."); In the Matter of Roger and Mary Candace Brush v. Merrill Lynch Pierce Fenner & Smith, Inc., 2004 NASD Arb. LEXIS 3073 (Dec. 10, 2004) ("Considerable energy was expended during the hearing on the question of using either standard deviation or beta as tools in choosing and explaining choices of securities. As aids to brokers in choosing stocks, both standard deviation and beta are helpful, but as aids in explaining to unsophisticated clients which stocks were chosen, they are very likely useless.").

and least objectively applied, than the ‘suitability’ requirement for stockbrokers.”<sup>29</sup>

Brokers and broker-dealers are subject to disciplinary actions by the SEC and SROs for making unsuitable recommendations.

In *Bartholomew*, the respondent . . . sold high-risk direct investments to several retired or close-to-retirement investors. The investors had expressly informed Bartholomew that they desired liquid, income-producing, low-risk investments. The respondent . . . misrepresented to these customers the liquidity, risks, and benefits of the direct investments. The SEC found that the respondent had violated Section 10(b) and Rule 10b-5 by selling investments that were unsuitable for the purchasers in view of their age, modest financial condition, and conservative investment objectives.<sup>30</sup>

The NASD Sanction Guidelines for violation of Rule 2310 include “monetary sanction, suspension, bar, or other sanctions.”<sup>31</sup> Adjudicators of disciplinary actions are instructed to consider monetary fines ranging from \$2,500 to \$50,000 and to consider

[s]uspend[ing] respondent [broker-dealer] in any or all capacities for a period of 10 business days to one year. In egregious cases, [adjudicators should] consider a longer suspension (of up to two years) or a bar of an individual respondent. Also [adjudicators should] consider suspending respondent member firm with respect to any or all activities or functions for up to two years.<sup>32</sup>

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29. Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U.L. REV. 189, 189 (1998).

30. POSER, *supra* note 3, § 3.03, at 3-97.

31. NASD, NASD SANCTION GUIDELINES 99 (2006).

32. *Id.* at 2 n.1 (“This guideline also is appropriate for violations of MSRB Rule G-19.”);

As set forth in General Principle No. 6, Adjudicators should increase the recommended fine amount by adding the amount of a respondent’s financial benefit or require respondent to offer rescission to the injured customers. In this instance, the factors to be considered in the calculation of financial benefit should include the amount of any commissions or other profits that the respondent derived from the unsuitable trading.

*Id.* at 2 n.2;

The National Adjudicatory Council (NAC), formerly the National Business Conduct Committee, has developed the NASD Sanction Guidelines for use by the various bodies adjudicating disciplinary decisions, including Hearing Panels and the NAC itself (collectively, the Adjudicators), in determining appropriate remedial sanctions. NASD has published the NASD Sanction Guidelines so that members, associated persons, and their counsel may become more familiar with the types of disciplinary sanctions that may be applicable to various violations.

*Id.* at 1.

The standard of proof required for sanctions may be higher than that for recovery of damages by claimants, but is subjective nonetheless. For example, “[a] broker who *knowingly engages in unsuitable trading* violates the antifraud provisions of the federal securities laws. [The broker’s] trading [of] highly speculative options in customer accounts, in disregard of customer objectives, resources, and sophistication, *clearly constituted unsuitable trading* in violation of the antifraud provisions.”<sup>33</sup>

## **B. THE DEVELOPMENT OF UNSUITABILITY CLAIMS UNDER FEDERAL LAW**

Claims based on unsuitable recommendations began to appear in federal courts more than forty years ago.<sup>34</sup> Since then, a Rule 10b-5<sup>35</sup> violation has been found in two situations, described as the “fraud by conduct” theory and the “misstatement or omission” theory.<sup>36</sup> Fraud by conduct exists, as in *Clark v. John Lamula Investors, Inc.*<sup>37</sup> where the

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33. Prudential-Bach Securities, Inc. Exchange Act Release No. 34-22755, 1986 WL 626342, at \*12 (emphasis added) (citing *Mauriber v. Shearson American Express*, 567 F. Supp. 1231 (S.D.N.Y. 1983)).

34. Lowenfels, *supra* note 1, at 1581.

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

*Id.* (citations omitted).

35. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2006).

36. *Banca Cremi, S.A. v. Alex. Brown & Sons*, 132 F.3d 1017, 1032 (4th Cir. 1997) (explaining that while the Court “has never considered an unsuitability claim under § 10(b), several courts have recognized an unsuitability claim in certain circumstances”).

37. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978). Prof. Poser summarizes the *Lamula* facts:

The plaintiff was a retired school teacher with little investment experience or sophistication, who had received a divorce settlement of \$138,000. She told the defendant broker that she wished to invest \$100,000 of the divorce settlement, in order to obtain an annual yield of \$12,000. The broker recommended that the plaintiff buy certain debentures, and she agreed. The defendant purchased the debentures for \$94,360 and resold them to the plaintiff for \$105,250 (a markup of over 11 percent of the amount actually invested on the plaintiff’s behalf). When the debentures declined in value, the plaintiff sued under Rule 10b-5, claiming that the debentures were unsuitable and that the markup charged by the broker was unreasonable. The jury, in

broker committed fraud by executing an unsuitable trade for a client. On the other hand, prosecution of a claim under the misstatement or omission is conceptually similar to most other 10b-5 claims,<sup>38</sup> where the broker misrepresented or omitted the suitability of the recommendation to his client, because suitability is information that a reasonable investor would want to have before making an investment decision, as recognized in 1993 by the Second Circuit in *Brown v. E.F. Hutton Group, Inc.*<sup>39</sup>

The Second Circuit was the first federal appeals court, in 1978, to recognize unsuitability as a violation of Rule 10b-5 in *Lamula*.<sup>40</sup> “*Lamula* require[d] that to establish a 10b-5 claim the investor must prove only (1) that the recommended securities were unsuitable and (2) that the defendant acted with scienter. Or, put another way, an unsuitability claim is made out if the trier of fact finds that the recommended securities were unsuited to the investor’s needs, and that the broker knew or reasonably believed that [the securities] were unsuitable but recommended the securities to the plaintiff anyway.”<sup>41</sup>

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response to interrogatories, found that the defendant failed to inform the plaintiff of the following material facts: (1) how the leading rating services rated the debentures; (2) that the plaintiff could not expect to receive annual income of \$12,000 from a \$100,000 investment unless she bought speculative securities involving great financial risk; and (3) the extent of the risks involved in purchasing the debentures. The court concluded that the defendant acted with scienter and that if the plaintiff had been informed of the omitted facts she would not have purchased the debentures. The court, however, did not stop with its conclusion that the defendant had ‘omitted to state facts material to an informed purchase’ by the plaintiff, in violation of subsection (b) of Rule 10b-5; it also held that the defendant’s intentional recommendation of an unsuitable security was ‘an act, practice or course of business which operated as a fraud or deceit’ upon the plaintiff, in violation of subsection (c) of the rule.

POSER, *supra* note 3, § 3.03, at 3-92.1.

38. *Banca Cremi*, 132 F.3d. at 1032. A claim for § 10(b) suitability fraud “is a subset of the ordinary § 10(b) fraud claim.” *Id.* See also *O’Connor v. R.F. Lafferty*, 965 F.2d 893, 897 (10th Cir. 1992) (recognizing that this type of suitability claim could be analyzed “simply as a misrepresentation or failure to disclose a material fact. In such a case, the broker has omitted telling the investor the recommendation is unstable for the investor’s interests. The court may then use traditional laws concerning omission to examine the claim.”).

39. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993); POSER, *supra* note 3, § 3.03, at 3-93.

40. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599–600 (2d Cir. 1978).

41. Poser, *supra* note 3, § 3.03, at 3-92.2. The SEC repealed in 1983 a suitability rule actionable under federal law which applied to broker-dealers who were not members of an SRO. Former 17 C.F.R. § 240.15b10-3 enacted in 1967 and repealed in 1983. Lowenfels, *supra* note 1, at 1584. “Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of a security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer.” *Id.* “The SECO regulations, including Rule 15b10-3, were rescinded in 1983 and virtually all broker-dealers were required to join an SRO and thereby become subject to its rules.” *Id.*

### **1. The Five Elements of a 10b-5 Unsuitability Claim Under *Brown***

In *Brown*, the Second Circuit opinion defined five elements of unsuitability within the misstatement-omission violations of § 10(b) and Rule 10b-5.<sup>42</sup> The court stated:

A plaintiff 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) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct."<sup>43</sup>

The first *Brown* element is the subject of this article, so discussion on this topic is reserved for later. The second *Brown* element queries whether or not the broker knew or should have known that the securities were unsuitable for the client,<sup>44</sup> requiring a finding of the first element. Thus, the first two *Brown* elements hinge on the same subjective reasonable belief standard.

The third *Brown* element can generally be proved through documentary evidence and the records of the clients' accounts along with the records that are required to be kept by broker-dealers in conformance with § 17(a) of the '34 Act, which include: records of communications with clients, records of communications about client activities, commission records for the broker that may show similar transactions in other clients' accounts (parallel trading).<sup>45</sup> Respondents may show evidence that the claimants engaged in the same or similar trading in other brokerage accounts as rebuttal evidence.<sup>46</sup> According to the NASD, "a broad range of circumstances may cause a transaction to be considered recommended," including both oral and written communication with a client.<sup>47</sup> Although not binding law, SRO

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42. *Brown*, 991 F.2d at 1031.

43. *Id.* (citing *Lamula*, 583 F.2d at 600-01; *National Union Fire Insurance Co. v. Woodhead*, 917 F.2d 752, 757 (2d Cir. 1990)).

44. *See Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 595-596 (2d Cir. 1969) ("Brokers and salesmen are 'under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act.' Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein.").

45. The '34 Act's Rule 17a-3 Records to Be Made by Certain Exchange Members, Brokers and Dealers, requires Broker-Dealers to maintain records of each purchase, sale, call, put, cash balance, margin balance, etc. for each and every customer and transaction, or communication. SEC Rule 17a-3, 17 C.F.R. § 240.17a-3 (2006).

46. *See generally* ROBBINS, *supra* note 20, § 5-5, at 5-19.

47. NASD NOTICE TO MEMBERS 96-60, Sept. 1996, at 474.

Rules may be used in federal courts as evidence of standards of professional conduct.<sup>48</sup>

Scienter, the fourth *Brown* element, “may be inferred by finding that the defendant knew or reasonably believed that the securities were unsuited to the investor’s needs, misrepresented or failed to disclose the unsuitability of the securities, and proceeded to recommend or purchase the securities anyway.”<sup>49</sup> An inability to prove scienter is not a bar, however, because “in appropriate circumstances recklessness satisfies the scienter requirement.”<sup>50</sup> “Reckless conduct is, at the least, conduct which is ‘highly unreasonable’ and which represents ‘an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.’”<sup>51</sup> Although some dissension remains, “[b]y 1990, eight Circuit Courts of Appeal had adopted standards of ‘recklessness’ to support Rule 10b-5 claims.”<sup>52</sup> Thus, the determination of scienter or recklessness also hinges on a finding that the recommendation was unsuitable.

The fifth *Brown* element of justifiable reliance contains two components. First, “[a] plaintiff’s burden with respect to the reliance element of an unsuitability claim . . . var[ies] depending on whether the claim alleges fraudulent representations or [] omissions.”<sup>53</sup> This reliance aspect begs comparison between the complexity of the recommended security and the sophistication of the client, and further with that of the broker.<sup>54</sup> Here it may be presumed that an unsophisticated client relied on her

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48. *Javitch v. First Montauk Fin. Corp.*, 279 F. Supp. 2d 931, 938 (D. Ohio 2003); *see also Lange v. H. Heinze & Co.*, 418 F. Supp. 1376, 1384 (N.D. Tex. 1976) (NASD rules can be used as evidence as to standard of care in the industry); *Stevenson v. Rochdale Investment Management, Inc.*, 2000 U.S. Dist. LEXIS 13110 at \*28-29, 2000 WL 1278479, at \*8 (N.D. Tex. 2000) (unpublished opinion) (violation of the rules may be evidence of standard of care).

49. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993).

50. *Rolf v. Blyth*, 570 F.2d 38, 44-47 (2d Cir. 1978).

51. *Id.* at 47 (citing *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

52. *Root*, *supra* note 10, at 316-17.

53. *Brown*, 991 F.2d at 1031 (citing *Burke v. Jacoby*, 981 F.2d 1372, 1378-79 (2d Cir. 1992)).

54. *Id.* at 1032.

An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth. Under this standard, § 10(b) liability will not be imposed when an investor’s conduct rises to the level of recklessness. To determine whether an investor acted recklessly, and therefore without justifiable reliance, no single factor is dispositive, and all relevant factors must be considered and balanced. In *Royal American* we considered the plaintiff’s sophistication and expertise in finance and in the subject matter of the securities transaction; the plaintiff’s representation by counsel; the plaintiff’s opportunity to detect the fraud; whether the fraud was concealed; and the nature of the fraud. This Court has never established a list of all relevant factors, although many courts have been guided by the following: (1) The sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of longstanding business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7)

broker's<sup>55</sup> recommendation because of the broker's exposure to sophisticated investment matters through licensing requirements<sup>56</sup> and the Shingle Theory, which states that by advertising investment services to the public, a broker-dealer holds itself out as a competent expert in investing.<sup>57</sup> The second component of the fifth *Brown* element requires a showing of

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whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

*Id.* (citations omitted).

55. *Cash v. Frederick & Co.*, 57 F.R.D. 71, 78 (D. Wis. 1972) (“A defendant must exercise a higher standard of care when he knows or has reason to know that the plaintiff has relied almost exclusively upon his advice.”).

56. Brokers are required to pass the Series 7 licensing exam to become Registered Representatives in the sales of securities. NASD.com, Registration and Qualifications - NASD Registration and Examination Requirements, [http://www.nasd.com/RegistrationQualifications/BrokerGuidanceResponsibility/Qualifications/NASDW\\_011051](http://www.nasd.com/RegistrationQualifications/BrokerGuidanceResponsibility/Qualifications/NASDW_011051). (“This registration qualifies a candidate for the solicitation, purchase, and/or sale of all securities products, including corporate securities, municipal securities, municipal fund securities, options, direct participation programs, investment company products, and variable contracts.”). For further discussion of the scope of material covered by Registered Representative licensing exam, see Content Outline for the General Securities Registered Representative Examination (Test Series 7), <http://www.nyse.com/pdfs/series7.pdf>.

The Series 7 Examination is the Qualification Examination for General Securities Registered Representatives. As a qualification examination, it is intended to safeguard the investing public by helping to ensure that registered representatives are competent to perform their jobs. Given this purpose, the Series 7 Examination seeks to measure accurately and reliably the degree to which each candidate possesses the knowledge, skills and abilities needed to perform the critical functions of a registered representative (RR). Candidates should note that the duties and functions of the RR must be performed in accordance with just and equitable principles of trade, federal and state laws, and industry regulations. Furthermore, it is the responsibility of the RR to be aware of changes in current legislation, regulation and policy. The RR's primary responsibility is to the client. When advising the client, the RR must do so fully and honestly. The RR must make a diligent good-faith effort to obtain essential facts prior to making appropriate recommendations. Soliciting clients and counseling established clients are intrinsic duties of an RR, and these tasks must never be performed in a deceptive or fraudulent manner for any purpose. An RR who violates industry regulations is subject to disciplinary action, including censures, fines, suspension, and/or permanent loss of registration.

*Id.*

57. *See Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 596–597 (2d Cir. 1969).

A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders. While this implied warranty may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon his unfounded representations, its applicability in the instant proceedings cannot be questioned.

*Id.* (citing *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961)) (providing approval regarding the “shingle theory”); BLACK'S LAW DICTIONARY (8th ed. 2004) (“[Shingle theory definition:] The notion that a broker-dealer must be held to a high standard of conduct because by engaging in the securities business (‘hanging out a shingle’), the broker-dealer implicitly represents to the world that the conduct of all its employees will be fair and meet professional norms.”).

damages, such as the trading losses sustained as a result of the broker's recommendation.<sup>58</sup> However, a broker-respondent may counter with a showing that other factors caused all or part of the losses complained of or that his client failed to mitigate her losses. In a bear market,<sup>59</sup> a broker may use the well-managed account theory of losses<sup>60</sup> as a defense by showing, for example, that the losses suffered in his client's account were less than the proportionate declines in broad market indices during the same period.

### 3. The Suitability of the Recommended Security is the Focal Issue<sup>61</sup>

Decisions about whether a recommendation was made, whether reliance was justifiable, and the broker's scienter or recklessness may in many cases be reserved until after the suitability of the investment for the claimant has been determined. It is practical to reserve such findings because the existence of a recommendation, scienter, and justifiable reliance may flow logically from, a finding that the security was unsuitable for the client. For example, a finding that a thinly traded stock underwritten by the broker's firm and traded by the broker's other clients was unsuitable could be useful in determining that the recommendation was made with scienter or recklessness, and that the client justifiably relied on that recommendation.<sup>62</sup>

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58. Recommendations for unsuitable purchases are the most straightforward in terms of proving damages. It is theoretically possible, but practically far more difficult to prove losses resulting from an unsuitable recommendation to sell, although *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (U.S. 1972), does show this to be a credible claim in some instances. Other forms of loss include: margin interest, commissions, and the "well-managed account" theory of damages which compares the performance of an index to the performance of an account or investment to determine whether the customer lost more or less than they would have if widely invested. See *Rolf v. Blyth*, 570 F.2d 38, 44 (2d Cir. 1978).

59. Bear market, ia.com, <http://investopedia.com/terms/b/bearmarket.asp> (last visited Nov. 21, 2006) [hereinafter Bear Market Definition] ("A market condition in which the prices of securities are falling or are expected to fall.")

60. The well-managed account theory can be used in a bear, or declining, market to show that losses suffered by a client were commensurate with market losses and that the client would have fared no better, or little better, if invested in broad market indices or mutual funds. See ROBBINS, *supra* note 20, § 5-2, at 49-52.

61. Rapp, *supra* note 29, at 192.

Individual recommendations or a specific recommended strategy are typically evaluated against an indicated investment objective and financial profile, *with liability determinations flowing from a third-party ex post facto assessment of whether the characteristics of a particular recommendation comported with the stated objective and were consistent with the level of "risk" considered appropriate for the investor's profile. The focal point becomes the risk characteristics of an individual security rather than the risk characteristics of a portfolio in which the particular security is recommended to be a component.*

*Id.* (emphasis added).

62. By way of illustration: At times the complexity or obscurity of an investment recommendation in and of itself suggests that it may be unsuitable for any but the most sophisticated investor. Imagine, for example, that a broker executed purchases of "naked calls" in

Thus, under either *Lamula* or *Brown*, the determination as to whether the security was suitable for the client is both a threshold question and often the ultimate determining factor.<sup>63</sup> Paradoxically, the least guidance is provided for the determination of whether “the securities purchased were unsuited to the buyer’s needs.”<sup>64</sup>

**C. WHETHER THE BROKER REASONABLY BELIEVED THAT THE RECOMMENDED SECURITY WAS SUITABLE FOR THE CUSTOMER IS THE CURRENT STANDARD, AND FURTHER DEVELOPMENT HAS BEEN FORESTALLED BY ARBITRATION OF SUITABILITY CLAIMS**

The subjective standard of *reasonable belief* of the broker is used to determine whether a recommendation was suitable under *Hanly*,<sup>65</sup> *Lamula*,<sup>66</sup> and *Brown*.<sup>67</sup> Reasonable belief is too subjective and amorphous a standard in determining the unsuitability of investment recommendations.<sup>68</sup> As stated by Lowenfels and Bromberg in their article *Suitability in Securities Transactions*:

The present problem for the industry is that this broad ethical standard embodying a laundry list of unacceptable activities has become in effect a quasi-legal standard which forms the basis for the award of private damages to customers against brokers in arbitration. In practical reality—in part because securities industry arbitration panels normally do not render reasoned decisions in writing, in part because an approach of equitable fairness rather than strict legal doctrine drives these arbitration

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small-cap company prior to rumor of take-over bid for the account of an unsophisticated investor approaching retirement age. In this situation, the obscurity of the company, the sophistication and market knowledge required to make such a selection, and the investment-type all suggest that a person educated in making investment decisions would have formed the idea to make that investment.

63. Exceptions to this statement include dismissal of the claim for failure to plead with specificity, or disposal for lack of recommendation, reliance, or damages. *See DeBruyne v. Equitable Life Assur. Soc’y*, 920 F.2d 457, 465–466 (7th Cir. 1990) (“[A]llegations as to . . . risk and volatility . . . appear more likely to raise a genuine issue of fact as to mis-representation,” but dismissing securities claim for other reasons”).

64. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993).

65. *Hanly v. Sec. & Exch. Comm’n*, 415 F.2d 589, 597 (2d Cir. 1969) (“In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.”).

66. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600–601 (2d Cir. 1978) (“Mr. Lamula, therefore, was required to have reasonable grounds to believe that the securities sold were suitable for [his client].”). “The jury specifically found that the debentures were unsuited to appellee’s needs, that appellant Lamula knew or reasonably believed they were unsuitable, but that he recommended them to her anyway.” *Id.*

67. *Brown*, 991 F.2d at 1031.

68. Lowenfels, *supra* note 1, at 1557.

panels, and in part because there is no effective right of appeal from the decisions of arbitration panels—the exposure of the industry to private damages for violations of NASD suitability rules has expanded in exponential fashion.<sup>69</sup>

“Ultimately, suitability rules require only good faith assessments by brokers,”<sup>70</sup> but subjective, amorphous standards lead to uncertainty and to inefficient application of the law. Similarly, it is difficult and expensive for the industry, and its customers, to apply and expect a standard which is so amorphous. This is especially true as common law respondeat superior liability is compounded by statutorily defined duties which require broker-dealers to design procedures and compliance guidelines and supervise broker conduct.<sup>71</sup>

The lack of new cases which would further develop a standard for unsuitable recommendation liability is due, at least in part, to the fact that almost all unsuitability claims are heard in arbitration.<sup>72</sup> The reason for this result is that arbitration awards do not have precedential value and tend not to contain instructional analyses of law or facts. Further, “the bounds of a broker’s suitability responsibility are . . . left for largely intuitive determination by panels comprised of individuals having widely disparate legal and finance backgrounds, and whose charge expressly includes ‘wide latitude in their interpretation of legal concepts’ involved in matters put before them.”<sup>73</sup>

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69. *Id.* at 1567.

70. Rapp, *supra* note 29, at 258–60.

Larry Ira Klein illustrates that the examination of good faith begins with the process whereby an investment objective is identified and *the risk associated with it is then assessed*. In Larry Ira Klein, the expected return of high yield debt securities was significantly greater than the certificates of deposit or tax-deferred retirement funds in which customers’ funds had previously been invested. Still, as the SEC opined, it was decidedly unreasonable to conclude that the commensurate risk of a portfolio constructed to achieve that return was suitable. It did not help that the broker was also found to have materially misled his customers concerning the degree of risk actually involved.

*Id.*

71. ROBBINS, *supra* note 20, § 5-6f (Failure to Supervise); *see also* Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t (Supp. II 2002).

72. Renee Barnett, *Online Trading And The National Association Of Securities Dealers’ Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM U.L. REV. 1089, 1104 (2000) (“Second, virtually all brokers require customers to sign pre-dispute arbitration agreements prior to opening a brokerage account. By entering into a pre-dispute arbitration agreement, customers waive their right to commence judicial proceedings against their broker and instead must settle disputes through arbitration.”).

73. Rapp, *supra* note 29, at 191–192. Lowenfels, *supra* note 1, at 1584–85 (“[W]ith this shift in the legal basis for unsuitability claims has come a shift in the legal elements that must be proven to establish a suitability violation, from fraud under Exchange Act section 10(b) and Rule 10b-5 which requires scienter (or at a minimum recklessness) to a nebulous quasi-legal, quasi-ethical test for breaches of standards of duty and care under SRO rules which does not require scienter or recklessness.”).

Changes proposed by the NASD may increase the instructional value of arbitrators' awards: "The purpose of the proposed rule change is to amend the Code of Arbitration Procedure . . . to provide written explanations in arbitration awards upon the request of customers, or of associated persons in industry controversies."<sup>74</sup>

Federal courts continue to adhere to the *Brown* elements, as in *Louros v. Kreicas*<sup>75</sup> where the court stated that "[a] plaintiff asserting such a claim 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 . . . ."<sup>76</sup> The *Louros* court described the continuing relevance of *Brown* because, although it

does not mention loss causation[,] *Brown* [] was rendered before the Private Securities Litigation Reform Act codified the causation requirement for Section 10(b) cases. In any case, *Brown* does require that "the buyer justifiably relied to its detriment on the defendant's fraudulent conduct." This element comprehends a requirement of causation, and with it the jurisprudence on loss causation in securities fraud cases.<sup>77</sup>

The lack of an objective standard for determining suitability under SRO Rules continues to be problematic under federal securities laws.<sup>78</sup> Court challenges to arbitration awards in suitability claims are largely ineffective, at least partly because manifest disregard for the law is the standard for vacating an arbitration panel's award.<sup>79</sup> Thus, to vacate an award, a court must find that the panel manifestly disregarded the law when it found, based on a subjective standard, that a broker had a reasonable belief that his

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74. On submission to SEC, the NASD is proposing to codify this policy in NASD Rules of the Association Rule 10330(i).

75. *Louros v. Kreicas*, 367 F. Supp. 2d 572, 592 (S.D.N.Y. 2005).

76. *Id.* at 585 (emphasis added).

77. *Id.* at 592.

78. *GMS Group, LLC v. Benderson*, 326 F.3d 75, 81–82 (2d Cir. 2003) ("GMS neither points this court to case law interpreting the terms 'recommendation' or 'suitability,' nor points to anywhere in the record where such law was brought to the attention of the arbitrators.").

79. *Id.*; *Goldman v. Architectural Iron Co.*, 306 F.3d 1214, 1216 (2d Cir. 2002).

An arbitration award may be vacated if it exhibits a "manifest disregard of the law." Given the deference afforded arbitration decisions, this standard requires more than a mistake of law or a clear error in fact finding. Manifest disregard can be established only where a governing legal principle is 'well defined, explicit, and clearly applicable to the case,' and where the arbitrator ignored it after it was brought to the arbitrator's attention in a way that assures that the arbitrator knew its controlling nature. An arbitrator (even an arbitrator who is a lawyer) is often selected for expertise in the commercial aspect of the dispute or for trustworthiness, rather than for knowledge of the applicable law, and under the test of manifest disregard is ordinarily assumed to be a blank slate unless educated in the law by the parties.

*Id.* (citations omitted).

recommendation was suitable for his customer. The result is a dearth of meaningful reviews of arbitration awards.<sup>80</sup>

## II. THE SUITABILITY STANDARD SHOULD BE OBJECTIVE AND WEIGH THE RISK OF A BROKER'S RECOMMENDATION AGAINST THE CLIENT'S APPROPRIATE RISK LEVEL

An objective standard is necessary to judge the suitability of a broker's recommendation to his client. Currently, brokers are required to make their suitability determinations based on objective measures in order to establish a reasonable belief. Rational thought is required to make a reasoned determination, and "[t]he broker's suitability obligation does not rest on intuition, it rests on a formal statistical process."<sup>81</sup> Under the shingle theory, it can be expected that brokers will use finance theory in assessing the suitability of securities for their clients.<sup>82</sup> Among the many tools available to brokers, "Modern Portfolio Theory (MPT) is a set of formulas used to determine, objectively, whether a portfolio is suitable for a particular client's objectives and circumstances."<sup>83</sup>

An objective measure is also needed to guide broker-dealers and to protect investors. In fact, "it is essential that there be a suitability paradigm within which stockbrokers may comfortably operate and against which their professionalism may fairly be evaluated in the face of a challenge. That is not the case today."<sup>84</sup> The SEC has supported some objective standards in determining suitability in disciplinary settings, including inadvisable concentration of a client's assets in the stock of one company, especially if

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80. Here the primary trier of fact is an arbitration panel, although a panel's "award," as a panel's decision is known in arbitration, is subject to review by courts. The standard of review is "manifest disregard for the law" and is infrequently found in client-broker claims. Arbitration awards are "vacated" upon a motion for vacature by a party to the arbitration. Telephone interview with Professor Marcella Silverman of Fordham Law School (Sept. 2006). An unpublished Fordham Law School study found only one such award was vacated in New York in the last twenty years. *Id.*

81. Reinsch, *supra* note 10, at 199.

82. For information on the Series 7 exam, see *supra* note 56.

83. Reinsch, *supra* note 10, at 173. The Second Circuit has also made reference to objective measures in affirming a finding of unsuitability in *Lamula* when "the jury found that Lamula failed to inform [the client] . . . how the leading rating services rated the debentures." *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 599 (2d Cir. 1978).

84. Rapp, *supra* note 29, at 262-63 could be characterized to disagree with some propositions of this article. The article explains that:

'Suitability rules' set ethical conduct expectations, but articulate no standard of care against which portfolio oriented recommendations of brokers can be adequately and fairly judged. This is not to say that there should, or could, be a litmus test for judging broker conduct. Wooden notions of any sort cannot suffice to articulate a standard of care in a world populated by such a vast array of investment opportunities and risks and the many and varied strategies for their use.

*Id.*

that stock is “speculative”. In affirming an NASD disciplinary ruling, evidence was presented in that:

[Broker] Faber recommended that [his Client] McKinzie purchase approximately \$52,000 of Interbet shares. These funds constituted nearly all of her SC portfolio and more than two-thirds of her total liquid assets. Interbet had no revenues and had never showed any profits. Moreover, [Broker] Faber recommended that [his Client] McKinzie concentrate her entire portfolio at SC in *one speculative security*. This concentration created a substantial risk that [his Client] McKinzie could lose all, or virtually all, of her account balance. We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.<sup>85</sup>

**A. MOST UNSUITABILITY CLAIMS ARE BROUGHT BY INDIVIDUAL INVESTORS UNDER NASD RULE 2310, TO RECOVER PRINCIPAL LOST IN COMMON STOCK INVESTMENTS**

The overwhelming majority of unsuitability claims are arbitrated due to the enforcement of the arbitration clauses contained in almost every account opening document<sup>86</sup> signed between an investor and her broker.<sup>87</sup> The enforceability of these clauses was assured by two Supreme Court decisions, *Shearson/American Express v. McMahon*<sup>88</sup> in 1987 and *Rodriguez de Quijas v. Shearson/American Express*<sup>89</sup> in 1989, which

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85. In the Matter of the Application of DANE S. FABER, 10 Libertyship Way # 4133, Sausalito, California 94965, For Review of Disciplinary Action Taken by, NASD, 2004 SEC LEXIS 277, at \*25–26 (SEC 2004) (citations omitted).

86. See Barnett, *supra* note 73 (“[V]irtually all brokers require customers to sign pre-dispute arbitration agreements prior to opening a brokerage account.”).

87. The account opening document is a contract between the customer-investor and the broker/dealer, and defines the respective rights and obligations of the parties, the inclusion of a pre-dispute agreement to arbitration is governed by NASD RULES OF THE ASSOCIATION R. 3110(f) and NYSE RULES R. 637, and require significant disclosures as to the implications of arbitration and the procedural distinctions from a court action. See generally ROBBINS, *supra* note 20, § 2-3.

88. *Shearson/American Express v. McMahon*, 482 U.S. 220, 226 (1987) (“The Arbitration Act thus establishes a ‘federal policy favoring arbitration,’ requiring that ‘we rigorously enforce agreements to arbitrate.’”) (internal citations omitted).

89. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989).

Once the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not such essential features of the Securities Act that § 14 is properly construed to bar any waiver of these provisions. Nor are they so critical that they cannot be waived under the rationale that the Securities Act was intended to place buyers of securities on an equal footing with sellers. *Wilko* identified two different kinds of provisions in the Securities Act that would advance this objective. Some are substantive, such as the provision placing on the seller the burden of proving lack of scienter when a buyer alleges fraud.

*Id.*

upheld application of the Federal Arbitration Act as it pertained to securities claims brought under the Securities Act of 1933<sup>90</sup> ('33 Act) or the '34 Act.<sup>91</sup>

The choice of arbitration fora available to investors depends upon the language in the account opening contract. The most common securities arbitration fora are: NASD Dispute Resolution,<sup>92</sup> New York Stock Exchange Dispute Resolution/Arbitration,<sup>93</sup> and the American Arbitration Association.

The NASD hears 90% of all investor-broker arbitration cases,<sup>94</sup> including suitability claims. Between January 1, 2001 and October 31, 2005, 55% of NASD claims involved common stock.<sup>95</sup> Unsuitability claims

90. Securities Act of 1933, ch. 38, 48 stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77bbbb).

91. Securities Exchange Act of 1934, ch. 404, 48 stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78mm). *See also* Lowenfels, *supra* note 1, at 1558.

Following the dictates of the U.S. Supreme Court in the landmark decisions of *Shearson/American Express, Inc. v. McMahon*, and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, the principal forum where customer damage claims for unsuitability are heard has shifted within the last decade from the courts to arbitration, primarily the arbitration tribunals provided by the NASD. Additionally, the specific provisions relied upon by customers pursuing unsuitability claims in these arbitration forums have shifted within this past decade from the anti-fraud provisions of the federal securities laws, primarily section 10(b) and Rule 10b-5 of the Exchange Act, which mandate a legal standard of intent to defraud or recklessness, to the unsuitability rules of the self-regulatory organizations (SROs), primarily NASD Rule 2310, which embody a comparatively nebulous, quasi-legal, quasi-ethical standard of due care and fair dealing between brokers and customers. This shift in forum and in governing standards has eased meaningfully the customer's path to recovery and consequently has increased the customer's leverage to compel a significant settlement.

*Id.*

92. "NASD operates the largest dispute resolution forum in the securities industry to assist in the resolution of monetary and business disputes between and among investors, securities firms, and individual registered representatives." NASD.com, Arbitration & Mediation, <http://www.nasd.com/ArbitrationMediation/index.htm> (last visited Nov. 18, 2006); "NASD ranks by far the most active forum today, administering 90% or more of the [brokerage industry] cases filed each year." ROBBINS, *supra* note 20, at app. N, 1.

93. New York Stock Exchange arbitration is described on the NYSE website.

For more than 125 years, the NYSE has used arbitration to resolve disputes between investors and brokers. Arbitration enables a dispute to be resolved quickly and fairly by impartial arbitrators, who are knowledgeable and trained in the art of resolving controversy. When a customer chooses arbitration to resolve the dispute, he waives the right to pursue the matter in court. Arbitration is final and binding.

NYSE Group, Inc., Dispute Resolution/Arbitration, <http://www.nyse.com/regulation/dispute-resolution/1089312755623.html> (last visited Nov. 18, 2006).

94. NASD.com, Arbitration & Mediation—What is Dispute Resolution, <http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/WhatIsDisputeResolution/index.htm> (last visited Nov. 18, 2006).

95. *See* NASD.com, NASD Dispute Resolution Statistics, Summary Arbitration Statistics October 2006, [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&nodeId=516&ssSourceNodeId=12](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12).

before NASD arbitrators are very frequent, in fact, 11,718 such claims were filed between January 1, 2001 and October 31, 2005,<sup>96</sup> making unsuitability one of the most common civil claims in securities.<sup>97</sup> Thus, discussion of a suitability standard for common stock recommendations to individual investors under NASD Rule 2310 would be applicable to a very high proportion of unsuitability claims.

In determining whether a broker's recommendation was suitable for an investor, the issue should be restated as: "Whether the level of risk inherent in the recommendation was greater than the appropriate level of risk for the investor." Thus, two separate sub-issues present themselves: the level of risk inherent in the recommendation and the appropriate level of risk for the investor (e.g., whether investors assume market risk when entering the securities markets).

The risk that an investor will lose her invested principal is central to determining a suitability claim. When the risk of investing in a security is excessive for an investor, recommendation of that security is unsuitable for that investor.<sup>98</sup> This is not the only reason that a recommendation may be unsuitable, but practically, it is the loss of principal which drives investors to take action against their brokers.<sup>99</sup> "A broker may assure a client that the broker will only make 'safe' investments, and then spend the client's money on extremely risky securities, which lose value; in such cases, the client is harmed when the concealed risk—the volatility of the actual investments—lowers the value of her portfolio."<sup>100</sup>

Most unsuitability cases discuss risk, for the simple reasons that: 1) damages claimed or losses actually realized by the claimant did have a level of risk at the time of recommendation; 2) that the gravamen of an unsuitability claim is whether the amount of risk at the time of recommendation was suitable for the investor; and 3) whether the broker knew or should have known of that risk and its suitability for the investor.<sup>101</sup>

Risk of loss is the foundation of an unsuitability claim because brokers may only make recommendations if they have a reasonable basis for the belief that the recommended security is suitable for their client. "As a retail

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96. *Id.*

97. Because "[e]ach case can be coded to contain up to four controversy types," the quantity of claims relative to each other is somewhat uncertain, as many claimants bring multiple claims. At least a third of the NASD arbitration filings have contained claims of unsuitable recommendations during the 2002 to 2005 period. *Id.*

98. See, e.g., Lowenfels, *supra* note 1, at 1595 ("In *Aaron v. Paine Webber, Inc.*, the brokerage firm was ordered to pay its seventy-one-year-old customer, a former art supplies dealer, \$500,000 in damages for failing to 'take reasonable steps to limit or otherwise safeguard the extent of [the customer's] risks and possible losses.'").

99. *Id.*

100. *In re Initial Pub. Offering Secs. Litig.*, 399 F. Supp. 2d 298, 303, (S.D.N.Y. 2005).

101. See, e.g., *Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 597 (2d Cir. 1969).

brokerage industry observer has counseled: ‘Almost nothing is more important than understanding a client’s risk tolerance. How well will this person weather the ups and downs—especially the downs—of the market? Is the client’s idea of safety having aggressive growth investments with some market timing mixed in? Or money under the mattress?’<sup>102</sup> Thus, a broker can be liable for making an unsuitable recommendation if the risk of loss is too great for a particular client, and the broker knew or should have known of that risk.<sup>103</sup>

### B. IDENTIFYING AND QUANTIFYING THE RISK OF A RECOMMENDATION

The risk component of a suitability claim is related to the volatility of a given security’s price. The risk of loss is greater in investments that have a higher degree of volatility,<sup>104</sup> as explained in *In re Merrill Lynch & Co. Research Reports Securities Litigation* where the court cited a document stating that certain types of “securities ‘historically have been very volatile’ which ‘increases the risk that the securities may lose value.’”<sup>105</sup> That court also noted that “smaller companies . . . ‘may be less financially secure than larger, more established companies,’ and that as a result ‘such companies may be subject to abrupt or erratic price movements and more unpredictable price changes than the stock market as a whole.’”<sup>106</sup> This is why “[l]egal approaches are concerned exclusively with risk of loss.”<sup>107</sup>

“Inadequate (or fraudulent) advice on risks is the gravamen of complaints about unsuitability. . . . Hence risk analysis and suitability are inextricably linked.”<sup>108</sup> Therefore, “if a broker cannot make any estimate of

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102. Rapp, *supra* note 29, at 276.

103. *Perry v. Markman Capital Mgmt.*, 2002 U.S. Dist. LEXIS 19103 (E.D. Pa. 2002). (“First, [plaintiffs] allege that they told defendants on numerous occasions that the assets under Markman Capital’s management constituted their entire life savings. Second, Markman Capital was aware that capital needed to be preserved for plaintiffs’ retirements, which explained their desire for conservative investments with low risk and moderate volatility as set forth in the agreements. Finally, plaintiffs aver that defendants never informed them of the risks involved in the type of trading that defendants conducted with plaintiffs’ accounts.”).

104. Suitability claims require damages. There are few exceptional cases which claim as damages underperformance. Almost all suitability claims have a loss of principal as damages. Therefore, the assessment of suitability begins with a loss, and looks back to whether or not that loss was foreseeable at the time of recommendation. Because a degree of risk is inherent in any investment, the issue is usually reformed as whether the risk of loss of principal was greater than what was appropriate for the investor at the time she made the purchase.

105. *In re Merrill Lynch & Co. Research Reports Sec. Litig.*, 272 F. Supp. 2d 243, 247 (S.D.N.Y. 2003).

106. *Id.*

107. Rapp, *supra* note 29, at 261.

108. Root, *supra* note 10, at 352 (emphasis added). *Id.* at 351–52 (“Inadequate (or fraudulent) advice on risks is the gravamen of complaints about unsuitability (i) by institutional investors taken over by the RTC, (ii) by so-called sophisticated investors in government securities, (iii) in actions arising under the federal securities laws and commodities laws, (iv) in federal diversity and state court actions.”).

the risk and expected returns associated with a given security, then he clearly lacks an adequate basis for evaluating its prospects and so is prohibited by the ‘shingle theory’ from ever recommending so-called uncertain investments.”<sup>109</sup> Thus, this risk that brokers must assess in forming a reasoned belief as to the suitability of a recommendation can be objectively quantified.

Thus, quantification of the risk inherent in a recommendation can lead to an objective standard for determining the suitability of a recommendation made by a broker to his client.<sup>110</sup> Further, recommendation risk can be quantified with a simple mathematical calculation using two measures accessible to brokers. Beta ( $\beta$ ) is a measurement of the volatility of a specific security relative to the securities market generally. The volatility of an investment is increased proportionally by the use of borrowed funds (leverage), thereby magnifying the effect of a security’s losses and gains in value. The risk level of a recommendation can be calculated by dividing the recommended security’s beta by the equity ratio of the recommendation (the percentage of equity of a security position). The resulting number is the “Risk Quotient.”

“An accurate determination of beta is the most important single element in predicting the future behavior of a portfolio.”<sup>111</sup> Beta is “[a] measure of [a security’s or portfolio’s] volatility, or systematic risk, in comparison to the market as a whole.”<sup>112</sup> “Although [beta] is the product of arcane analysis of historic data, beta information for [almost all exchange] traded securities is easily accessed by investors and investment professionals alike.”<sup>113</sup> Because “[r]etail stockbrokers have the resources to make, or at least fairly estimate, the needed determinations in regard to particular recommendations”<sup>114</sup> it is reasonable to use beta information in determining

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109. Neil B. Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L. J. 1604, 1607–08 (1971).

110. The NASD supports this theory as well, as it told its members in a Fall 1998 Regulatory Short Take on Suitability Issues.

When considering “suitability,” one often thinks in terms of a customer’s financial status, investment background, and investment objectives. It is equally important to consider the factors relevant to the security and/or product being recommended. *Before making any recommendation, the firm should perform adequate due diligence to ascertain essential facts such as financial status of issuer, degree of risk, maturity date, and withdrawal penalties.* It is important that suitability standards be reviewed with each and every trade.

NASD, REGULATORY & COMPLIANCE ALERT 13 (Sept. 1998) (emphasis added).

111. Reinsch, *supra* note 10, at 196.

112. Beta, Investopedia.com, <http://www.investopedia.com/terms/b/beta.asp> (last visited Nov. 14, 2006) [hereinafter Beta Definition].

113. Rapp, *supra* note 29, at 252

114. *Id.* at 251–52.

whether or not a recommendation was suitable, or at least whether a broker had a basis for a reasonable belief that the recommendation was suitable.<sup>115</sup>

Beta is calculated by comparing the historic fluctuation of a security's price relative to changes in the market as a whole.<sup>116</sup> If a security has a beta lower than 1.00, that security's historic price has been less volatile than the overall market over the same period. A beta higher than 1.00 signifies that security's price has been more volatile than the market. "For example, if a stock's beta is 1.2 it's theoretically 20% more volatile than the market."<sup>117</sup> The Standard & Poor 500 index (S&P 500) is "the [most popular, but not only] standard for calculating beta . . . where the S&P 500 has a beta equal to 1.00."<sup>118</sup>

Volatility is "a statistical measure of the tendency of a market or security to rise or fall sharply within a period of time."<sup>119</sup> "Volatility is typically calculated by using variance or annualized standard deviation of the price or return. . . . A highly volatile market means that prices have huge swings in very short periods of time."<sup>120</sup> Standard deviation is a statistical measure "of the dispersion of a set of data from its mean. The more spread apart the data is, the higher the deviation. . . . A volatile stock would have a high standard deviation."<sup>121</sup> Standard deviation is symbolized by the Greek letter sigma ( $\sigma$ ). Sigma squared ( $\sigma^2$ ) is beta.

115. See *Central Nat'l Bank v. United States Dep't of Treasury*, 912 F.2d 897, 901-02 (7th Cir. 1990). In *Central*, Circuit Judge Posner recognized beta as a quantification of investment risk. *Id.*

116. "Beta is calculated using regression analysis, and you can think of beta as the tendency of a security's returns to respond to swings in the market. A beta of 1 indicates that the security's price will move with the market." Beta Definition, *supra* note 113.

117. *Id.*

118. The Major American Equity Indices, <http://www.benbest.com/business/indexusa.html> (last visited Nov. 18, 2006).

The S&P 500 is intended to be comprised of the 500 biggest [publicly]-traded companies in the United States by market capitalization (in contrast to the FORTUNE 500, which are the largest 500 companies in terms of sales revenue). Although the general principle for calculating the S&P 500 Index on the basis of market capitalization of the largest 500 companies is simple, the details can be complex. . . . The S&P 500 Index comprises about three-quarters of total American capitalization. In 2001, forty of the S&P 500 stocks provided half of the Index's total market cap. In 1999, nine of the S&P 500 stocks provided half of the Index's total return. Most money managers treat the S&P 500 as a proxy for the US stock market. Three-quarters of money in American index funds is tied to the S&P 500. Analysts using the Capital Asset Pricing Model (CAPM) use the S&P 500 as a proxy for the stock market . . . .

*Id.*

119. RealNetworks, Inc., Glossary (V), <http://investor.realnworks.com/glossary.cfm?FirstLetter=v> (last visited Nov. 18, 2006).

120. Volatility, TheFreeDictionary.com, <http://financial-dictionary.thefreedictionary.com/Volatility> (last visited Nov. 18, 2006).

121. Standard Deviation, Investopedia.com, <http://www.investopedia.com/terms/s/standard-deviation.asp> (last visited Nov. 14, 2006).

These measurements are used in financial analysis to determine the value of risk, which is defined as “the chance that an investment’s actual return will be different than expected.”<sup>122</sup> This includes the possibility of losing some or all of the original investment. It is usually measured using the historical returns or average returns for a specific investment.<sup>123</sup> As is commonly understood, “[h]igher risk means a greater opportunity for high returns... and a higher potential for loss.”<sup>124</sup>

There are several types of risk associated with securities investment, which can be categorized into one of two types: “Systematic Risk” and “Unsystematic Risk.” Systematic Risk is “[t]he risk inherent to the entire market or entire market segment. [It is a]lso known as ‘un-diversifiable risk’ or ‘market risk’”<sup>125</sup> because the entire market is susceptible to this type of risk and no strategy of diversification can protect an investor from a global market decline. Thus, this is a type of risk that cannot be avoided by any investor, and therefore is not compensated for.<sup>126</sup>

Unsystematic Risk is “[r]isk that affects a very small number of assets. Sometimes referred to as specific risk.”<sup>127</sup> This type of risk affects individual securities or investment sectors, “[f]or example, news that is specific to a small number of stocks, such as a sudden strike by the employees of a company,”<sup>128</sup> or the dramatic negative effect of increasing fuel prices on airlines’ stocks, as opposed corresponding increase to the shares of oil drilling supply companies.

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122. See Risk-Return Tradeoff, Investopedia.com, <http://investopedia.com/terms/r/riskreturntradeoff.asp> (last visited Nov. 14, 2006).

Risk-Return Tradeoff [Definition:] The principle that potential return rises with an increase in risk. Low levels of uncertainty (low risk) are associated with low potential returns, whereas high levels of uncertainty (high risk) are associated with high potential returns. In other words, the risk-return tradeoff says that invested money can render higher profits only if it is subject to the possibility of being lost. [Example:] Because of the risk-return tradeoff, you must be aware of your personal risk tolerance when choosing investments for your portfolio. Taking on some risk is the price of achieving returns; therefore, if you want to make money, you can’t cut out all risk. The goal instead is to find an appropriate balance - one that generates some profit, but still allows you to sleep at night.

*Id.*

123. Risk, Investopedia.com, <http://www.investopedia.com/terms/r/risk.asp> (last visited Nov. 14, 2006).

124. *Id.*

125. Systematic Risk, Investopedia.com, <http://www.investopedia.com/terms/s/systematicrisk.asp> (last visited Nov. 14, 2006).

126. *Id.* (“Interest rates, recession and wars all represent sources of systematic risk because they will affect the entire market and cannot be avoided through diversification. Whereas this type of risk affects a broad range of securities, unsystematic risk affects a very specific group of securities or an individual security. Systematic risk can be mitigated only by being hedged. Even a portfolio of well diversified assets cannot escape all risk.”)

127. Unsystematic Risk, Investopedia.com, <http://www.investopedia.com/terms/u/unsystematicrisk.asp> (last visited Nov. 14, 2006).

128. *Id.*

Brokers have a duty to disclose these types of risk to investors, especially when there are specific risks inherent in particular investment types and, especially, in specific securities.<sup>129</sup> Among the many rules requiring such disclosure are NASD Rule 2310<sup>130</sup> and NYSE Rule 405.<sup>131</sup> Case law elaborates that a broker must inform a client of the risks of an investment.<sup>132</sup> Measuring the recommendation risk of an individual security, the broker must take that security's volatility or beta into account to determine whether it may be suitable for the investor at the time he makes such a recommendation.<sup>133</sup>

Another component in quantifying the risk inherent in a recommendation is the leverage or "margin"<sup>134</sup> recommended in purchasing such a security, as leverage will increase the volatility of a position.<sup>135</sup> "[T]he

129. See *Lieb v. Merrill Lynch, Pierce, Fenner and Smith*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6<sup>th</sup> Cir. 1981).

<sup>130</sup> NASD RULES OF THE ASSOCIATION R. 2310.

<sup>131</sup> NYSE RULES R. 405.

132. A broker's failure to conduct a proper investigation and to inform a potential purchaser of its findings could in itself be a basis for liability under 10b-5. *Cash v. Frederick & Co.*, 57 F.R.D. 71, 77 (D. Wis. 1972); see also *Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 597 (2d Cir. 1969).

133. See *Shad v. Dean Witter Reynolds, Inc.*, 799 F.2d 525, 530 (9th Cir. 1986), discussing the need for comparison in determinations of churning or suitability.

*Suitability is apparent only by comparison with other possible investments. To determine whether the investments are suitable, one must know the spectrum of possible investments to which the ones in issue are compared. The significance of statistical measurements of account activity, such as the turnover rate, is apparent only in comparison to activity in other accounts. If an expert is not allowed to testify that given statistics evidence excessive trading, the jury is left with meaningless numbers from which they cannot judge the appropriateness of the transactions.*

*Id.* (emphasis added).

134. See *Margin*, Investopedia.com, <http://investopedia.com/terms/m/margin.asp> (last visited Nov. 14, 2006). Definitions of "margin: 1. Borrowed money that is used to purchase securities. This practice is referred to as 'buying on margin'. 2. The amount of equity contributed by a customer as a percentage of the current market value of the securities held in a margin account." Examples include:

1. Buying with borrowed money can be extremely risky because both gains and losses are amplified. That is, while the potential for greater profit exists, this comes at a hefty price—the potential for greater losses. Margin also subjects the investor to a number of unique risks such as interest payments for use of the borrowed money.
2. For example, if you hold futures contracts in a margin account, you have to maintain a certain amount of margin depending on how the market value of the contracts change.

*Id.*

135. *NASD Dept. of Enforcement v. Raghavan Sathianathan*, 2004 NASD Discip. LEXIS 55, 60–61 (NASD Discip. 2004) ("Sathianathan did so because he used margin and options trading in his clients' accounts without consideration of the suitability of those strategies for his customers. This is a grave departure from the standards governing his duty to ensure that his recommendations are suitable for his customers.").

extent to which the broker used margin was unsuitably risky” for the investor.<sup>136</sup> The amount of margin affects suitability because a drop in the recommended security’s price will affect the value of the position attributable to both the portion owned with the investor’s own funds and *also* the portion controlled with borrowed funds.

There are two distinct types of recommendations that may occur in a broker-client relationship: the recommendation of an individual security (or securities) and the recommendation of an individual security (or securities) in the context of allocating the assets of a portfolio. When measuring the recommendation risk of a security in the context of a portfolio, the broker must take into account the weighted average beta of the portfolio (portfolio beta)<sup>137</sup> and what the impact of the recommendation will be on the portfolio beta at the time he makes a recommendation as to whether it may be suitable for the investor. Thus, a broker who makes recommendations based on a portfolio approach must take ongoing measures of the portfolio’s volatility into consideration, and may recommend adjusting components’ weights or adding more or less volatile securities to achieve the best distribution for the investor.<sup>138</sup>

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136. Lowenfels, *supra* note 1, at 1577–78.

In *In re Rangen*, the broker recommended that three unsophisticated, inexperienced investors, two of them elderly and all with limited means, concentrate their investments in margin purchases of non-income-producing U.S. Treasury (STRIP) securities and speculative over-the-counter securities. These recommendations were subsequently adjudged unsuitable on three grounds. First, the recommendations were unsuitable because the customers were “seeking safe, income-producing investments and did not wish to speculate.” Second, the extent to which the broker used margin was unsuitably risky for inexperienced customers seeking to generate additional income through their investments. Third, the concentration of so much of the customers’ equity in particular securities “increased the risk of loss . . . beyond what is consistent with the objective of safe non-speculative investing.”

*Id.*

137. The beta of a portfolio can be measured by multiplying the weight, or percentage, of each portfolio component by its individual beta and adding the weighted betas of each component. For example, Pfizer common stock, accounts for 50% of a given portfolio’s value, Google common stock, accounts for 25% of that portfolio’s value, and the remaining 25% in Microsoft common stock. If Pfizer’s beta was  $0.8 \times 50\% = 0.4$ ; Google’s beta that day is  $1.6 \times 25\% = 0.4$ ; and Microsoft’s beta that day is  $1.2 \times 25\% = 0.3$ , the portfolio beta would equal  $0.4 + 0.4 + 0.3 = 1.1$ , or 10% more volatile than the S&P 500.

138. The broker in a non-fiduciary capacity is under no overt duty to monitor the performance or volatility of the portfolio, but only to make recommendations that are suitable at the time that they make them. Therefore a Broker, who claims to use the portfolio approach, will be bound to re-assess the volatility each of the existing components when making any further recommendations. See generally Rapp, *supra* note 29, at 271 (“Only after the suitability of risk/return parameters is established does it matter what recommendations for the construction of or addition to a portfolio are made. At that point, however, the stand-alone characteristics of a particular recommendation matter only as to the contribution of the asset to the performance of the portfolio, which now has its own risk/return profile. A recommended asset which adds to the efficiency of the portfolio, i.e., one which moves the entire portfolio to maximum return associated with the established risk level of the portfolio, or which is made in order to maintain

### C. RISK QUOTIENT (RQ)

The Risk Quotient measures the volatility of a particular investment or portfolio at the time of recommendation by taking the relative volatility and the leverage of the position both into account.<sup>139</sup> These two measures are easily identified by the broker<sup>140</sup> and are significant factors in making any investment decision because leverage proportionally impacts the beta's volatility measure. RQ is calculated by dividing the beta of the individual security by the equity percentage recommended ( $RQ = \beta \div \text{equity \%}$ ). The equity percentage is calculated as 100 percent less the percentage of loan recommended to make the purchase. Thus,  $\beta$  is the numerator and the equity percentage is the denominator. The resulting RQ reflects the impact of "leverage," as the use of borrowed funds amplifies the risk inherent in any investment.

For example: A broker recommended American International Group common stock, listed as AIG on the NYSE, on December 5, 2005 when it had a beta of 0.79. The broker recommended that the purchase be made with one-half cash and one-half borrowed funds from the broker's firm, yielding an equity percentage of 50%. The RQ formula would be  $0.79 \div 50\% = 1.58$ . Thus, the recommendation of AIG, a stock less volatile than the S&P 500 by 21% (where the beta of the S&P 500 is 1.0),<sup>141</sup> is rendered 58% more volatile than the S&P 500 by the use of leverage.

If a broker is recommending a change to a position or positions within a portfolio, reassessment of the existing portfolio components is required for the RQ to be meaningful.<sup>142</sup> Because "[s]uitability... is an ongoing

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maximum return without altering overall risk characteristics, should not be open to challenge on the basis of the individual risk characteristics.").

139. Reinsch, *supra* note 10, at 177-78 ("The correlation of a stock with the stock market as a whole is called the beta of the stock. The beta of each stock in the portfolio is then used to determine the overall risk of the portfolio. The level of risk produced is supposed to correspond to the level of risk the customer stated he or she wanted in the investment portfolio. This is the factor that makes the portfolio 'suitable' or not 'suitable' for a particular investor. In suitability claims, the basis of the lawsuit is that the portfolio was not suitable for the investor's stated objective(s).").

140. The typical data sheet for any common stock will have a three year beta calculated versus the S&P 500. Additionally, beta information is available through Bloomberg<sup>TM</sup> terminals, financial websites such as finance.yahoo.com, and analysts' reports; *see also* Rapp, *supra* note 9, at 251-52 ("[A]vail to retail brokers and investors alike. . ."),

141. *See supra* note 119.

142. Reinsch, *supra* note 10, at 195 ("Whatever the general risk preferences of the investor, within a diversified portfolio there should be both risky and risk-free investments. Through diversification, the portfolio eliminates the non-systematic risks of component securities and leaves only an identifiable, but accepted, level of systematic risk associated with the expected return of the portfolio. . . . Conversely, such a portfolio will have the minimum risk at the desired level of expected return.").

obligation [the broker-dealer may be liable if it] failed to maintain any ongoing supervision of the Claimant's suitability."<sup>143</sup>

A portfolio's RQ is the weighted average RQ of each component, with existing components reassessed at the time of recommendation at the then-current beta<sup>144</sup> and then-current equity percentage.<sup>145</sup> A broker who undertakes such analysis would have a defense to a claim of unsuitability as he would have used a portfolio approach to client recommendations. The broker would have known the portfolio's level of risk and would have been able to manage the amount of risk his client was exposed to.

**D. THE CLIENT'S APPROPRIATE RISK LEVEL (CARL) SHOULD BE THE BASIS OF COMPARISON TO THE RECOMMENDATION RISK<sup>146</sup>**

As part of the Know Your Customer duties, a Broker must determine what level of risk is appropriate for the client before making any recommendations.<sup>147</sup> To appropriately determine his client's CARL, a broker is required under NASD Rule 2310(b) to "make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."<sup>148</sup>

"Such other information" may include: 1) the client's age, as it may be indicative of the amount of time that she will hold the investments contemplated, or when the principal amount invested may be needed to sustain her or provide income; 2) the client's employment or other income

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143. *Peterzell v. Charles Schwab & Co.*, No. 88-02868, 1991 WL 202358 \*2 (N.A.S.D. 1991). See also Lowenfels, *supra* note 1, at 1594 (discussing "dram shop" cases).

144. See Reinsch, *supra* note 10, at 196 n.111 ("The beta of an individual component is subject to change over time, as an earnings report or other news may put unsystematic pressure on a company's securities and drive it away from market trends.").

145. The equity percentage of a component is subject to change over time, as the rise in a component's value will increase the equity percentage and conversely, a decrease in value will decrease the equity percentage.

146. Reinsch, *supra* note 10, at 193 ("The broker must ensure that the investor's risk profile is given due consideration in terms of the beta of the portfolio. The most common violations by a broker are recommendations or purchases of securities that are not suitable for an investor's stated risk level because the broker is required to create and maintain a suitable portfolio for each particular investor.").

147. *Id.* at 175 ("A broker must understand the investor's financial needs in order to determine what would suit those needs. In order to do that, the broker must complete an investor profile. The profile consists of what the client wants the investment to accomplish and the level of risk the investor is willing to undertake. Rule 2310 and the other suitability rules require a broker to create an accurate "investor profile" and then use that profile to make proper investments or recommendations.").

148. NASD RULES OF THE ASSOCIATION R. 2310.

producing activities because her ability to generate income apart from the contemplated investment is central to the amount of risk she may be prepared to sustain, since typically, a professionally employed individual or family is better suited to put invested capital at risk than one who is disabled or without ready ability to replace or contribute additional principal for investment purposes; 3) the client's other assets because of the general desire to preserve a core of assets that can be sustained in a relatively risk-free investment, since often a client who owns a home or other significant investments is better suited to sustain risk in an investment account than one who has no other assets.

"In a section entitled, 'Know Your Customer,' the Series 7 study guide advises that before making a recommendation, a broker should appreciate the customer's balance sheet, the customer's income statement, non-financial investment considerations, and the customer's investment outlook."<sup>149</sup> Risk tolerance in financial terms is "[t]he degree of uncertainty that an investor can handle in regards to a negative change in the value of their portfolio."<sup>150</sup> A familiar example provides that because "[a]n investor's risk tolerance varies according to age, income requirements, financial goals, etc. . . . a 70-year-old retired widow would generally have a lower risk tolerance than a single 30-year-old executive."<sup>151</sup>

In *Louros v. Kreicas*, the client's "risk tolerance was 'aggressive' (the other choices were 'moderate' and 'conservative')."<sup>152</sup> Another example of risk tolerance can be stated in terms of investment goals.

Preservation of capital—"A person with this as his most important objective would not be willing to invest in most equity securities. . . . In general, when clients speak of safety, they usually mean preservation of capital from losses due to credit or financial risk. Financial risk is the danger of losing all or part of the principal amount a person has invested."<sup>153</sup>

"All investments involve some degree of risk. According to the oft-quoted maxim, 'The greater the risk assumed by the investor, the greater the potential reward.' But just what are the risks inherent in an investment? What risks should be considered in determining the suitability of an investment recommended by a broker?"<sup>154</sup>

The most important considerations in determining CARL do not have to do with goals, but with a client's ability to sustain and recover from losses,

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149. ROBBINS, *supra* note 20, § 5-5, at 5-14.

150. Risk Tolerance, Investopedia.com, <http://www.investopedia.com/terms/r/risktolerance.asp> (last visited Nov. 14, 2006).

151. *Id.*

152. *Louros v. Kreicas*, 367 F. Supp. 2d 572, 593 (S.D.N.Y. 2005).

153. ROBBINS, *supra* note 20, § 5-5, at 5-14 (citing PASSTRAK SERIES 7, a study guide on Know Your Customer duties).

154. *Id.*

or “risk tolerance.” If a client expresses goals that are incompatible with her risk profile,<sup>155</sup> it is the broker’s duty to reconcile the expectations of return with the anticipation of risk before making *any* recommendation.<sup>156</sup> Accordingly, without such reconciliation of goals and risks, a broker is not positioned to make any recommendations to the client, as such recommendation would either fail to meet the investor’s goal or exceed her risk expectation.

A survey of risk tolerance options available for selection on account opening documents of broker-dealers shows a wide diversity in the way that firms allow clients to describe their own vision of risk tolerance.<sup>157</sup> Discussions of client risk in legal and arbitration fora tend to focus on three general categories: conservative, moderate, and aggressive (or speculative).<sup>158</sup>

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155. An example of contradictory goals and risk expectation would be a goal 20% annual, tax-free income without risk of loss of principal. A Broker could explain that 20% returns may be achieved, but can not be anticipated without a high degree of risk, possibly including leverage; that tax-free income is only available in a limited number of investments, namely municipal bonds, which tend to offer only slight premiums above US Government-backed bonds, and are not likely to approach 20% in normal circumstances; or that the only “risk-free” investments in securities are US Government-backed bonds which offer a modest return nowhere near 20% annually, historically. The Broker could further suggest that a goal of 8% annual returns might be possible, with a portfolio comprised of US Government-backed bonds, Municipal Bonds, and equities that would not put all of the client’s principal at risk.

156. Cohen, *supra* note 110, at 1607–08.

157. ROBBINS, *supra* note 20, § 5-5, at 5-13–5-14.

Few opening account forms delineate an investor’s true investment objectives because the categories to check off on the forms are either too general or not applicable or otherwise cannot define the customer’s needs. A survey of the “investment objectives” portion of many opening account forms found a myriad of possibilities: income, income and growth, businessperson’s risk, speculation, investment grade, growth, investment hedge, safety of principal, tax-sheltered income, long-term growth, short term trading, trading, appreciation with safety, appreciation with risk, tax free income, trading profits, intermediate term, good quality, high risk, conservative growth, and aggressive growth. “Unfortunately, many new account forms are limited in their ability to accurately describe a customer’s objective. This can cause real problems when the testimony surrounding the issue of investment objectives occurs many years later . . . compounded by the fact that until recently, customers were not sent copies of their new account forms unless the forms were for an options account.” It is important for a customer’s attorney to appreciate the various investment objectives a broker *should* have discussed with a customer so that if a loss took place based on a recommended investment, counsel can determine whether the broker engaged in a substantive conversation on this issue.

*Id.*

158. On November 14, 2006 the following LexisNexis search produced 129 results, composed of NASD and NYSE reported awards and disciplinary decisions: “Source: Securities > Self-Regulatory Organizations (SRO) Materials > Combined NYSE & NASD materials” “Terms: client w/25 (conservative or moderate or aggressive or speculative).” On November 14, 2006 the following LexisNexis search produced 26 results, composed of federal and state suitability decisions and disciplinary decisions reviews: “Source: Securities > Cases & Court Rules > Federal and State Securities Cases” “Terms: client w/25 (conservative or moderate or aggressive or speculative) & suitab! w/25 securit!”

The client's description of her own risk tolerance, however, is not the end of the inquiry for a broker, as he is still bound by the Know Your Customer duties.<sup>159</sup> It may be the case that a broker's dutiful investigation leads him to discover that his client has not honestly described her financial condition or situation, or that such a condition or situation may have changed due to factors such as illness, divorce, or unemployment. Additionally, a client may not be in a position to accurately describe her own risk tolerance, while the trained broker can make such an assessment.

The broker is bound to make recommendations suitable for the CARL, regardless of the client's subjective opinion of what suitable risk may be. This is not to say that the broker may not place unsolicited orders for a client, but only that recommendations by the broker should not conveniently fit the client's self-assessed risk level, when the broker knows the CARL to be lower, or more conservative.

As a general rule, it is not appropriate for a broker to determine that a client's CARL is higher than she suggests, or more aggressive or speculative, regardless of the client's financial condition or situation, because it should be the client's informed decision as to the maximum amount of risk she wants to take on with her funds.<sup>160</sup> In fact, the overestimate of his client's risk tolerance is what often leads to claims of unsuitability. Another situation where the broker's estimate of his client's CARL is different than her selected CARL may occur when a client elects to have multiple accounts with divergent goals and risk tolerances (e.g., one account with broker X invested solely in money market funds and another account with broker Y in which she chooses to make more speculative or aggressive investments). In such a situation, the broker is restricted to making recommendations that conform with his clients' selected CARL.

Thus, the client may set the higher bound of risk for herself, and the broker may be bound to make recommendations of a more conservative nature.<sup>161</sup> This duty may be owed to any investor, but certainly more so in

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159. See *supra* note 18.

160. Root, *supra* note 10, at 298 ("Risks involved in a change in investment objectives must be explained, and the broker-dealer should not solicit a customer's purchase of securities 'inappropriate in light of the customer's financial situation.'" (quoting Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233, 243 (1966))). "The courts in *Tiernan v. Blyth Eastman Dillon & Co.* . . . and *Alton* . . . both use the term 'inappropriate' to be interchangeable with 'unsuitable.'" *Id.* at 298 n.38.

161. Rapp, *supra* note 29, at 265-66.

In 1971, Stephen Cohen argued for integration of economic theory into a legal standard for suitability determinations in a manner that addresses the essential point. He asserted that a suitability determination should be based upon an assessment of investor risk preferences: Willingness to bear risk being the first consideration and then, incorporating earlier work of Mundheim, the capacity to bear it. This produces the notion of a 'risk threshold' as the critical constraint on the freedom of brokers to make recommendations to their customers. Thus, "A widow with a moderate amount of capital . . . might be anxious to speculate and to incur high risks. But such

the case of an individual investor as compared to an institutional investor. Prof. Poser discussed a California Court of Appeals interpretation of a broker's duty in regard to an institutional investor in the case of *Duffy v. King Cavalier*:

It is true that the decision requires the broker to "second guess" his customers' expressed wishes; however, the customer in *Duffy* was an institution, whose true investment objectives may not have been identical to the investment objectives as they were understood by the representatives who dealt with the broker. In this situation, it is not unreasonable to impose on the broker *a duty to inquire whether the stated investment objectives are in the customer's best interests. The broker, as a professional, may have been in a better position than the representatives of the institution to determine the suitability of the recommended investments.*<sup>162</sup>

### III. COMPARING RQ TO CARL IS AN OBJECTIVE STANDARD FOR DETERMINING SUITABILITY

Because a broker has a responsibility to understand the risk inherent in a recommendation, to know his client's CARL, and to only recommend securities that appropriate are appropriate for her, an objective standard for determining suitability can be established using fundamental financial theories.

#### A. BROKER'S RESPONSIBILITY TO EXPLAIN RISK

Among the broker's duties to an investor is the duty to explain the risks of a recommended security.<sup>163</sup> The omnipresent legends that adorn a vast quantity of a broker-dealer's or issuer's literature include warnings such as: "past performance is not indicative of future results," "results can not be guaranteed," "deposits are not guaranteed by the FDIC," "investments may lose value, including the principal amount invested,"<sup>164</sup> and many others. All such warnings are intended to put the investor on notice that there is risk in making investments in the securities markets. These must be displayed prominently on prospecti, analysts' reports, advertisements, and other documents, to comply with government and SRO rules and regulations.<sup>165</sup>

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speculation would be beyond her ability or capacity to bear risk if a prudent investor in her situation would not adopt that strategy."

*Id.*

162. POSER, *supra* note 3, § 3.03, at 3-100-3-101 (emphasis added).

163. *Cf. Hanly v. Sec. & Exch. Comm'n*, 415 F.2d 589, 597 (2d Cir. 1969).

164. *See generally* Rule 482 of the Securities Act of 1933.

165. *See, e.g.*, Securities Act of 1933 § 7, 15 U.S.C. 77g (2000).

### B. INVESTORS ALSO HAVE A RESPONSIBILITY

When an investor determines to enter the securities markets, it is presumed that she has been made aware of the risks inherent in making such an investment. Accordingly, an investor is not absolved of the responsibility for thought, contemplation, and decision-making that such an investor must entertain before depositing a check into an investment account.<sup>166</sup> The manifold notices, disclaimers, and legends are designed to assure that this determination is made knowingly and—*notwithstanding* exceptional circumstances such as fraudulent inducement—that such a presumption is legally plausible.<sup>167</sup>

The SEC's execution of its mandate under the '34 Act was interpreted by the Second Circuit when it stated that "[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks."<sup>168</sup> Thus, both Congress and courts have recognized that the gains anticipated by investors are accompanied by risks.<sup>169</sup> The numerous disclosures and legends that accompany securities materials are clearly intended to convey the risks and dangers associated with investing in securities to all investors, and prospective investors.

### C. SECURITIES INVESTORS ACCEPT MARKET RISK

Investors are deemed to have been warned about the risks associated with investing, and that they themselves are subject to the market risks. This presumption follows from a broker's duty of informing his client. Therefore, "an investor [] implicitly assumes the commercial risk that a change in market conditions may produce adverse economic consequences."<sup>170</sup> Thus, an investor takes on market risk by investing in the securities markets unless she instruct her broker that she was only willing to sustain lesser levels of risk. Stated differently, investors assume a market-

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166. *See, e.g.*, *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993) (regarding justifiable reliance).

167. *See, e.g., id.* at 1032–33.

168. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851–852 (2d Cir. 1968).

169. *Id.* (The SEC's Rule 10b-5, promulgated under its 1934 Act authority, elaborates on the types of conduct prohibited in connection with the purchase or sale of a security). *See also* *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 279 A.D.2d 239, 244 (N.Y. App. Div. 2001) ("[R]ecovery is unavailable even in the face of actual loss where such loss results from an inherent market risk assumed by the investor" (emphasis added) (quoting *Nat'l Union Fire Ins. Co. v. Robert Christopher Assocs.*, 257 A.D.2d 1, 12–13 (N.Y. App. Div. 1999))); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974)).

170. *Robert Christopher Assocs.*, 257 A.D.2d at 12–13. "Finally, as a fundamental principle, a contracting party—especially one denominated an investor—implicitly assumes the commercial risk that a change in market conditions may produce adverse economic consequences." *Id.* (emphasis added). These risks, however, are distinct from the risks of individual securities.

level of risk by investing in the securities markets, unless they specify otherwise to their brokers.

Broker-dealers and claimants alike cite the well-managed account theory of damages which can be used to argue for a reduction of a firm's liability in a bear market<sup>171</sup> or a boost to the claimant's damages in a bull market.<sup>172</sup> The theory was explained by the Second Circuit in *Rolf v. Blyth* as such:

The district court should then reduce Rolf's gross economic loss by the average percentage decline in value of the Dow Jones Industrials, the Standard & Poor's Index, or any other well recognized index of value, or combination of indices, of the national securities markets during the period commencing with Stott's aiding and abetting and terminating with its cessation. Thus if during the relevant period the stock market declined in value by 25%, then Rolf's gross economic loss should be reduced by 25%.<sup>173</sup>

As investors accept market risks upon entering the securities investment arena, this establishes a threshold of acceptable risk for investors, because "recovery is unavailable even in the face of actual loss where such loss results from an inherent *market risk assumed by the investor*."<sup>174</sup> Whether or not an investment is suitable can be determined by comparing the risks of the recommended investment with the amount of risk the investor accepted by entering the markets.

#### **IV. SUGGESTED STANDARDS COMPARING RQ & CARL TO DETERMINE SUITABILITY**

Because "[t]he professional intermediary must be oriented in his or her investment recommendations either by the creation or existence of a portfolio with identifiable risk/return characteristics and then by the expected impact of a particular recommendation on the performance of that portfolio,"<sup>175</sup> he should be judged accordingly.

The . . . suitability rule[s may] be violated in two different ways. First, a broker may violate the suitability rules if he fails so fundamentally to comprehend the consequences of his own recommendation that such recommendation is unsuitable for any investor, regardless of the investor's

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171. Bear Market Definition, *supra* note 59.

172. Bull market, Investopedia.com, <http://investopedia.com/terms/b/bullmarket.asp> (last visited Nov. 21, 2006) ("A financial market of a certain group of securities in which prices are rising or are expected to rise.").

173. *Rolf v. Blyth*, 570 F.2d 38, 44-47 (2d Cir. 1978).

174. *Bluebird Partners, L.P. v. First Fid. Bank, N.A.*, 279 A.D.2d 239, 244 (N.Y. App. Div. 2001) (emphasis added) (citing *Robert Christopher Assocs.*, 257 A.D.2d at 12-13); *Tannebaum v. Clark*, 1993 U.S. Dist. LEXIS 4088 (D. Ill. 1993); *DeBruyne v. Equitable Life Assur. Soc'y*, 920 F.2d 457, 461 (7th Cir. 1990) (finding that the plaintiff failed to show loss caused by risk and volatility of investment rather than by market forces).

175. Rapp, *supra* note 29, at 268.

wealth, willingness to bear risk, age, or other individual characteristics. More commonly, however, the suitability rules will be violated by a recommendation that might be suitable for some investors but is unsuitable for a specific investor to whom the recommendation is directed.<sup>176</sup>

Because these two types of suitability violations can be objectively described and broad parameters can be laid, the field of what suitability cases can be argued in good faith can effectively be narrowed.

#### **A. AN RQ $\leq$ 1.0 IS PRESUMPTIVELY SUITABLE FOR ANY INVESTOR**

Any recommendation, either of an individual security or for a portfolio, with a Risk Quotient less than or equal to one ( $RQ \leq 1.0$ ) should be presumed suitable for any investor because any investor who enters the securities market should be prepared and able to sustain market losses, unless she made her low tolerance for risk known to her broker.<sup>177</sup> Some clients may not be able or willing to accept market risk, and may choose not to accept such risk with some or all of their funds. If a client is not able or willing to accept market risk with their funds, her broker should reject any and all orders to avoid potential liability.

#### **B. AN RQ $\geq$ 2.0 IS PRESUMPTIVELY UNSUITABLE FOR ANY INVESTOR**

Despite the fact that “[i]f the investor’s risk tolerance is high, he or she can be expected to assume higher non-diversifiable systematic risk given by higher beta stocks,”<sup>178</sup> there is a limit to the amount of risk that is reasonable for most investors. A Risk Quotient of greater than two ( $RQ \geq 2.0$ ) should be presumed unsuitable for a “conservative” or “moderate” CARL investor, unless the recommendation is made as a component of a portfolio<sup>179</sup> which has a CARL-appropriate Risk Quotient. This is true

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176. See F.J. Kaufman & Co., Exchange Act Release No. 34-27535, 50 S.E.C. 164 (Dec. 13, 1989); Reinsch, *supra* note 10, at 199.

177. Reinsch, *supra* note 10, at 199.

If the overall portfolio beta is much higher than 1, the portfolio carries a risk level higher than that of the stock market as a whole and is not suitable for an investor who is unable or unwilling to assume above average risk. Conversely, if the overall portfolio beta is much less than 1, the portfolio has relatively low risk and is unsuitable for an investor who is able and willing to assume above average risk.

*Id.*

178. Reinsch, *supra* note 10, at 195

179. Rapp, *supra* note 29, at 272 (“Portfolio-driven recommendations must be treated differently than those that are only security-driven.”).

The standard of care against which the suitability responsibility of brokers is to be measured should be grounded in the dichotomy between stand-alone and portfolio recommendations. The inquiry should begin with the question of whether a

because excessive risk fails to provide incremental returns under Modern Portfolio Theory,<sup>180</sup> and is therefore unsuitable.<sup>181</sup> The burden of such objective standards on broker-dealers must be weighed against their certainty and freedom to operate and also against the potential benefits to

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recommendation is reasonably designed for the creation of, or to contribute to, a portfolio, the risk/return characteristics of which are reasonably matched to the investment objective, which is in turn a function of financial profile and risk preference of the investor. Where there is no identifiable and reasonable portfolio orientation for a recommendation, the isolated consideration of that recommendation is entirely appropriate. But a recommendation that is shown to be reasonably based as a portfolio component should not be evaluated on the basis of its stand-alone risk in isolation from the portfolio. In its most practical application, as a defense against unsuitability claims, MPT compels this result.

*Id.* at 273.

180. Reinsch, *supra* note 10, at 199.

According to MPT, individual stock risk can and should be reduced or diversified away by combining stocks that are not positively correlated. If an investor consciously chooses to over-concentrate his or her resources in a single stock or a set of correlated stocks, the investment strategy is clearly unsuitable and he or she alone is responsible for the consequences that might follow. However, market risk, which affects the stock market as a whole and is also called systematic risk, cannot be diversified away. The entire stock market could conceivably be pulled down by some unexpected bad economic or political news and this is likely to have an adverse effect on all stocks in one's portfolio regardless of the care taken to create a well-diversified holding. For example, a terrorist attack will cause an immediate collapse of the stock market, pulling down all stocks.

*Id.*

Erlich set the stage for two cases from the Seventh Circuit. In 1988, that court reasoned that when investment advisors make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given investment is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.

*Id.* at 176.

181. In a search for the highest current and long-term risk-rated mutual funds by Morningstar ("Morningstar Risk Score" of "5" and "Rating for Morningstar Risk Score" 10Yr of "5"), seven mutual funds had the highest rating in both categories. Out of this group the highest  $\beta$  was 3.4 by the Rydex U.S. Government Bond Inv. Fund ("RYGBX"), which had achieved a year-to-date return of -13.34% by December 2, 2005. The second highest  $\beta$  was 3.31 by the Apex Mid Cap Growth ("BMCGX"), which had posted 24.02% losses by December 2, 2005. As a group, the seven had an average 3-year  $\beta$  of 2.575 and an average year-to-date return of -2.80% as of December 2, 2005. The risk of loss from high  $\beta$  investments has been real for these investors. Meanwhile, the highest performance for 2005 has been turned in by the BlackRock Global Resources Instl. Fund ("SGLSX") which has a  $\beta$  of 0.83 and "Year to Date Return" of 44.63% and "5-Year Average Return" of 34.29%. Morningstar Ratings CD-ROM (2005); Yahoo!, Finance, <http://finance.yahoo.com> for 3-year  $\beta$  and performance statistics and rankings (last visited Nov. 20, 2006).

investors. Whatever the burden, it is less now than in the past due to the development of electronic oversight and compliance programs.<sup>182</sup>

### C. THE IMPACT OF AN OBJECTIVE STANDARD FOR SUITABILITY

A clear and well-defined standard for suitability would have a significant impact on the brokerage industry. Many claims would be prevented by more reasoned recommendations by brokers and with an opportunity for better supervision by broker-dealers of the recommendations their brokers make. Further, electronic supervision could be effective if boundaries for conduct are set. In addition to the prevention of client losses due to more reasoned recommendations, claimants' attorneys would be better positioned to determine what claims would be colorable and respondents' attorneys would likely settle a larger proportion of those colorable claims. Remained claims could be decided on the basis of objective comparison of conduct to a clear and well-defined standard.

#### 1. Thousands of Claims Could be Prevented When the Next Market Correction Occurs

As discussed above, actual losses to investors' accounts precipitate the vast majority of unsuitability claims. The quantity of investors who lose enough principal to make a claim increases dramatically during bear markets,<sup>183</sup> when losses outpace gains, and during market corrections.<sup>184</sup> If an objective standard has been adopted before the next market correction occurs, thousands of claims could be prevented.

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182. Barnett, *supra* note 73, at 1122–23.

In fact, suitability review technology is already in existence. E\*Trade has been looking for a vendor to provide the online broker with technology that would enable it to conduct suitability reviews of online trades. Suitability review technology would use algorithms and mathematical formulas to determine whether a specific trade is appropriate for a particular customer. With this type of review, online brokers could identify unsophisticated online investors attempting to purchase securities that are too risky for their financial position and notify the investors about their findings. Some industry participants believe that online technology enables brokers to assess customer suitability more easily than if a customer traded via a traditional broker. n164 Additionally, online brokers would only be required to run these suitability checks on a portion of their customers who are classified as unsophisticated. This limitation will reduce the additional costs that online brokers anticipate as a result of running suitability checks. Furthermore, it is arguably better for online investors and the economy as a whole to pay slightly higher prices in exchange for suitability checks, which provide investor protection and promote investor confidence.

*Id.*

<sup>183</sup> Bear Market Definition, *supra* note 59.

<sup>184</sup> Unsuitability claims doubled from 2001 to 2003, attributable in large part to the burst of the so-called "tech bubble" in 2001. The reason for the delay, from March 2001 when the NASDAQ peaked, to 2003 can be explained by the time required by investors to realize their losses, retain attorneys, and file claims.

If the proposed standard is implemented and enforced by broker-dealers, the majority of investors would remain within the bounds of broad market declines and gains, and thus would be more likely to realize the long-term benefits of investment in the securities markets. Such a result would undoubtedly be positive for individual investors and for the securities industry as a whole.

## **2. More Reasoned Recommendations by Brokers**

At the present time, brokers are required to have a reasonable basis for the belief of the suitability of their recommendations, but proving such belief is difficult without objective evidence. Under the proposed standards, brokers would be better able to support their recommendations by reproducing the analysis they engaged in when they originally made the recommendations. This contrasts with the current standard. Reasonable is relative and whether or not a security is later determined to have been suitable depends on many factors. Most troubling for brokers, this analysis comes with the clarity of hindsight and a security's actual performance which, in most arbitration claims, is a significant financial loss.

Brokers make recommendations to their clients that have CARL appropriate RQs, will be better positioned to inform their clients as to why those recommendations are suitable and to defend their recommendations should a clam be brought against them months or years later.

## **3. An Opportunity for Better Supervision by Broker-Dealers**

Broker-dealers are charged with supervision of their brokers, and can be held liable for negligent supervision if their brokers' recommendations are determined to be unsuitable. The "red flags" which signal that an investigation is required for a certain account depend on monitoring the signals of executed trades and the actual performance of the clients' accounts.<sup>185</sup> Broker-dealer supervision would be greatly aided by a clear, well-defined standard for judging the suitability of these trades *before* losses are realized. Broker-dealers could assign a CARL level for every account by using the questions regarding the client's desired level of risk currently on account opening applications,<sup>186</sup> and the brokers' input.

Only with an objective standard for brokers can the broker-dealer's duty of supervision be objectively judged. Without a clear and well-defined standard, the broker-dealer is subjectively determined to be liable to their clients regardless of the level of care exercised.

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185. The use of so called "comfort letters" by broker-dealers is an example of retrospective supervision, where contact is initiated with a customer after she has realized significant losses to her account.

186. See *supra* note 159 (regarding risk determinations based on account opening documents).

#### **4. Electronic Oversight of Recommendations**

Effective electronic oversight of recommendations would be possible with the objective measure of suitability proposed by this article. Such systems have already been developed and are in use by some broker-dealers,<sup>187</sup> but for such oversight to be effective, meaningful parameters need to be set for the systems to monitor.

With the proposed CARL and RQ levels, a broker-dealer would be able to monitor the accounts of all clients on an ongoing basis. The systems could measure the individual recommendation's RQ against the appropriate account's CARL, and notify the broker, supervisor and client along with the trade confirmation which is already required to be prepared and sent to the client. In addition to the individual recommendation, broker-dealers could monitor clients' portfolio RQs at the time of every trade or upon periodic review, and notify their clients of the amount of risk that their principal is exposed to at that time.

#### **5. Claimants' Attorneys Would Bring Fewer Claims**

Whether or not broker-dealers changed their recommendations to conform to the proposed standards, claimants' attorneys would not file as many unsuitability claims. This would occur because claimants' attorneys would be able to determine in advance whether or not the trades that their clients complained of had RQs that were appropriate for their client's CARL, and whether their clients' portfolio RQ was appropriate.<sup>188</sup>

There would be two distinct results of the application of the proposed standard by claimants' attorneys. First, attorneys would be effectively barred from bringing claims that they did not have a good faith belief to be unsuitable as judged against the proposed standard. Second, those claims filed would be vetted for at least a colorable claim of unsuitability. As a result, there would be fewer filed claims and those claims would better plead cases for unsuitability.

#### **6. Respondents' Attorneys Would be Able to Settle the Better Claims**

Broker-dealers faced an average of 2,516 unsuitability claims through the NASD during the 2001 through 2004 calendar years. With the significant decrease in the quantity of claims contemplated above, through more reasoned recommendations, better supervision, electronic oversight,

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187. *See supra* note 183 (regarding electronic oversight by on-line broker-dealers).

188. It is true that the argument may shift focus to what the CARL is, but broker-dealers are already required to make reasonable inquiry into a client's financial situation and goals. Further, broker-dealers are in a position to require that brokers and supervisors make an accurate determination of CARL upon the opening of an account, and periodically thereafter. Broker-dealers may also require that confirmation of a CARL be made with the clients, as well.

and claimants' attorneys bringing only better pled claims, broker-dealers could see a dramatic reduction in the number of claims against them. As a result, broker-dealers would be in a position to settle a larger proportion of the claims that were made, and dispose of the remainder more quickly. The quick disposition of ill-advised claims would be possible with the application of an objective standard by arbitrators analogous to summary judgment relief.

### **7. Arbitration Panels Would Objectively Determine the Remaining Claims**

With a clear, well-defined standard of conduct for brokers, and the historical data available to both claimants and respondents, an objective determination by arbitration panels would be possible. Whether or not a recommendation was suitable alone or within a portfolio would be presumptively determined based on verifiable facts about which parties to the arbitration could stipulate, as the beta of a security, the amount of equity in the position at the time of purchase and the portfolio's RQ would not be subject to argument. This opportunity for objective comparison is in sharp contrast to the determination of current claims where the actual loss and the current financial position of the investor-client are surely more influential factors than they need to be.

#### **D. THE NECESSITY OF A CLEAR, WELL-DEFINED STANDARD FOR MEANINGFUL REVIEW OF UNSUITABILITY AWARDS AND THE CONTINUED APPLICABILITY OF THE FAA**

As the Supreme Court noted in *McMahon*, when securities claims were held to be within the enforcement powers of the Federal Arbitration Act,<sup>189</sup> "although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute." It may, therefore, be argued that the enforceability of pre-dispute agreements to arbitrate requires the opportunity for "sufficient" judicial review. If, however, review of arbitration awards is not sufficient, securities claims, specifically unsuitability, may not be subject to arbitration due to § 29(a) of the '34 Act, which states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

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189. 9 U.S.C. § 2 (2000).

### 1. The Conflict Between *McMahon* and the *Benderson* and *Wallace* Decisions

In *Wallace v. Butar* the Second Circuit held that “[a]n arbitral award may be vacated for manifest disregard of the law ‘only if a reviewing court . . . finds both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case.’”<sup>190</sup> The Second Circuit has applied this reasoning in reviewing the securities arbitration awards in *Wallace* and *Benderson*.<sup>191</sup> In *Benderson*, the court stated that “GMS [the broker,] neither points this court to case law interpreting the terms ‘recommendation’ or ‘suitability,’ nor points to anywhere in the record where such law was brought to the attention of the arbitrators.”<sup>192</sup>

The current subjective reasonable belief of the broker standard for determining suitability is not what the Second Circuit held was required for vacation of an arbitration award on the grounds of manifest disregard. Thus, because the current standard is not a well-defined and explicit law, the ‘34 Acts’ restriction on contracting away protections are at odds with the sufficient review component of the Supreme Court’s *McMahon* and decision.

### 2. Averting a Crisis for Securities Arbitration

It appears that a crisis is brewing in securities arbitration because of the lack of legally sufficient review of awards. Therefore, the very enforceability of arbitration agreements is in question unless a well-defined and explicit standard is adopted to avert this brewing crisis.

*Blair H. Wallace*\*

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190. *Wallace v. Butar*, 378 F.3d 182, 189 (2d Cir. 2003).

191. *GMS Group, LLC v. Benderson*, 326 F.3d 75, 75 (2d Cir. 2003).

192. *Id.*

\* Associate with Katten Muchin Rosenman LLP’s Financial Services Group in New York, NY; J.D., Brooklyn Law School, 2006; B.A., University of California at San Diego, 1993. The author wishes to thank Professor Roberta Karmel for her encouragement, patience and inspiration; and his wife Jessica, daughter Madeleine, and son Harrison for their love, support and understanding.