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Norman S. Poser

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* Professor of Law, Brooklyn Law School. A.B., LL.B., Harvard University. The work of my research assistants, Todd Doyle, Luke Fitzgerald, and Tracey Seraydarian, is gratefully acknowledged. I thank Professors James Fanto, Roberta Karmel, Therese Maynard, Arthur Pinto, Susan Poser, and William Wang for their helpful comments and suggestions. I am solely responsible, however, for the views expressed in this article. I also thank Brooklyn Law School and Dean Joan G. Wexler for the assistance provided to me through a Summer Research Stipend.

I. INTRODUCTION

The suitability doctrine prohibits a securities broker-dealer from recommending a security to a customer unless she has a reasonable belief that the security is suitable for that customer.[1] It imposes a

1. Nat'l Ass'n of Sec. Dealers, NASD Rule 2310, NASD MANUAL (CCH) 4261 (2000) [hereinafter NASD Rule 2310]; NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION § 3.03, at 3-77 (3d ed. 2000) [hereinafter POSER, BROKER-DEALER LAW]. The Securities and Exchange Commission has taken the position that the suitability doctrine applies not only to the choice of securities but also to the pattern of trading that a broker recommends to a customer. For example, purchasing securities with borrowed funds (i.e., margin trading)

duty on the broker-dealer to take the financial situation, risk threshold, investment sophistication, investment objectives, and other securities holdings of her customers into account when she recommends a security to them.[2] The suitability doctrine was originally formulated more than sixty years ago as an ethical standard by the National Association of Securities Dealers ("NASD"), a self-regulatory organization ("SRO") of the securities industry to which almost all brokers and dealers are required to belong.[3] A broker-dealer who recommended an unsuitable security could be disciplined by the NASD,[4] but she would not be subject to legal sanctions.[5]

Over the years, however, the suitability doctrine has undergone "a subtle shift from ethics to law."[6] As long ago as 1978, the Second Circuit held in *Clark v. John Lamula Investors, Inc.*,[7] that a broker's unsuitable recommendation to a customer violated Rule 10b-5, the SEC's general and most important antifraud rule.[8] Furthermore, a

rather than for cash, or day trading over the Internet, may be unsuitable for a customer because of the risks involved in these activities. *See In re* Application of Rangen, Admin. Proc. File No. 3-8994, 1997 SEC LEXIS 762, at *9 (Apr. 8, 1997).

2. *See* Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 449.

3. The Securities Exchange Act of 1934 requires every registered broker-dealer to be a member of a registered national securities association unless its only transactions are on a stock exchange of which it is a member. 15 U.S.C. § 78o(b)(8) (1994); 17 C.F.R. § 240.15b9-1 (2001). The NASD is the only registered national securities association and has about 5,500 member firms. SEC. INDUS. ASS'N, SECURITIES INDUSTRY FACTBOOK 31 (2000). The NASD adopted the suitability rule in 1939, shortly after the NASD was established as a national securities association. *See* 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, 197 (1998).

4. In two early cases the SEC affirmed NASD disciplinary actions against members for violating the suitability rule. *See In re* Philips & Co., 37 S.E.C. 66 (1956); *In re* Greenberg, 40 S.E.C. 133 (1960).

5. As discussed in more detail below, the overwhelming majority of the courts that have considered the question have refused to imply a private right of action on the basis of a violation of an SRO rule.

6. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 900 (3d ed. 1995).

7. 583 F.2d 594 (2d Cir. 1978).

8. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact

broker's unsuitable recommendation may be actionable under state law.[9] Although the law differs from state to state in how it characterizes the relationship between a broker and a customer, the prevailing view is that where the customer places her trust and confidence in the broker, the broker owes the customer a fiduciary duty and that an unsuitable recommendation may be a breach of this duty.[10]

Until the 1980s, the suitability doctrine was applied almost exclusively to recommendations made to individual investors. 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, an elderly widow or retired person who needs the income from her investments for her living expenses and who has no reasonable expectation of being able to replace any substantial trading losses might also be unaware of the risks of the recommended investment because she lacks the background or education to understand investments or the securities markets. The investment might also be inconsistent with her investment objective. For example, the widow or retiree might want conservative investments, in order to preserve her principal and receive an assured income, rather than speculation or short-term trading.[11] Thus, the recommendation of speculative securities might be unsuitable for the investor if she is unable to bear the risks of the investment, if she is unable to understand these risks, or if the investment is inconsistent with her investment objectives.[12]

> necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2001). The SEC adopted Rule 10b-5 in 1942, pursuant to its authority under section 10(b) of the 1934 Act to adopt rules prohibiting, "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b) (1994).

In view of the breadth and scope of the rule, which prohibits fraud by *any* person in connection with the purchase or sale of *any* security, the courts have interpreted the rule to prohibit misconduct by broker-dealers as well as various other types of deceitful conduct, including misleading corporate publicity and trading on inside information.

9. *See* Rupert v. Clayton Brokerage Co., 737 P.2d 1106 (Colo. 1987).

10. *See generally* POSER, BROKER-DEALER LAW, *supra* note 1, § 2.02.

11. *See, e.g.*, *In re* Guevara, Exchange Act Release No. 34-42793, 2000 WL 679607, at *5 (May 18, 2000). In evaluating a security, however, financial managers today often look to its total return to shareholders, including price appreciation, rather than only to the dividends paid. *See* VICTOR BRUDNEY & WILLIAM W. BRATTON, CASES AND MATERIALS ON CORPORATE FINANCE 544–70 (4th ed. 1993).

investment is inconsistent with her investment objectives.[12]

In recent years, however, a number of lawsuits and arbitrations have been brought to recover losses suffered not by individual investors but by institutions, including states and municipalities, publicly and privately owned companies, and educational and religious organizations. In several well-publicized cases, large government entities, including Orange County, California,[13] and the State of West Virginia,[14] and large publicly owned corporations, such as Procter & Gamble[15] and Gibson Greeting Cards,[16] have attempted to recover substantial losses incurred as a result of making risky investments. Losses have also been incurred by many smaller institutions, including churches, credit unions, colleges, and school districts. In some of these cases, the institution has claimed that the investments recommended to it by a broker-dealer were unsuitable for the institution in light of its investment objectives as reflected in the governing law, its charter, or its written investment policy. In other cases, institutions claimed that their investment officers were misled by broker-dealers as to the nature and risk of the recommended investments.

In some of these institutional unsuitability cases, the institutions and their financial officers were the unsuspecting victims of overly enthusiastic brokers who misrepresented the nature and risk of the securities they were selling.[17] In others, the institutions' financial of-

12. Portfolio theory indicates that one should look at the risk of the entire mix of securities in a portfolio, rather than the risk of each security separately. Thus, even a conservative portfolio might include some speculative securities. *See* Stuart D. Root, *Suitability—the Sophisticated Investor—and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 347–48; Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805, 819–22 (1985).

13. In 1995, Orange County filed a complaint against Merrill Lynch claiming that the brokerage firm had breached its fiduciary duty to the Country and had committed a securities fraud by recommending securities that were not authorized for purchase by state law, not suitable for the investment of public monies, and inconsistent with the County's principal investment objective of preservation of capital. Complaint of County of Orange, *In re County of Orange*, 191 B.R. 1005 (Bankr. C.D. Cal. 1996). In 1998, Merrill Lynch settled the lawsuit for $400 million. Andrew Pollack & Leslie Wayne, *Ending Suit, Merrill Lynch to Pay California County $400 million*, N.Y. TIMES, June 3, 1998, at A1.

14. *See* State v. Morgan Stanley & Co., 459 S.E.2d 906 (W. Va. 1995).

15. *See* Proctor & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).

16. *See In re* BT Sec. Corp., Exchange Act Release No. 35,136, 1994 SEC LEXIS 4041 (Dec. 22, 1994).

17. *See*, *e.g.*, *In re* Schulte, Admin. Proc. File No. 3-9051, 1997 WL 173668 (S.E.C. Apr. 10, 1997).

ficers purchased the securities even though they were aware of their unsuitability for their institutional employers; thus, the officers were themselves guilty of misconduct.[18] The willingness (or even eagerness) of an institution's financial officer to act on a broker's recommendation to buy an unsuitable high-yield (and high-risk) security may also be partly or wholly the result of perceived pressure from the financial officer's superiors or governing board to take risks in order to obtain higher returns on the institution's investments in times of tight budgets and low interest rates.[19]

Given the centrality of the suitability doctrine to the nature of the relationship between a broker and his customer, it is not surprising that a substantial body of writing exists on the subject; furthermore, the suitability cases involving institutional customers that arose during the 1980s and 1990s provided additional stimulus to law review writers.[20] The justification for writing yet another article on the subject is that it is necessary to reexamine the assumptions that are routinely made by judges and legal writers: that institutional investors are sophisticated and that, whether sophisticated or not, they do not need the protections afforded by suitability rules. Whether insti-

18. In the *Orange County* case, Merrill Lynch argued that Robert L. Citron, the County Treasurer, made all the investment decisions and was aware of the risks. Citron was criminally prosecuted and received a one-year jail term for misappropriation of funds. Pollack & Wayne, *supra* note 13.

19. *See Derivatives Use by State and Local Governments: Testimony Before the House Comm. on Banking, Fin. and Urban Affairs* (Oct. 5, 1994) (statement of Alan McDougle, Director of Finance & Purchasing, Lima, Ohio) [hereinafter Testimony of Alan McDougle].

20. *See* Seth C. Anderson & Donald Arthur Winslow, *Defining Suitability*, 81 KY. L.J. 105 (1992–93); Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527 (1998); Kerr, *supra* note 12; Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996); Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REG. 345 (1995); Mundheim, *supra* note 2; Norman S. Poser, *Civil Liability for Unsuitable Recommendations*, 19 REV. SEC. & COMM. REG. 67 (1986); Rapp, *supra* note 3, at 190 n.3; Lyle Roberts, *Suitability Claims Under Rule 10b-5: Are Public Entities Sophisticated Enough to Use Derivatives?*, 63 U. CHI. L. REV. 801 (1996); Root, *supra* note 12; Jennifer A. Frederick, Note, *Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market*, 64 FORDHAM L. REV. 97 (1995); Geoffrey B. Goldman, Note, *Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed"?*, 95 COLUM. L. REV. 1112 (1995); Dennis J. Block & Jonathan M. Hoff, *Suitability Standards for Sophisticated Investors*, N.Y.L.J., Feb. 19, 1998, at 5; Roberta S. Karmel, *The Suitability Doctrine*, N.Y.L.J., June 15, 1995, at 3; Gregory J. Wallance & Andrew S. Carron, *Suitability Disputes and the Institutional Investor*, N.Y.L.J., Oct. 9, 1997, at 1.

tutional investors should be able to use the suitability doctrine to recover investment losses from their broker-dealers poses complex questions of policy and law. Most courts, arbitrators, and legal commentators have been unsympathetic to these institutional investors with suitability claims. The reluctance to award damages to these claimants seems to be based, at least in part, on a reluctance to apply a doctrine that is essentially paternalistic in its nature to a broker's dealings with its institutional (and wealthy individual) customers.[21] Critics of the doctrine as so applied reason as follows: first, investment officers of institutions tend to be sophisticated professionals; second, even if an institution hires an unsophisticated investment officer or fails to supervise him properly, that is the institution's own fault. The first prong of the argument tends to support establishing a rebuttable presumption of institutional sophistication, while the second prong tends to support a conclusive presumption of sophistication. According to the reasoning of these critics, the institutional investor, not the broker-dealer who knowingly or recklessly recommends an unsuitable security to the investor, should bear the responsibility for the recommendation if it goes bad.

It is my purpose in this article to examine the above premises from both a factual and normative point of view. While many institutional investment officers are highly experienced and capable, many others lack the ability or training to understand the nature and risks of the complex investments that many securities firms sell to their customers. Many institutional investors, including small ones and those whose principal purpose is not investment, should not be faulted for their failure to hire sophisticated investment officers, because it is not cost-effective to employ persons with the training to understand arcane investment vehicles.

Furthermore, the system of compensation in general use on Wall Street, under which broker-dealers and their salespersons receive very large commissions if they are successful in their sales pitches, gives them a strong incentive to oversell. Even a sophisticated investment officer may not be able to resist selling pressure from a highly motivated and well-trained salesperson. It has long been held that sophisticated as well as unsophisticated investors are entitled to protection

21. *See* Markham, *supra* note 20, at 369 (arguing that the suitability rule is "a very paternalistic approach to customer protection").

from fraudulent conduct by securities salespeople[22] and that such conduct is actionable under Rule 10b-5 only if it is made with scienter, i.e., intentionally or recklessly.[23]

Following a brief discussion of the key role played by institutional investors in today's securities markets, Part II discusses the applicability of the suitability doctrine to institutional investors. Part II raises two principal questions. First, to what extent can the investment officers of institutions be considered sophisticated? Second, should the courts adopt a presumption (either rebuttable or conclusive) of institutional sophistication? Because a conclusive presumption of sophistication is, in effect, a legal rule, it would protect broker-dealers from liability for unsuitable recommendations made to unsophisticated as well as sophisticated institutional investors.

Part III will examine the three principal regulatory and legal categories on which the suitability doctrine is based—self-regulatory rules, federal securities fraud, and common-law breach of fiduciary duty—and the difficulties faced by institutional plaintiffs in bringing an action to recover losses suffered as a result of unsuitable recommendations. My conclusion is that the goals of the federal securities laws—protection of investors and the markets—as well as traditional principles of agency law, require that a broker-dealer be held to account in damages for unsuitable recommendations that are made recklessly or with knowledge of their unsuitability, whether the customer is an individual or an institutional investor.

It is important to note, however, that most claims brought against broker-dealers by their customers, including their institutional customers, are heard by arbitration panels, not by courts, because broker-dealers generally insist that their customers sign pre-dispute arbitration agreements when they open their accounts.[24] No distinction will be made in this article between lawsuits and arbitrations, since arbitrators are required to apply the same substantive law

22. Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969).

23. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that scienter is a necessary element of a violation of Rule 10b-5).

24. In 1987 the Supreme Court held that pre-dispute agreements to arbitrate claims brought under the 1934 Act were enforceable. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987). Following *McMahon*, arbitration largely replaced litigation as the method of resolving disputes between customers and their brokers. Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1101 (1993).

that a court would.[25] Nonetheless, there is a notable difference in that arbitration panels typically do not write opinions explaining their decisions, and these decisions have no value as precedent.[26] Furthermore, the scope of judicial review of arbitral awards is extremely narrow.[27] It therefore is often impossible to ascertain either the basis for an arbitral award or whether the award reflects the current state of the law.[28]

II. THE INSTITUTIONAL INVESTOR AND INVESTMENT SOPHISTICATION

A. Institutional Investment in the Securities Markets

1. The extent of institutional investment

Perhaps the most important and influential development in the securities markets during the past half-century has been the growth of institutional investment, in both relative and absolute terms. The percentage of all corporate stock owned by American institutions (principally pension funds and mutual funds) increased from seven percent of the total in 1950 to fifty-one percent in 2000.[29] In abso-

25. *See* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 481 (1989) ("By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.") (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).

26. *See* Martin H. Malin & Robert F. Ladenson, *Privatizing Justice: A Jurisprudential Perspective on Labor and Employment Arbitration from the* Steelworkers Trilogy *to* Gilmer, 44 HASTINGS L.J. 1187, 1226 (1993) ("under the prevailing judicial view, . . . the only law that results [from an arbitral award] is the award itself, and that law is binding only on the immediate parties.").

27. Under the Federal Arbitration Act, 9 U.S.C. § 10 (1994), a court may not vacate an arbitrator's award simply because the arbitrator made erroneous findings of fact or misinterpreted the law, *see* Miller v. Prudential Bache Sec., Inc., 884 F.2d 128, 130 (4th Cir. 1989), but only if the arbitrator acted in manifest disregard of the law, *see* Halligan v. Piper Jaffray, Inc., 148 F.3d 197 (2d Cir. 1998), *cert. denied*, 119 S. Ct. 1286 (1999).

28. *See* Norman S. Poser, *Judicial Review of Arbitration Awards: Manifest Disregard of the Law*, 64 BROOK. L. REV. 471 (1998); *see also* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1593 (1999) (asserting that tribunals have a great deal of flexibility in deciding cases initiated by customers against brokers for unsuitable transactions).

29. NEW YORK STOCK EXCHANGE FACT BOOK FOR THE YEAR 2000 61 (2001) [hereinafter NYSE FACT BOOK 2000].

lute terms, institutions' assets increased more than a hundred-fold during this period, from $143 billion to over $19 trillion.[30] Institutional investors have also outdistanced individuals as the principal type of participant in the securities markets.[31] It has been estimated that institutional investors account for about seventy percent of trading volume on the New York Stock Exchange ("NYSE"), which is by far the nation's largest market for equity securities.[32]

2. *Regulatory implications of institutional investment*

The growth of institutional investment has important regulatory implications. In view of the presumed greater ability of institutional investors to fend for themselves, it may be argued that the regulatory burden placed on persons selling securities to institutional investors should be lightened.[33] On the other hand, because individual inves-

30. *Id.*

31. The growth of institutional investment is the result of a variety of social, political, and economic forces, including more liberal retirement benefits to employees, favorable tax treatment of retirement funds, and the propensity of individuals to invest indirectly in the market through mutual funds rather than directly. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 27–28 (2d ed. 1997).

32. *See* JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 282 (5th ed. 1998). In the year 2000, the total market capitalization of stocks listed on the NYSE was $12.4 trillion, compared to $3.6 trillion for Nasdaq, the second largest equity market. SEC. INDUS. ASS'N, SECURITIES INDUSTRY FACT BOOK 48 (2001) [hereinafter SECURITIES INDUSTRY FACT BOOK].

Between 1960 and 2000 the average daily volume of trading on the NYSE increased from 3 million shares to 1.04 billion shares. NYSE FACT BOOK 2000, *supra* note 29, at 100. A good indication of the dominance of the market by institutional investors is the percentage of trading volume that is in block transactions (i.e., transactions of more than 10,000 shares), because relatively few individuals have the resources to trade in such large amounts. In 1965, 16.2 percent of reported share volume on the NYSE consisted of block transactions. NEW YORK STOCK EXCHANGE FACT BOOK FOR THE YEAR 1998, at 93 (1999) [hereinafter NYSE FACT BOOK 1998]. By 1979 this figure had risen to 26.5 percent, and by 2000, block transactions accounted for 51.7 percent of reported volume. In absolute terms, block transactions increased more than sixty-fold in the past twenty-one years—from 2.2 trillion shares in 1979 to 135.7 trillion shares in 2000. Assuming that most block transactions are made by institutional customers, this percentage increase demonstrates the importance of institutions in the securities markets. *Id.* at 93.

The dominance of the NYSE in the securities industry is demonstrated by the fact that in 2000 the 271 member firms of the NYSE that did business with the public, although comprising less than four percent of all broker-dealer firms, accounted for seventy percent of all revenues and eighty-two percent of all assets of the securities industry. SECURITIES INDUSTRY FACT BOOK, *supra* note 32, at 28.

33. *See* Saul Cohen, *The Death of Securities Regulation*, WALL ST. J., Jan. 17, 1991, at A10.

tors now tend to participate in the market indirectly through mutual funds, pension funds, and other institutions rather than by opening up their own individual brokerage accounts, it can be argued that the SEC and other securities regulators should direct their regulatory efforts to broker-dealers' selling practices with respect to institutional investors. As institutions have become a major source of commission revenue for brokerage firms, they share with individual investors the dubious honor of being targets of predatory and abusive brokers. It is, therefore, hardly surprising that sales of securities to institutional investors have presented suitability problems.

3. Institutional investors: Size and purposes

There is no single definition of the term "institution," "institutional investor," or "institutional customer."[34] The NASD defines "institutional customer" as "any entity other than a natural person."[35] The term thus includes mutual funds and closed-end funds; private and public pension funds; life and casualty insurance companies; bank-managed personal trusts; corporate profit-sharing plans; state and local governments; savings institutions; commercial banks; credit unions; and various kinds of nonprofit organizations, such as churches and other religious organizations, college endowment funds, foundations, and the like.[36]

Institutional investors vary widely in size. While the largest insti-

34. A leading financial dictionary defines "institutional investor" simply as an "organization that trades large volumes of securities." DOWNES & GOODMAN, *supra* note 32, at 282.

35. Nat'l Ass'n of Sec. Dealers, NASD Rule 2310-3, NASD MANUAL (CCH) 4265 (2000) [hereinafter NASD Rule 2310-3].

36. At the end of 2000, institutions held $10.0 trillion in U.S. equities (i.e., shares of corporate stock), or 58.9% of the total, while households held the remainder. Of these holdings, mutual funds held $3.2 trillion (19.1%); private pension funds held $2.0 trillion (11.8%); public pension funds held $1.4 trillion (7.9%); foreign institutions held $1.7 trillion (10.1%); life insurance companies held $943 billion (5.5%); bank personal trusts held $315 billion (1.9%); other insurance companies held $188 billion (1.1%); state and local governments held $115 billion (0.7%); and closed-end funds held $36 billion (0.2%). SECURITIES INDUSTRY FACT BOOK, *supra* note 32, at 70–71.

If all financial assets are taken into account, the sheer size of institutional holdings is even more impressive. Just to list the largest categories of institution, at the end of 1999, commercial banks held $6.0 trillion in financial assets; private pension funds held $5.0 trillion; mutual funds held $4.5 trillion; life insurance companies held $3.1 trillion; and state and local government employee retirement funds held $3.0 trillion. BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, FOURTH QUARTER 1999, at 69–77 (2000).

tutions own or manage vast amounts of money, there are many smaller institutional investors whose holdings of securities and other investment instruments are relatively modest. Some idea of the variety of institutional investors in terms of their size and characteristics may be gained by looking at the lawsuits and arbitrations in which suitability issues have been raised. The plaintiffs in these disputes include the State of West Virginia;[37] Orange County, California;[38] the City of San Jose, California;[39] several towns and villages;[40] local governmental authorities;[41] public educational institutions;[42] public and corporate pension funds;[43] union pension funds;[44] commercial banks;[45] savings and loan institutions;[46] religious organizations;[47] publicly held companies;[48] and family trusts.[49] A review of these cases shows that the investment assets of the institutions that have initiated claims against broker-dealers raising suitability issues ranged from $2 million (in the case of a corporate pension plan)[50] to $7.4 billion (in

37. *See* State v. Morgan Stanley & Co., 459 S.E.2d 906 (W. Va. 1995).

38. *See In re* County of Orange, 191 B.R. 1005 (Bankr. C.D. Cal. 1996).

39. *See* City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991).

40. *See* Vill. of Arlington Heights v. Poder, 712 F. Supp. 680 (N.D. Ill. 1989).

41. *See* Memphis Hous. Auth. v. Paine, Webber, Jackson & Curtis Inc., 639 F. Supp. 108 (W.D. Tenn. 1986).

42. *See* Cmty. Coll. Dist. No. 508 v. Westcap Gov't Sec., Inc., No. 94 C 1920, 1994 WL 530849 (N.D. Ill. Sept. 29, 1994).

43. *See* Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176 (Minn. 1994); *Vill. of Arlington Heights*, 712 F. Supp. 680; Duffy v. Cavalier, 259 Cal. Rptr. 162, 171 (Cal. Ct. App. 1989), *review granted*, 778 P.2d 549 (Cal. 1989), *review denied*, 264 Cal. Rptr. 740 (Cal. Ct. App. 1990).

44. *See* Pension Fund-Mid Jersey Trucking Indus.-Local 701 v. Omni Funding Group, 731 F. Supp. 161 (D.N.J. 1990).

45. *See* Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208 (7th Cir. 1993); Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997).

46. *See* MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249 (10th Cir. 1989).

47. *See* Congregation of the Passion, Holy Cross Province v. Kidder Peabody & Co., 800 F.2d 177 (7th Cir. 1986); Westchester Jewish Ctr. v. Gruntal & Co., 1994 NYSE Arb. Dec. LEXIS 615 (July 6, 1995) (Filson, Gray, Guggenheimer, Arbs.).

48. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996); *In re* Gibson Greetings, 159 F.R.D. 499 (S.D. Ohio 1994); *In re* BT Sec. Corp., Exchange Act Release No. 34-35136, 1994 SEC LEXIS 4041 (Dec. 22, 1994).

49. *See* Boettcher & Co. v. Munson, 854 P.2d 199 (Colo. 1993).

50. *See* Duffy v. Cavalier, 259 Cal. Rptr. 162, 171 (Cal. Ct. App. 1989), *review granted*, 778 P.2d 549 (Cal. 1989), *review denied*, 264 Cal. Rptr. 740 (Cal. Ct. App. 1990).

the case of Orange County, California).[51] Obviously, the size of an institution affects its financial ability to hire investment officers with the training and professional skills necessary to understand the complex types of financial instruments marketed by the securities industry today.

Institutional investors differ not only in their size but also in their underlying purposes. The principal or sole purpose of some types of institutions, most notably mutual funds and pension funds, is to invest money on behalf of their shareholders or beneficiaries. The growth of these institutions into multi-billion-dollar giants reflects the trend of individuals to invest their savings in the market indirectly rather than directly, thus enabling even investors with little capital to invest to gain the twin advantages of professional management of their money and diversification of their investments. Such investment-oriented institutions, particularly if they are large, can be expected to employ trained and experienced professionals to handle their investments, professionals who will bring their own independent judgment to bear on brokers' recommendations. For many types of institutions, however, investment of their funds is only a secondary or incidental purpose. These include such entities as municipalities, educational organizations, business corporations, churches, and other nonprofit organizations. These institutions may not understand the need for, and may not be able to afford, a professional staff that is trained to keep abreast of and evaluate all the new types of "financial engineering" that brokerage firms may urge upon them.

The nature and purposes of an institution will also determine the time frame of its investments. Depending on its stated investment objectives, a mutual fund or large pension fund, which invests the funds it manages for the needs of its shareholders or beneficiaries, may have a large proportion of its assets allocated to long-term investments, such as stocks and bonds. On the other hand, the normal investment activities of a municipality, thrift company, or educational, religious, or other nonprofit organization, whose liquid assets consist largely of idle funds that will be needed periodically for the operations of the organization, will be different. Such institutions typically buy low-risk or risk-free short-term instruments from a bank

51. *See In re* County of Orange, 191 B.R. 1005 (Bankr. C.D. Cal. 1996); PHILIPPE JORION, BIG BETS GONE BAD: DERIVATIVES AND BANKRUPTCY IN ORANGE COUNTY 21 (1995).

or brokerage house and roll them over every few months, a procedure that does not require a great deal of time or financial sophistication.[52]

For an institution whose principal purpose is not investment, the responsibility for handling its investments typically is given to the institution's treasurer or chief financial officer, who may have several other important functions that take up most of his time, and who may possess little knowledge or understanding of the securities markets or complex financial instruments such as derivatives.[53] Such a person's understanding of the market or of particular investment instruments may be inadequate to enable him to exercise independent judgment concerning the advisability of investing in novel or complex instruments, especially in the face of a determined and skillful selling effort by a broker. Furthermore, it may not be economically feasible for the institution to hire full-time professional money managers to handle its investments. It may also not seem necessary to the institution to retain outside professional advice, even if that is affordable, if the broker-dealer represents itself to the institution as an investment adviser working for the institution, upon whom the institution can safely rely, rather than as a commercial venture whose paramount goal is to maximize its sales.

B. The Investment Sophistication of Institutional Investment Officers

1. Why sophistication is important

The investor's sophistication is a key concept in relation to claims based on unsuitable recommendations. If the claim is brought under Rule 10b-5, which prohibits fraud in connection with the purchase or sale of a security, sophistication is relevant to the question of

52. Some educational and religious organizations, however, also have permanent endowments, which may be invested in stocks and bonds.

53. For example, Philip Luhmann, the treasurer of the City Colleges of Chicago, was responsible for all of City Colleges' banking relationships; for preparing its budget; for receiving, maintaining custody of, and disbursing cash; and for setting up procedures that dealt with the institution's cash management. He could, therefore, devote only a limited amount of his time to his investment responsibilities. Transcript of testimony of Philip R. Luhmann at 3–4, *In re* Westcap Enter., Case No. 96-43191-H2-11 (Bankr. S.D. Tex. Aug. 20, 1997) [hereinafter *Westcap I*], *rev'd on other grounds*, 230 F.3d 717 (5th Cir. 2000) [hereinafter *Westcap II*].

whether misleading statements or omissions made by the broker-dealer were material[54] and whether the investor justifiably relied on the misstatements or omissions.[55] Materiality and justifiable reliance are both requisite elements in a private suit brought under Rule 10b-5.[56] In a suitability claim brought under Rule 10b-5, control of the account by the broker may also be a necessary element of the claim.[57] The investor's sophistication is relevant to the question of whether the investor or the broker controlled the account.[58]

If an institutional investor's claim is that the broker-dealer, by recommending unsuitable securities, breached a fiduciary duty to the investor, the sophistication of the institution's investment officers may be relevant to the issue of whether the broker owed fiduciary duties to the institution, a question which in many jurisdictions depends on whether the investment officers placed their trust and confidence in the broker-dealer.[59]

54. *See* Lehman Brothers Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., No. 94 Civ. 8301 JFK, 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000).

55. *See* Davis v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1217 (8th Cir. 1990); Michael Slonim, *Customer Sophistication and a Plaintiff's Duty of Due Diligence: A Proposed Framework for Churning Actions in Nondiscretionary Accounts Under SEC Rule 10b-5*, 54 FORDHAM L. REV. 1101, 1106–07 (1986) ("[T]he inquiry into customer sophistication is really an equivalent of the Rule 10b-5 requirement that the customer exercise good judgment and due care in order to recover damages. This requirement is termed due diligence.").

For a comprehensive discussion of the cases requiring that the plaintiff justifiably rely on the defendant's misstatements or omissions in order to state a cause of action under Rule 10b-5, see WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING § 4.1 n.11 (1996 & Supp. 2001). The justifiable reliance requirement is sometimes described as a requirement that the plaintiff exercise due diligence. *Id.*; *see also infra* text accompanying notes 172–80.

56. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988).

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

58. *See* Follansbee v. Davis, Skaggs & Co., 681 F.2d 673 (9th Cir. 1982).

59. *Lehman Bros.*, 2000 WL 1702039, at *26 (quoting Scott v. Dime Sav. Bank, 886 F. Supp. 1073, 1078 (S.D.N.Y. 1995), *aff'd*, 101 F.3d 107 (2d Cir. 1996)) (applying New York law); *see also* MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249 (10th Cir. 1989) (applying Oklahoma law); Connor v. First of Mich. Corp., Fed. Sec. L. Rep. (CCH) ¶ 95,350 (W.D. Mich. 1990) (applying Michigan law); Police Ret. Sys. of St. Louis v. Midwest Inv. Advisory Servs., Inc., 706 F. Supp. 708 (E.D. Mo. 1989), *aff'd*, 940 F.2d 351 (8th Cir. 1991) (applying Missouri law). For a discussion of the circumstances under which a broker-dealer is considered to be a fiduciary of its customer, see POSER, BROKER-DEALER LAW, *supra* note 1, § 2.02.

2. Sophistication and complex investments

An investor usually is regarded as sophisticated if she has sufficient understanding and intelligence to be able to evaluate a broker's recommendations and to exercise independent judgment as to those recommendations.[60] Strictly speaking, an institutional investor, not being a natural person, cannot have (or, for that matter, lack) sophistication. The degree of sophistication of an institutional investor is necessarily the sophistication of the individual or individuals to whom the institution gives the responsibility of investing its money.

Some courts have been unwilling to impose liability on broker-dealers who recommend unsuitable securities to institutional customers, because they assume the investment officers of institutions to be sophisticated. Investor sophistication, however, has meaning only in relation to the instruments that are being sold. During recent years, a plethora of novel and highly complex securities have come to the market. Many of these are called derivatives, because their value is derived from the performance of an underlying financial asset, index, or other investment.[61] Some derivatives, such as options on a stock or a well-known index (e.g., the Standard & Poor's 500 Industrial Index), have standardized terms and are traded on stock exchanges.[62] Others are custom-made derivative instruments (not all of which, however, fall within the definition of a security). Many of these "over-the-counter" derivatives, including complex options, swaps, and collateralized mortgage obligations ("CMOs"), have been sold to institutions.[63] Some of these instruments are contracts

60. *See* Paine, Webber, Jackson & Curtis Inc. v. Adams, 718 P.2d 508, 516 (Colo. 1986).

61. DOWNES & GOODMAN, *supra* note 32, at 147. For a description of derivatives and their uses, see Frank Partnoy, *Adding Derivatives to the Corporate Law Mix*, 34 GA. L. REV. 599 (2000). For a practicing lawyer's view that regulation of derivatives is often counterproductive, see Saul S. Cohen, *The Challenge of Derivatives*, 63 FORDHAM L. REV. 1993 (1995).

62. For a description of the exchange-listed options market, see Norman S. Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 586–92 (1984).

63. For descriptions of a complex custom-made swap and an option that were sold by a broker-dealer to a large corporation, see *In re* BT Sec. Corp., Exchange Act Release No. 35,136, 1994 SEC LEXIS 4041, at *10–*13 (Dec. 22, 1994).

In 1994, a municipal financial officer testified before Congress concerning the variety and complexity of derivatives:

> Collateralized mortgage obligations (CMOs), zero-coupon instruments such as STRIPS, stripped into interest-onlys (IOs) and principal-onlys (POs), forwards, fu-

that are custom-made by broker-dealer firms for the purpose of selling them to their institutional customers.

While a derivative may be purchased for the purpose of hedging and is a useful tool for limiting risk, derivatives can themselves be highly risky, and, owing to their complexity, the risk is not always readily apparent to the person who assumes it.[64] The investment officer of an institution who has no difficulty understanding the limited risk involved in purchasing certain traditional institutional investments, such as short-term Treasury bills and high-grade commercial paper, may lack the necessary experience or training to evaluate a complex derivative instrument and may, therefore, place his trust in the judgment and honesty of the broker to select the institution's investments.[65] In some instances, this trust has been misplaced.[66]

In a rapidly changing financial world driven by increasing competition, new technology, and new investment instruments, any generalizations about investors' sophistication must be viewed with suspicion. According to one commentator, "[I]nvestor sophistication, as that term is generally used, may in fact be a myth. Certainly it is a concept that has to carry far too much weight in light of the search by fiduciaries for help in understanding the complexities of modern investment opportunities, strategies and markets."[67] It is clear that the officers of many small institutions who are responsible for handling their investments lack investment sophistication. Sometimes these persons perform several other functions and have neither the time nor the training to keep up with developments in modern finance, including the creation of complex investment instruments

> tures, currency and interest rate swaps, options, floaters/inverse floaters, floaters hedged with swaps, indexed/fixed-rate bonds, cap, floors and collars, as well as exotic fixed-rate programs known as RIBS/SAVRS, PARS/INFLOS, and Bull/Bear floaters—this myriad of esoteric and intricate products is enough to confound even the most experienced finance professional, whether public or private.

Testimony of Alan McDougle, *supra* note 19.

64. One definition of a derivative is a "transferable high-risk security such as a future or an option." JOHN CLARK, INTERNATIONAL DICTIONARY OF BANKING AND FINANCE 111 (1999).

65. *See* Root, *supra* note 12, at 337 ("Our financial world is one in which investment opportunities are evolving swiftly; institutional management is unable realistically to keep up with changes produced by the so-called 'rocket scientists'; and, regulatory authorities themselves are often ill-equipped to assess the impact of investment choices produced from a vast array of new creations.").

66. *See, e.g.*, *In re* BT Sec. Corp., 1994 SEC LEXIS 4041.

67. Root, *supra* note 12, at 355.

that are designed to allocate and transfer risk.[68]

3. Lack of sophistication of some institutional investment officers

A relatively recent SEC administrative action illustrates the lack of sophistication of some of the smaller institutions. Between 1990 and 1994 a securities salesman named Kenneth J. Schulte and several other salespersons, working out of a room in Houston, Texas, sold over $39.4 million worth of risky derivative securities to at least thirteen municipalities and school districts in Ohio. The Ohio investors lost more than $8.2 million.[69] An SEC administrative law judge ("ALJ") found that the financial officers of these institutional investors were unsophisticated and did not understand derivatives. They had informed Schulte that they had conservative investment policies and maintained essentially risk-free portfolios. Nevertheless, Schulte, by means of aggressive and intimidating sales tactics, was able to sell highly speculative securities to these institutions. By persistent phone calls, he pressured the financial officers to buy the derivatives. The investors relied on Schulte's representations that the derivatives were risk-free investments guaranteed by the United States government or a government agency. The ALJ found that Schulte knew that these statements were false and that he persuaded the investors to purchase the securities regardless of whether they were consistent with their investment objectives. He did not provide the investors with written materials describing the securities, nor did he disclose or discuss with them the substantial risks involved in the investments.[70]

Schulte preyed primarily upon the unsophisticated financial officers of small institutions.[71] However, the representatives of larger in-

68. *See* Transcript of Testimony of Richard C. McCoy, vol. 29 at 5179–80, City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C. 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991).

69. *In re* Schulte, Admin. Proc. File No. 3-9051, 1997 WL 173668, at *2–*3 (S.E.C. Apr. 10, 1997).

70. *Id.* at *3–*4. The SEC barred Schulte from the securities industry. He was also convicted in federal court of wire fraud, mail fraud, and securities fraud and was sentenced to fifty-one months imprisonment. His conviction and sentence were affirmed by the Sixth Circuit. United States v. Schulte, No. 97-3511, 1999 Fed. App. 110U, 1999 WL 331655 (6th Cir. 1999). The SEC also brought a civil action against him in federal court in Ohio, which led to an injunction against him and an order to disgorge $400,000 in commissions that he obtained through fraudulent means. *Schulte*, 1997 WL 173668, at *4.

71. The response of the Securities Industry Association, the trade association of the securities industry, to this kind of situation is that the institutions, not the securities dealers, are at fault:

stitutions, whether or not they can be considered sophisticated, may be unable to counter a broker-dealer's efforts to mislead them. For example, BT Securities, the broker-dealer affiliate of Bankers Trust, was found by the SEC to have intentionally allowed Gibson Greetings, Inc., a publicly owned corporation, to believe that the risk of certain interest-rate swaps was substantially less than it actually was.[72]

Even professional managers can be influenced by recommendations of broker-dealers. Economists have noted the "herd behavior" of professional institutional investors. These money managers are known to mimic each other in allocating their funds' assets. A money manager who follows the herd in making an investment decision will avoid damage to his reputation if the decision turns out to be wrong. A study of the factors that determined institutional investors' decisions to purchase a particular stock showed that:

> Purchase of stocks that had recently had large price run-ups tended to be motivated by the advice of others (other investment professionals, newsletters, etc.). . . . This suggests that the comfort inher-

> Investment officers who commit a municipality to a financial obligation that they do not understand merit neither sympathy nor a remedy when losses result. Municipalities can retain professional advisors to assist investment officers in evaluating transactions and strategies they do not fully understand. On the other hand, dealers who have not been engaged as financial advisors and who do not have access to the type of information necessary to evaluate the appropriateness of a transaction should not be held responsible for such a determination.

Testimony Before House Comm. on Banking and Fin. Servs., Subcomm. on Capital Markets, Sec. and Gov't Sponsored Enters., 104th Cong. (1995) (statement of Marc E. Lackritz, President of the Sec. Indus. Ass'n).

To be sure, the suggestion that an institution that does not have its own sophisticated investment officers can retain professional advisors has merit. However, owing to the officer's lack of sophistication and the broker's reassurance, an investment officer may have believed that he understood the investments and therefore did not see a need to turn to others for advice.

72. BT Securities' internal taping system recorded a conversation in which a managing director of the brokerage firm discussed the "differential" between the actual value of Gibson's positions and the valuation that BT Securities provided to Gibson:

> I think we should use this [downward market price movement] as an opportunity. We should just call [the Gibson contact], and maybe chip away at the differential a little more. I mean we told him $8.1 million when the real number was 14. So now if the real number is 16, we'll tell him that it is 11. You know, just slowly chip away at that differential between what it really is and what we're telling him.

In re BT Sec. Corp., Exchange Act Release No. 35,136, 1994 SEC LEXIS 4041, at *7 (Dec. 22, 1994); *see also In re* Smith Barney, Inc., Exchange Act Release No. 34-39118, 1997 WL 583732 (Sept. 23, 1997) (SEC settled administrative action against broker-dealer for allegedly making false disclosures to municipal customer concerning swaps).

> ent in following common wisdom can lead professional money managers to invest in stocks where fundamentals might dictate otherwise.[73]

Even a sophisticated investment officer may be easy prey for a skillful and highly motivated securities salesman. As Professor Langevoort has pointed out, a broker may subtly manipulate an institutional investor's professional ego:

> Take, for example, a well-prepared broker who pitches an exotic, customized interest rate swap to a corporate treasurer. Even if the treasurer has a fair degree of financial sophistication, it is unlikely that her knowledge or understanding extends to such a unique product. Under these circumstances, many potential buyers will resist displaying their ignorance.[74]

An illustration of a relatively large institutional investor suffering substantial losses as a result of unsuitable recommendations is the experience of the City of San Jose (the "City"). A lack of institutional sophistication (and perhaps an excess of institutional vanity) was a contributing factor to the market losses suffered by the City. During the early 1980s, the City engaged in short-term trading (including many purchases and sales in large volume on the same day) of 30-year Treasury bonds. Although the credit risk of long-term Treasury bonds is virtually nil, there is a substantial market risk unless the holder plans to hold the bonds until their maturity, because the market price of long-term bonds is extremely sensitive to fluctuations in interest rates.[75] The City lost about $60 million in 1984, when interest rates rose and the market value of the bonds plummeted.[76]

73. David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 477 (1990).

74. Donald C. Langevoort, *supra* note 20, at 657.

75. As the maturity of a bond increases, any difference between the current rate of interest and the yield of the bond will have a greater effect on the price of the bond. Long-term bonds, therefore, have more price volatility than short-term bonds. *See* SIDNEY HOMER & MARTIN L. LEIBOWITZ, INSIDE THE YIELD BOOK: NEW TOOLS FOR BOND MARKET STRATEGY 44–53 (1972).

76. City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C. 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991). The City had been able to engage in trading on a large scale through the use of a form of financing known as reverse repurchase agreements, pursuant to which the City resold the securities that it purchased to the brokerage firm, agreeing to repurchase them at a higher price. The difference between the resale and repurchase prices represented the cost of the financing. *See* MARCIA STIGUM, THE REPO AND REVERSE MARKETS 25–27 (1989).

The City sued several brokerage firms and banks in federal court for securities fraud, claiming that they had recommended securities and a pattern of investment that were unsuitable for a municipality investing public funds.[77] After a six-month trial, a federal jury awarded the City a verdict of $18 million in damages against two brokerage firms, although several jurors afterwards criticized City officials for their failure to monitor investments and for failing to alert the City to danger.[78]

Testimony given at the trial revealed that the officials who managed the City's investments had little investment experience and an inadequate understanding of the risks of the kind of trading in which the City was engaged. Richard McCoy, the City's treasurer, had a Master's degree in Business Administration but only limited experience with investments.[79] Moreover, because McCoy had numerous other duties to perform as treasurer, he largely relied on the assistant treasurer, Arthur Matthiesen, to handle the City's investments. A long-term employee of the City, Matthiesen had only a high school education and no training in investments.[80] Nor had he ever read a book on investments.[81] It is difficult to believe that the brokers and bank employees who dealt with Matthiesen were not cynically taking advantage of his naiveté and sense of his own importance.[82]

77. The City also claimed that the defendants had breached their fiduciary duty to it under the common law. The judge dismissed this claim on the ground that the City did not have a fiduciary relationship with the defendants. The jury also rejected a claim of churning the City's account.

78. *City of San Jose*, 1991 WL 352485; *see also Shearson, Paine Webber Found Guilty*, L.A. TIMES, June 22, 1990, at D2. Ten other bank and brokerage-firm defendants had meanwhile settled with the City for a total of $12 million. The jury also imposed damages of $500,000 on the City's outside auditing firm. The verdict also included $8.4 million in interest. Maline Hazle, *San Jose Bond Suit Victory—City Wins $26 Million in Verdict*, SAN JOSE MERCURY NEWS, June 21, 1990, at 1A. The two brokerage firms against which the verdict had been entered moved for judgment notwithstanding the verdict, but the case was settled before the motion could be decided. *See City of San Jose*, 1991 WL 352485.

79. Transcript of testimony of Richard C. McCoy, vol. 29 at 5179–80, *City of San Jose*, 1991 WL 352485.

80. Transcript of testimony of Arthur Robert Matthiesen, vols. 8-1374, 8-1402, 8-1404, *City of San Jose*, 1991 WL 352485. Before becoming assistant treasurer, Matthiesen had worked for the City of San Jose, among other things, as a license inspector, collector of sewer charges, orderer of supplies, and as a designer of forms. *Id.* at 8-1382, 8-1390.

81. *Id.* at 8-1404. Matthiesen testified at the trial that he had never heard of anything called a fundamental or a technical approach to investing. *Id.* at 8-1437, 8-1440.

82. *See also Westcap I*, Case No. 96-43191-H2-11 (Bankr. S.D. Tex. Aug. 20, 1997). In *Westcap II*, a bankruptcy court found that Luhmann, the treasurer of the City Colleges of Chicago, was not fully aware of the high-risk nature of certain collateralized mortgage obliga-

C. Should There Be a Presumption That Investment Officers of Institutions Are Sophisticated?

Although not all investment officers are sophisticated in the sense that they are able to understand the nature and risks of complex derivative securities, several writers have suggested that there should be a presumption that institutions are sophisticated investors.[83] Such a presumption would have the advantage of being a clear rule, which might have the effect of reducing the amount of litigation in this area. It also might induce some institutional investors to retain the services of professional investment advisers. While this author knows of no court that has explicitly adopted the suggestion that institutional investors are presumptively sophisticated, the courts have generally been ready to find sophistication without giving adequate weight to the complexity of the recommended securities or the impact of the skills of a salesperson on an investment officer who is reluctant to admit that he doesn't fully understand the securities or their risks.[84]

1. Rebuttable and conclusive presumptions

There are two different kinds of presumptions—rebuttable and

tions that were sold to the City Colleges by two enterprising brokers. On review, however, the Fifth Circuit reversed this finding and absolved the brokerage firm of liability under the Texas Securities Law, in part because "Luhmann gave every indication to [the brokers] of being a sophisticated investor." 230 F.3d 717, 731 n.27 (5th Cir. 2000).

83. *See* C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1153 (proposing a conclusive presumption that all institutions are sophisticated); Markham, *supra* note 20, at 376 (asserting that any institution that is qualified as an "accredited investor" under Regulation D of the Securities Act of 1933 should be presumed sophisticated); Roberts, *supra* note 20, at 804 (arguing that any public entity should be conclusively presumed sophisticated based on its institutional capacity); *see also* Ass'n of the Bar of N.Y., *Report of the Committee on Securities Regulation*, 53 THE RECORD 62, 96 (1998) [hereinafter Bar of N.Y.] (stating that all institutional investors should be presumed to be "sophisticated enough to evaluate risk, seek outside financial advice or refrain from investing in complex instruments. Any other rule [would] effectively [convert] dealers into guarantors of investments.").

84. *See, e.g.*, Westcap II, 230 F.3d 717 (finding that the Treasurer of the City Colleges of Chicago gave the appearance of sophistication to the two brokers who sold securities to the institution because he had previously traded in the same derivatives that were the subject of the dispute and because he had the use of a split-screen Bloomberg system to track the market); Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 955 F. Supp. 499, 512–17 (D. Md. 1997) *aff'd.*, 132 F.3d 1017 (4th Cir. 1997) (refusing to adopt a presumption that an institution is sophisticated as a matter of law but finding that there was no material dispute as to the sophistication of the plaintiff bank's employees).

conclusive.[85] If there were a rebuttable presumption that an institutional investor (or, alternatively, an institutional investor of a given size) is sophisticated, the fact of sophistication would be assumed, once the fact is established that the party in question is an institution. The institution could then rebut the presumption by introducing evidence of non-sophistication. A conclusive presumption, on the other hand, establishes one fact (i.e., the investor is sophisticated) upon proof of another fact (i.e., the plaintiff is an institution). A conclusive presumption is simply a rule of substantive law, which makes the established fact irrelevant.[86] Thus, a conclusive presumption that institutions (or institutions of a certain size or type) are sophisticated would simply be a rule of law that makes the question of sophistication irrelevant.

2. A rebuttable presumption of institutional sophistication?

Rebuttable and conclusive presumptions are supported by different kinds of reasons. The reasons for creating a rebuttable presumption relate to facilitating the conduct of a trial. A rebuttable presumption may be created in order to avoid occupying the time of the court unnecessarily on issues that are unlikely to be litigated, on which evidence is lacking, which heavily accord with probability, or which are difficult to prove by direct evidence.[87] A conclusive presumption, on the other hand, like any other rule of substantive law, is supported by reasons of fairness, certainty, and public policy.

85. A rebuttable presumption is a rule of evidence that states that where a basic fact has been established, another fact will be assumed unless and until evidence has been introduced which would support a finding of the nonexistence of such other fact. Mason Ladd, *Presumptions in Civil Actions*, 1977 ARIZ. ST. L.J. 275, 277.

86. Ronald J. Allen, *Presumptions in Civil Actions Reconsidered*, 66 IOWA L. REV. 843, 846 n.16 (1981).

87. *See* Basic Inc. v. Levinson, 485 U.S. 224, 245 (1987) ("Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult."). Justice Holmes has commented: "A presumption upon a matter of fact, when it is not merely a disguise for some other principle, means that common experience shows the fact to be so generally true that courts may notice the truth." Greer v. United States, 245 U.S. 559, 561 (1918).

Professor Ladd cites five reasons for the creation of presumptions: (1) to expedite trials on issues not likely to be litigated; (2) to avoid a procedural impasse and an undesirable result because of the lack of evidence; (3) to weigh certain factual inferences more heavily because they accord with probability; (4) to account for special means of access or peculiar knowledge of the facts by one of the parties; and (5) to recognize the social desirability of the legal consequences of a particular presumed fact. Ladd, *supra* note 85, at 280–81.

It is my view that proposals for a rebuttable presumption of institutional sophistication are not justified; in fact, the courts have not adopted these proposals. A person's degree of sophistication is not a characteristic that lends itself to being quantified, particularly since it must be measured in relation to the securities that the broker recommends. The numerous cases that have come up in recent years, including the *Schulte*, *City of San Jose*, and *City Colleges* cases discussed in this article, in which institutions of different types and sizes were sold unsuitable securities, suggest that any presumption of institutional sophistication does not accord with actual experience.[88]

The sophistication of an institution's financial officers—that is, their ability to understand complex securities and their risks—cannot realistically be assumed. Aside perhaps from some professionally managed mutual funds or pension funds,[89] the financial officers of even large institutions may be unsophisticated in terms of understanding the characteristics and risks of complex, recently invented securities.[90] Furthermore, it does not waste the time of the fact finder to hear evidence on the issue of sophistication because that issue may be central to determining whether a suitability claim against a broker-dealer will succeed. Nor is ascertaining the sophistication of an institution's financial officers a more difficult task than that of making any other factual determination; in most cases, these individuals will be among the principal witnesses examined at the trial or arbitration hearing. The issue of sophistication may, in fact, be the most important issue to be decided by the finder of fact.

3. A conclusive presumption of institutional sophistication?

Although institutional size is no guarantee of sophistication, the argument has been made that even if the financial personnel of some

88. In support of his proposal for a conclusive presumption of sophistication for all institutions, Professor Fletcher quotes a statement by Dean Clark that "[i]nstitutional investors are usually sophisticated and powerful enough to demand and get the information they need before committing their money," but provides no other basis for this generalization. Fletcher, *supra* note 83, at 1153–54.

89. Even mutual funds managers have shown that they may lack sophistication; as a result, some funds have suffered huge losses from derivatives trading. Markham, *supra* note 20, at 361.

90. Although Professor Markham is in not in favor of imposing a suitability requirement on brokers dealing with institutional investors, he concedes that "institutional investors have established, quite conclusively, that they can seem as naive in their investments in derivative instruments as a proverbial widow or orphan." *Id.* at 358–59.

institutions, particularly large institutions, are not sophisticated, they should be treated as if they were. Some commentators have, therefore, proposed that there be a conclusive presumption of institutional sophistication, regardless of whether the institution's financial officers are actually sophisticated, on the ground that such a rule would force institutions to hire competent, sophisticated investment managers.[91] A conclusive presumption would, as a practical matter, foreclose institutional investors from making suitability claims in most cases.[92] In fact, one legal writer cuts right through the "presumption" language and simply proposes that institutions not be permitted to bring suitability claims.[93] As that writer put it, the courts should not "pierce the veil" of the prima facie sophistication of the institution to get at the sophistication of the individual decision makers.[94] Another version of the conclusive presumption (or rule) proposal would apply only to institutions whose assets under management exceed a certain amount.[95]

If all institutional investors were conclusively presumed to be sophisticated, it would be prudent and even necessary for every institution covered by the presumption to hire a professional investment adviser. The effect of the presumption would be to shift the cost of investigating recommended securities from the broker-dealer to the customer. The proponents of a conclusive presumption argue, however, that allowing institutional investors to bring suitability claims essentially guarantees them a "win-win" position when they invest in

91. Fletcher, *supra* note 83, at 1154 ("Although some institutions may lack sophistication in investment matters, the law should encourage them to have sophisticated parties invest on their behalf."); Markham, *supra* note 20, at 376 ("Any [brokerage] firm should be able to assume that an institution has the 'independent' capability to assess the risk of its investments.").

92. Of course, if a broker intentionally or recklessly made a material misrepresentation to an institutional investor and the investor justifiably relied on the misrepresentation, the broker would be liable for securities fraud, quite aside from any question of suitability. However, as I discuss later in this article, it is likely to be difficult for a sophisticated investor to prove that any reliance it placed on a broker's misstatement was justifiable. *See infra* text accompanying notes 143–96.

93. Roberts, *supra* note 20, at 804 (stating that courts should not allow public entities sustaining losses in derivatives to make suitability claims).

94. *Id.* at 829.

95. *See* Goldman, *supra* note 20, at 1159 (suggesting that the obligations of broker-dealers selling derivatives to large institutions be "essentially restricted to disclosure," while for other derivatives users, "a stronger, affirmative suitability requirement should force dealers to take some responsibility for ensuring that the customer belongs in the derivatives market and that the particular transaction is appropriate.").

unsuitable high-risk securities. If the investments are successful, the institution takes the profit; if not, the institution brings a suitability claim, using the incompetence or lack of sophistication of its financial officers to rebut the broker's defense that the institution was sophisticated.[96]

D. Institutional Sophistication and Cost Efficiency

These arguments take too little account of the realities of institutional investment and the securities markets. Many institutions, particularly small ones, would find it prohibitively expensive to hire experts familiar with the derivatives markets and the complex array of new financial instruments in order to ensure that the institution will be able to respond intelligently and capably in the event that a broker recommends the purchase of a risky investment. Small institutional investors are unlikely to have the financial resources to employ investment officers who have the knowledge, training, and experience to understand the risks involved in new and complex types of securities and whether a given investment increases or decreases the total risk of an institution's portfolio. Furthermore, even professional managers are not immune from investing an institution's funds in unsuitable securities.[97]

Of course it would be desirable for all brokerage-firm customers, including individual investors, to be diligent and knowledgeable in handling their investments. However, even a large institutional investor such as Procter & Gamble or the State of West Virginia may find it uneconomical to employ an entire department of specialized financial experts in order to avoid any possibility of suitability problems arising. Because many custom-made over-the-counter derivative securities are invented by the firms that sell them, there is likely to be a wide disparity of knowledge about these instruments between the sellers and even the most financially acute buyers. As one municipal financial officer testified before a congressional committee:

> Regardless of the size of their portfolio or their level of sophistication, state and local government investors are unlikely to have ac-

96. Roberts, *supra* note 20, at 829.

97. *See, e.g.*, *In re* Mitchell Hutchins Asset Mgmt., Inc., Exchange Act Release No. 34-39001, 1997 WL 537042 (Sept. 2, 1997) (SEC settled administrative action against broker-dealer and investment advisory firm for investing in risky derivative securities on behalf of a fund, which fund was marketed to the public as a low-volatility investment).

> cess to either the quantity or quality of information relating to specific investment instruments that a broker-dealer has. Broker-dealers have real-time, virtually unlimited access to information, such as pricing, structure, and risk factors of an instrument.[98]

In general, duties should be placed on the party who can avoid the risk of harm at the least cost.[99] Here, the question is whether it is cheaper and more efficient to place suitability obligations on broker-dealers and to require them to police their sales personnel effectively, on the one hand, or to require institutional investors to hire sophisticated investment officers or retain sophisticated independent investment advisers, on the other. The answer to the question may be different, depending on whether the institution is, for example, a large mutual fund with a multi-billion-dollar portfolio or a college with an investment portfolio of $50 million. In general, however, it is likely to be more efficient and less costly to place the responsibility of understanding the risks of these instruments on the persons who manufactured them or who are selling them on behalf of their manufacturers than on the institutional buyers, who would be put to considerable expense in order to assure themselves of a sufficient understanding of the instruments. As a leading jurist of our time has stated:

> [P]recautions are wasteful, and rules of law ought not induce buyers of securities to verify information that the sellers are supposed to provide. Securities laws are designed, in large part, to compel the person who knows firm-specific information to reveal it, and thereby eliminate wasteful duplication of effort in digging out facts.[100]

98. *Testimony Before the House Commerce Comm., Subcomm. on Telecommunications and Fin., on Behalf of the Gov't Fin. Officers Ass'n*, 104th Cong. 1995 (statement of Mark J. Saladino, Principal Deputy County Counsel, Los Angeles County, Cal.).

99. *See* Holtz v. J.J.B. Hilliard W.L. Lyons, Inc., 185 F.3d 732, 743 (7th Cir. 1999) (finding broker not liable for failing to ensure that customer completed application designating the beneficiary of his IRA account because the customer was in a better position than the broker to ensure that the application accurately reflected the customer's intentions). Tort law theorists have advanced the concept that the party who could avoid an accident at the lowest cost—i.e., the cheapest cost-avoider—should bear the legal responsibility for the accident, regardless of fault. *See* Stephen G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost-Avoider*, 78 VA. L. REV. 1291 (1992); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 137–42 (2d ed. 1977); GUIDO CALABRESI, THE COSTS OF ACCIDENTS (1970).

100. Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1546 (7th Cir. 1990) (Easterbrook, J.).

Similarly, the "win-win" argument is unrealistic. It strains credulity to believe that an institution's senior managers would intentionally hire "gun-slingers" or incompetents to handle its investments in the belief that the institution will be able to recover their losses in court or before an arbitration panel if the investments go wrong. Sane persons do not make their business plans in that way, if only because of the uncertainty of the outcome of the litigation and the attorneys' fees and other tangible and intangible litigation costs. Any senior official or director of an institution who took that gamble would himself be subject to liability for mismanagement. Nor is it realistic to believe that an institution's financial officers will cynically make risky investments knowing that their employers will be able to bring a suitability claim if the investments are unsuccessful. In fact, several of the financial officers of institutions that have brought suitability claims lost their jobs as soon as the losses came to light, and some were sued or criminally prosecuted.[101]

Perhaps most important, if a conclusive presumption of sophistication were to apply to any entity other than a natural person (including such entities as small municipalities, churches and synagogues, school districts, estates, trusts, close corporations, and pension plans of close corporations), the practical effect of that presumption would be to deny the protections of the securities laws and the common law to many investors with little or no investment sophistication, because they were unable to evaluate or to resist the sales pitch of a securities salesman. On the other hand, to adopt a presumption of sophistication that is limited to larger institutions ignores the fact that the financial officers of even these entities may not actually be sophisticated when it comes to complex securities such as derivatives. Certainly, the novelty and complexity of the security should be a factor in determining whether an institution's investment officer should be considered sophisticated in a particular instance. However, it would be difficult to devise standards that account for the varied sizes and types of institutions that would be excluded from the presumption.

E. Institutional Investors As Accredited Investors

Professor Markham has proposed that any institution having the

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

status of "accredited investor" under Regulation D of the Securities Act of 1933 (1933 Act)[102] be presumed to be sophisticated.[103] In general, issuers of securities can sell securities to an unlimited number of accredited investors and still qualify for exemption from registration under the 1933 Act.[104] Furthermore, Regulation D does not require issuers to furnish any specific information to accredited investors,[105] and accredited investors need not meet the sophistication requirement of Regulation D.[106] Since the term "accredited investor" includes a bank, savings and loan institution, insurance company, public or private pension plan with assets of over five million dollars, small business investment company, tax-exempt organization, or trust with assets of over five million dollars,[107] Professor Markham's proposal would effectively bar many small institutions from bringing suitability claims. He argues that since institutions accept the regulatory benefits of "accredited investor" status, they should not be allowed to make after-the-fact claims against brokers that they lacked knowledge and sophistication.[108]

102. 17 C.F.R. §§ 230.501–.506 (2001).

103. As Professor Markham makes clear: "Any [brokerage] firm should be able to assume that an institution has the 'independent' capability to assess the risk of its investments if that institution has the status of an accredited investor under the federal securities laws or is an exempt institution under the Commodity Exchange Act." Markham, *supra* note 20, at 376.

Regulation D exempts an issuer from registering securities under the Securities Act if certain conditions are met. Under Rules 505 and 506, which are part of Regulation D, an offering may be made to an unlimited number of accredited investors, but to no more than thirty-five non-accredited investors. Furthermore, certain specified information that must be furnished to non-accredited investors need not be furnished to accredited investors. 17 C.F.R. § 230.502(b).

104. Under Rules 505 and 506, an issuer may sell to no more than thirty-five non-accredited investors and to an unlimited number of accredited investors.

105. *See* 17 C.F.R. § 230.502(b)(1).

106. Rule 506 requires that each purchaser who is not an accredited investor, or his purchaser representative, have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. . . ." 17 C.F.R. § 230.506(b)(2)(ii).

107. The term "accredited investor" also includes wealthy individuals. 17 C.F.R. § 230.501(a) (2001). Rule 501 is part of Regulation D under the Securities Act, which removes certain regulatory requirements where persons offer or sell securities to accredited investors. The Commodity Exchange Act exempts institutional investors, including banks, trust companies, savings associations, credit unions, governmental entities, and insurance companies from the requirement that most commodity options contracts be traded on an exchange. Markham, *supra* note 20, at 355–56; *see also* section 207 of the Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1394 (codified as amended at 15 U.S.C. § 78c) (defining "qualified investor").

108. Markham, *supra* note 20, at 347.

This argument has two flaws. First, the principal purpose and result of accredited-investor status are not to confer a regulatory benefit on an institution; principally, it benefits the issuer or controlling person of an issuer by permitting it to sell securities to institutional investors and wealthy individuals without regard to their sophistication and without making the disclosures that it otherwise would be required to make, either in a registration statement or other disclosure document.[109] Second, accredited investor status provides an exemption only from the registration requirements of the Securities Act; it was never meant to relieve any person from liability for defrauding an investor, however sophisticated he may be.[110] Professor Markham's proposal goes much further than the SEC has been willing to go: it would exempt a broker-dealer from liability in a private suit for intentionally or recklessly recommending unsuitable securities to any institution that qualifies as an accredited investor. For example, a church or school district whose total assets consist principally of real estate worth $5 million would be conclusively presumed to be a sophisticated investor.

The SEC's willingness to create a conclusive presumption of sophistication for most institutional investors under Regulation D was part of the agency's effort to assist small business capital formation.[111] It was based on the premise that institutional investors and rich individuals could fend for themselves without the protections afforded by registration because they could be expected to have sufficient bargaining power in transactions with small issuers to ask for and obtain the information they feel is necessary to their making an informed investment decision.[112] These purposes are not relevant in a situation where a broker is selling derivatives or other complex securities to institutional investors in the secondary trading markets. Putting aside the questions of whether the SEC's presumption of sophistication is factually justified and whether the qualifications for being an accredited investor are set at the optimum level,[113] these

109. Under Regulation D, specific disclosures are not required to be made to accredited investors. *See* 17 C.F.R. §§ 230.502(b), 230.506 (2001).

110. 17 C.F.R. § 230.501 (2001) (preliminary note 1).

111. *See Proposed Revision to Certain Exemptions*, Release No. 33-6339 (Aug. 18, 1981).

112. *Id.*; *Exemption of Limited Offers & Sales*, Exchange Act Release No. 33-6121, 1979 SEC LEXIS 711, at *8–*9 (Sept. 11, 1979).

113. *See* MARK I. STEINBERG, SECURITIES REGULATION 157–59 (2d ed. 1993) (criticiz-

transactions with the issuer in the more formal setting of a private placement of securities (where the institution may itself be represented by a brokerage firm) involve a very different level of bargaining power from that enjoyed by an institutional investor in a trading-market transaction.

F. Sophisticated Investors Are Entitled to Protection

The foregoing discussion suggests that not all, and perhaps only a small percentage of, institutional investors are sophisticated in any meaningful sense, given the training, knowledge, and experience needed to evaluate the complex securities and market strategies that broker-dealers create and recommend to their customers. Many large institutions undoubtedly have sophisticated investment officers, but some do not; and many small institutions lack the resources to hire sophisticated officers or advisers. Moreover, the Second Circuit has held in a landmark case that even sophisticated investors deserve the protection of the securities laws, including protection from intentionally or recklessly fraudulent conduct by securities salesment: "[A] salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. . . . The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard."[114]

Just as doctors and lawyers are liable for defrauding both their sophisticated and unsophisticated patients and clients, brokers should likewise not be immunized from liability because their customers are sophisticated.[115] Professor Langevoort has persuasively shown that

ing Regulation D on the ground that it gives certain investors "far less protection than they previously had enjoyed").

114. Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1968) ("The speculators and chartists of Wall Street and Bay Street are also 'reasonable' investors entitled to the same legal protection afforded conservative traders.").

115. In the settlement of an administrative action against a brokerage firm for failing reasonably to supervise a salesmen whose largest and most active customers were institutions, the SEC stated:

> [I]t was not appropriate for the firm to structure its supervision of [the salesman] in reliance, in part, on the expectation that, because most of [his] sales and trading activities were for institutional or other large and presumably sophisticated customers, his customers would themselves be more alert to improper sales practices than unsophisticated retail customers.

In re Howe Barnes Inv., Inc., Exchange Act Release No. 37-707, 1996 WL 536517, at *4 (Sept. 23, 1996).

brokers, whose income usually depends on a high volume of sales, are both motivated and able to manipulate their customers' egos in order to sell securities:

> There are methods . . . to lower both retail and institutional customers' resistance to the sales pitch and create a desire for a particular investment, all subtly exploiting the moral hazard implicit in every principal-agent relationship. None of these requires that the compliant customer be unsophisticated (though he or she may be acting imprudently). Indeed, . . . the customer's very possession of a degree of financial sophistication is manipulated in certain sales techniques. Nor are customers who are effectively manipulated likely to realize this manipulation, given their strong need to view themselves as reasonable and responsible.
>
> . . .
>
> [O]nce a broker successfully cultivates trust, willing reliance by the sophisticated investor—imprudent though it may seem in hindsight—is quite likely and, for that reason, alone, worthy of some protection.[116]

Given the huge variety of institutional investors in terms of size, nature, and purpose, there is no justification to presume the sophistication of an institutional financial officer or to impute sophistication to the institution itself, either as a matter of fact, law, or public policy.

G. Suitability and Broker-Dealers' Compensation

A compelling argument can be made that the root of the problem of unsuitable recommendations (and other abusive selling practices) is the compensation system in general use in the securities industry.[117] Broker-dealers have a "temptation to oversell [when] involved in . . . excessively large commissions."[118] The normal method of compensation is the commission, which is based on the price of the securities sold, not on the success of the investment. If

116. Langevoort, *supra* note 20, at 631. I believe that even a non-reliant plaintiff may be entitled to protection under Rule 10b-5. *See infra* text accompanying notes 177–209. Nevertheless, I agree with much in Professor Langevoort's article.

117. *See, e.g.*, *supra* note 70 and accompanying text; *infra* text accompanying note 127.

118. *See* Anderson v. Knox, 297 F.2d 702, 722 (9th Cir. 1961) (commenting on an unsuitable recommendation by an insurance salesman).

securities are not sold, the broker-dealer receives no compensation. The broker (i.e., the salesperson who is employed by the broker-dealer) is in the same position, because his only compensation is a percentage—usually between thirty and fifty percent—of the commission or markup received by the broker-dealer.[119] As one financial writer has stated, under this compensation system, "few brokers are immune to the temptation to consider their financial self-interest from time to time while they are advising clients. Being at once a salesman and a counselor is too much of a burden for most mortals."[120]

Furthermore, brokers are often paid more, and therefore are motivated to exert more sales pressure, for selling riskier securities or for selling the firm's proprietary securities. Thus, the customer may be paying a higher commission for assuming greater risk. While it may seem illogical and counterintuitive to charge a customer more to buy a less desirable product, the justification that is given for this practice is that higher commissions are necessary in order to encourage brokers to sell these investments.[121] The commission system gives brokers an incentive not only to trade their customers' accounts frequently but also to promote speculative securities, which in many instances are not suitable for the customer.[122]

The motivation to sell risky securities (and not to disclose their risk adequately) that the compensation system creates applies to sales efforts aimed at institutional as well as individual investors. The selling-practice problems driven by the securities industry's compensation system have thus far resisted efforts for reform.[123] Institutional finance officers, whether sophisticated or not, are often barraged by sales pitches from their self-styled financial counselors, who are in reality highly paid and thus highly motivated salesmen and saleswomen. In addition, in many instances brokerage firms exert economic pressure on their sales staffs by imposing quotas to sell more

119. For a discussion of the commission system, see Report of the Comm. on Compensation Practices, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,614, at 86,508 (Apr. 10, 1995) [hereinafter Compensation Practices Report].

120. Albert Haas, *Let's Put Brokers on a Straight Salary*, N.Y. TIMES, Sept. 4, 1977, § 3, at 12.

121. Ellen E. Schultz, *Getting Started: Failing to Consider Commissions Can Be Costly Error*, WALL ST. J., Oct. 28, 1991, at C1.

122. *See* Robert T. Greene, Comment, *Differential Commissions as a Material Fact*, 34 EMORY L.J. 507 (1985).

123. *See* Compensation Practices Report, *supra* note 119, ¶ 85,614, at 86,508.

securities and more securities of particular kinds. If the quotas are not met, the broker may forego perks and other compensation or may lose his or her job.[124] It is unlikely that these production quotas are ever disclosed to customers.

Any detailed discussion or critique of the compensation system of the securities business is beyond the scope of this article. Nonetheless, in deciding whether institutional investors to whom unsuitable securities are sold should be afforded the protection of the securities laws, the powerful motivation of the broker-dealers and their salespersons to exert pressure must be taken into account. Like the legendary bank robber Willie Sutton, who allegedly said (or more likely didn't say) that he robbed banks "because that's where the money is,"[125] brokers, whose living depends on commission income, are naturally drawn to institutional investors. While broker-dealer firms may have difficulty preventing their salespersons from recommending unsuitable securities, perhaps the principal reason for this difficulty is the incentive to do so provided by the commission system.

The commissions to be earned from transactions with institutions can be enormous. For example, in the *Westcap Government Securities* case, in which the City Colleges of Chicago lost $50 million, or half of its entire portfolio, as a result of its purchase of derivatives known as collateralized mortgage obligations, two salesmen received commissions of $2.7 million from the sale of derivatives to a single institutional customer over a period of a few months.[126] Similarly, Schulte, a broker who sold unsuitable derivative securities to thirteen small municipalities, received commissions of $400,000 on these sales.[127] Even a sophisticated financial officer may have difficulty resisting a salesperson who is not only skillful and determined

124. *See* Charles Gasparino, *Merrill Retreats on Broker Sales Quotas For Its Financial Foundations Program*, WALL ST. J., Aug. 7, 2000, at C23; *see also* POSER, BROKER-DEALER LAW, *supra* note 1, § 16.01.

125. *See* WILLIE SUTTON, WHERE THE MONEY WAS (1976). Like many legends, the truth of this one is subject to considerable doubt. According to one source, what Sutton actually said was that he robbed banks because "I enjoyed it. I loved it. I was more alive when I was inside a bank, robbing it, than at any other time of my life." Steve Cocheo, *The Bank Robber, THE QUOTE, and The Final Irony*, *at* http:/www.banking.com/aba/profile_0397.htm (March 1997).

126. *Westcap II*, 230 F.3d 717, 719 (5th Cir. 2000); *see also Westcap I*, Case No. 96-43191-H2-11, ¶ 66 at 18 (Bankr. S.D. Tex. Aug. 20, 1997).

127. *In re* Schulte, 1997 WL 173668, at *2–*3 (S.E.C. Apr. 10, 1997).

but also highly motivated.

The sale of securities, even to a large institutional investor, is not likely to resemble a typical commercial transaction between two business entities. It is a truism that securities are not bought; they are sold. The agents of brokerage firms who sell securities are above all skillful professional salespersons that wage energetic campaigns to sell their wares. The institutions targeted by these campaigns are typically subjected to persuasive selling arguments and subtle flattery by brokers.[128] The brokers' compensation on successful sales efforts tends to be enormous by most standards and provides a strong incentive for aggressive sales tactics, which the financial officers of the institutions may as a practical matter be unable to resist.[129]

III. THE REGULATORY AND LEGAL SOURCES OF THE SUITABILITY REQUIREMENT

In view of the advantage that brokerage firms have over their customers with respect to access to information and the strong incentive to oversell created by the compensation system used in the securities industry, unsuitable recommendations are proscribed by three types of legal or quasi-legal rules. First, the self-regulatory organizations in the securities industry, including any national securities exchange or national securities association, are required by law to regulate their members;[130] and the rules of the SROs specifically prohibit unsuitable recommendations. Although, according to the majority view of the courts, a violation of the NASD (or other SRO) suitability rule does not give rise to criminal or civil liability,[131] such a violation can have major consequences for a broker-dealer. The NASD has the power to fine and to bar a broker-dealer, or an individual who is associated with a broker-dealer, temporarily or perma-

128. *See, e.g.*, Transcript of testimony of Arthur Robert Matthiesen, vol. 9-1441 to 9-1456, City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991).

129. The *Schulte* and *Westcap* cases provide examples of the substantial compensation that securities salesmen have received through the sale of derivatives to institutional investors are. *See supra* note 70 and text accompanying notes 126–27.

130. The 1934 Act provides that a national securities exchange or a national securities association shall not be registered unless its rules "are designed to prevent fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade." Securities Exchange Act of 1934, 15 U.S.C. §§ 6 (b)(5), 78f(b)(5), 15A(b)(6), 78o-3(b)(6).

131. *See* cases cited in POSER, BROKER-DEALER LAW, *supra* note 1, § 2.06[A], at 2-107 to 2-111.

nently from the securities industry.[132]

Second, the antifraud rules of the federal securities laws, particularly SEC Rule 10b-5, have been interpreted to prohibit unsuitable recommendations if intentionally or recklessly made and to subject the broker-dealer to liability in an enforcement action by the SEC[133] as well as in a private lawsuit.[134]

Finally, under the common law of agency, a broker who makes such a recommendation may be liable for breach of his fiduciary duty to his customer.[135] Each of these sources of liability will now be considered.

A. Self-Regulatory Rules

1. The NASD suitability rule

The Securities Exchange Act of 1934[136] (the "1934 Act" or "Act") contemplates that much of the regulation of broker-dealers will be conducted by self-regulatory organizations, particularly national securities exchanges and national securities organizations. In fact, the Act does not give the Securities and Exchange Commission ("SEC") general authority to adopt rules governing a broker-dealer's conduct in its dealings with its customers,[137] but largely leaves it to

132. Nat'l Ass'n of Sec. Dealers, NASD Rule 8310(a), NASD MANUAL (CCH) 7271 (2000).

133. *See In re* Guevara, Exchange Act Release No. 34-42793, 2000 WL 679607 (May 18, 2000).

134. *See* Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978).

135. *See* MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249 (10th Cir. 1989).

136. Securities Exchange Act of 1934, 15 U.S.C. § 78 (2000).

137. The 1934 Act gives the SEC authority to regulate several specific activities of broker-dealers, including margin lending, 15 U.S.C. § 78g (1994), financial responsibility, 15 U.S.C. § 78o(c)(3) (1994), and floor trading, 15 U.S.C. § 78j(a) (1994). The only way the SEC can regulate the conduct of broker-dealers in relation to their customers, however, is through the SROs and through the antifraud provisions of the Act. The SEC has followed both routes in its regulation of brokers' unsuitable recommendations.

The proposed Federal Securities Code, developed by the American Law Institute during the 1970s under the direction of Professor Louis Loss, would have given the SEC authority to adopt rules to define, and to prescribe means to prevent, unfair dealings by a broker with its customers. The proposed provision was designed "to carve out a degree of misconduct that is more than 'unethical,' so that it is within the proper sphere of direct regulation rather than self-regulation, but less than 'fraudulent.'" AM. LAW INST., FED. SEC. CODE, PROPOSED OFFICIAL DRAFT § 915 & n.1 (1978). The Code, however, was never enacted.

the SROs to develop and enforce standards in this regulatory area.[138]

Under the Act, national securities associations are required to be registered with the SEC, and almost all broker-dealers are required to be members of a national securities association. The only national securities association ever to be registered with the SEC is the National Association of Securities Dealers. The 1934 Act requires the NASD to establish and enforce rules "to promote just and equitable principles of trade" in the securities industry.[139] Pursuant to its statutory mandate, the NASD adopted its suitability rule not long after the NASD was established in 1939.[140] The rule, which is now designated as Rule 2310, states in part:

> (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.[141]

The NASD's suitability rule is one of the principal components of the standards of fair dealing and professional conduct that are applicable to a stockbroker when dealing with a customer.[142] Although misrepresentations or nondisclosure of information may accompany a violation of the suitability rule, the rule itself is a substantive requirement that imposes on a broker-dealer "an obligation not to recommend a course of action clearly contrary to the best interests of the customer, whether or not there was full disclosure."[143]

138. The NASD is the only national securities association. There are nine active national securities exchanges, the largest of which is the New York Stock Exchange (NYSE). SEC, 2000 ANNUAL REPORT 38, 145–55 (2001).

139. Securities Exchange Act of 1934, 15 U.S.C. § 78o-3 (1994).

140. SEC REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, at 228 (1963) [hereinafter SEC SPECIAL STUDY].

141. NASD Rule 2310, *supra* note 1, at 4261. Before the NASD recodified its rules in 1996, the suitability rule was Article III, section 2 of the NASD's Rules of Fair Practice.

142. Although the majority view is that a violation of an SRO rule, including the suitability rule, does not give rise to a private right of action, such violations may be taken into account in determining whether a broker acted reasonably and in accord with the prevailing standards of the securities industry. Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981).

143. *In re* Powell & McGowan, 41 S.E.C. 933, Exchange Act Release No. 7302, 1964 WL 66868 (Apr. 24, 1964).

By its terms, Rule 2310 applies only to recommendations. The rule is not implicated where a broker sells to a customer a non-recommended security. This raises the question of what constitutes a recommendation. In 1996, the NASD stated that it would deem a transaction to be "recommended" when a broker "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."[144] Subsequently, the staff of NASD Regulation, Inc., the NASD's regulatory subsidiary, qualified this broad definition of the term "recommend" by stating that a suitability obligation does not apply in situations where the broker acts solely as an order-taker, that every statement that mentions a security would not necessarily be considered a recommendation, and that the term "recommended" does not depend on whether an order was deemed "solicited or unsolicited."[145] The SEC takes the position that the NASD rule is violated even where the broker makes an unsuitable recommendation in response to the customer's expressed wish to speculate in the market. As a fiduciary, a broker may only make recommendations that are in the best interests of his customer, even when the recommendations contradict the customer's wishes.[146] However, there is no bright-line test as to what constitutes a recommendation for purposes of Rule 2310, but rather a spectrum of situations, from a broker acting merely as an order-taker, at the one extreme, and the urging by a broker of a customer to buy a particular security, at the other. In between are a variety of situations in which it may not be entirely clear whether or not the rule applies.

Although misrepresentations or nondisclosure of information may accompany a violation of the NASD suitability rule, the rule itself is a substantive requirement that imposes on a broker-dealer "an obligation not to recommend a course of action clearly contrary to

144. NASD Notice to Members No. 96-60, 1996 NASD LEXIS 76 (Sept. 1996). In 2001, the NASD published a "policy statement" advising its members as to the kinds of communications over the Internet that constituted "recommendations" under Rule 2310. *Online Suitability*, NASD Notice to Members No. 01-23, 2001 WL 278614 (Mar. 19, 2001).

145. *See* N.Y. COUNTY LAWYERS' ASS'N, STRATEGIES FOR FINANCIAL INSTITUTIONS IN THE NEW E-COMMERCE ECONOMY 5–6 (Jan. 19, 2000).

146. *In re* Reynolds, [1991–92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,901, at 82,311 (SEC Dec. 4, 1991) (holding that broker violated NASD suitability rule where he engaged in aggressive and speculative trading on behalf of church fund, even if the church board did suggest that he engage in this type of trading).

the best interests of the customer, whether or not there was full disclosure."[147] Unlike Rule 10b-5, the principal antifraud rule of the Securities and Exchange Commission, NASD Rule 2310, does not require that the brokerage firm act with scienter (i.e., intent or recklessness).[148] A broker who recommends the purchase or sale of a security to a customer without having a reasonable belief that it is suitable may be sanctioned by the NASD for acting negligently.[149]

Because of the inclusive membership of the NASD and perhaps also because the NASD rule was the earliest suitability rule to be adopted by any regulator, the rule has been highly influential in the development of the doctrine. Nevertheless, although violation of the NASD suitability rule (or any other SRO rule) subjects a broker-dealer to possible disciplinary action, the majority view of the courts is that no private right of action can be implied from such a violation.[150] Rules such as NASD Rule 2310, however, are admissible, in lawsuits and arbitrations based on negligence or breach of fiduciary

147. *In re* Powell & McGowan, Inc., 41 S.E.C. 933, 1964 WL 66868, at *2 (1964).

148. Erdos v. SEC, 742 F.2d, 507, 508 (9th Cir. 1984). The Supreme Court held in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that a defendant cannot violate section 10(b) and Rule 10b-5 unless he acts with scienter.

149. Professor Mundheim has pointed out that the suitability doctrine is closely related to section 2-315 of the Uniform Commercial Code, which provides that a seller of goods makes an implied warranty of fitness for a particular purpose, where the seller has reason to know the particular purpose for which the goods are acquired and where the buyer relies on the seller's skill or judgment in selecting or furnishing goods which are suitable for that purpose. Mundheim, *supra* note 2, at 452. Article 2 of the code, however, applies only to sales of goods, not to sales of securities.

150. The courts are divided on the question of whether an SRO violation can give rise to an implied private right of action, but the prevailing view on this question is negative. *See* Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980) (no implied private right of action for violation of an SRO rule). *But see* Buttrey v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir. 1969) (private right of action for violation of an SRO rule may be implied if the defendant's conduct was tantamount to fraud); *see also* cases cited in POSER, BROKER-DEALER LAW, *supra* note 1, § 2.06[A], at 2-107 to 2-111.

The majority view on this question has been sharply criticized by the California intermediate appellate court:

> It may be asserted the proposed [suitability] guidelines are merely ethical standards and should not be a predicate for civil liability. Good ethics should not be ignored by the law. It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions.

Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 244 (Cal. Ct. App. 1968); *see also* LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 834 (2d ed. 1988).

duty, as evidence of the standard of conduct that should be applied to members of the securities industry.[151]

2. Recommendations to institutional customers under the NASD rule

Rule 2310 applies to recommendations made to institutional as well as individual customers, although not in exactly the same manner. Although Part (a) of the rule, which is quoted above, by its terms applies to all customers, Part (b) applies only to individual customers. Part (b) requires a broker, when recommending a security to a non-institutional customer, to make reasonable efforts to obtain information concerning the customer's financial status, tax status, investment objectives, and any other information that the broker considers to be reasonable.[152]

The NASD has made it clear that Part (a) of the rule does not implicitly exempt from its requirements recommendations made to institutional customers. In 1996, the NASD adopted an interpretation of its suitability rule (the "Suitability Interpretation") that defines the suitability obligations of brokerage firms to institutional customers.[153] The NASD considers an institutional customer to be any entity other than a natural person, but suggests that the Suitability Interpretation should normally be applied only to institutions with at least $10 million invested in securities.[154]

The NASD's Suitability Interpretation limits, but does not eliminate, the responsibility of a broker to determine the suitability of its recommendations to an institutional customer. Under the interpretation, the extent of the responsibility depends upon the investment sophistication of the customer and the nature and circumstances of the relationship between the broker and customer. The broker must determine the suitability of a recommended investment unless the

151. Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981).

152. Twenty-five years before the NASD adopted Part (b) of Rule 2310, the SEC had held that the suitability rule imposed an implied duty on a NASD member to investigate its customers' situation before it recommended securities to the customer. *In re* Greenberg, 40 S.E.C. 133 (1960); *see also* Erdos, 742 F.2d at 508.

153. NASD Rule 2310-3, *supra* note 35, at 4265.

154. *Id.* The NASD does not explain why it determined that the cutoff should be $10 million. Presumably, the determination was based on the assumption that an institutional investor with a securities portfolio of under that amount is unlikely to be able to afford professional financial management.

broker is satisfied that the customer has both a general capability to evaluate investment risks and a specific capability to evaluate the risks of a particular investment.[155] If the broker has reasonable grounds for concluding that an institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, the member's obligation to determine that a recommendation is suitable is fulfilled. Where an institutional customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the broker-dealer must determine the ability of the agent to evaluate the investment risk.

Thus, a broker's suitability obligation to an institutional customer is narrower than to an individual customer, for whom the broker is required to determine the suitability of any investment that it recommends, regardless of the customer's investment sophistication. A possible explanation for the difference in approach is that since institutional investors are likely to be under professional management, there is no need to burden a broker-dealer with a suitability responsibility once the broker-dealer has determined that the institutional manager is capable of independently evaluating the recommended securities.[156] Although this argument is also plausible

155. The Suitability Interpretation states in part:

> The two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a member's recommendation. A member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

Id. at 4264.

156. The Interpretation provides that, in determining the institutional customer's (or agent's) capability to evaluate investment risk, the broker should consider the following factors:

> (1) The customer's use of consultants, investment advisors, or bank trust depart-

where a broker-dealer recommends securities to a sophisticated individual investor, the NASD rule does not limit a broker-dealer's responsibility in the same way in that situation.

Despite the more limited application of the NASD suitability rule to institutional investors, the Suitability Interpretation makes it clear that a broker's obligation to determine the suitability of recommendations applies to recommendations made to institutional as well as individual investors.

3. Suitability and the professional status of the securities industry

The NASD's position in this area is not unrelated to the fact that broker-dealers wish to gain professional status as advisors, equivalent to that of a doctor, lawyer, or accountant. Brokerage firms seek to encourage customers to believe that their salespersons are professionals upon whom the customers can rely for expert investment advice. This is made patently clear by their advertising, which emphasizes that brokerage firms can be trusted to give investment advice, designating their salespersons as "financial consultants," "financial advisors," or "account executives"; and in other ways in their customer contacts.[157] Brokers seek the trust and confidence not only of individuals but of institutional investors as well.[158] Clearly, the NASD

ments.

(2) The customer's general level of experience in financial markets and specific experience with the type of investment under consideration.

(3) The customer's ability to understand the economic features of the security.

(4) The customer's ability to independently evaluate how market developments would affect the security.

(5) The complexity of the security.

The Suitability Interpretation states that the above factors are guidelines and that the presence or absence of any of them is not dispositive of the determination of suitability. "Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction." *Id.* at 4265.

157. A review of the web sites of several brokerage firms shows that they encourage the public to depend on them for investment advice. Typical slogans are "Advising Investors for Over a Century" (Legg Mason), "Your Guide to the Financial World" (First Union Securities), "We Help You Invest Responsibly" (Fidelity Investments), "We want your business, we'll earn your trust" (Ferris Baker Watts), and "We Measure Success One Investor at a Time" (Morgan Stanley).

Titles such as "financial advisor" or "financial consultant" "are pregnant with important legal meaning," since they invite the customer to enter into a relationship of "trust, confidence and dependence" with the broker. Rapp, *supra* note 3, at 190 n.3.

158. Paine Webber, for example, provides consulting services to institutions and wealthy

considers the suitability requirement a requisite of the professional status to which the securities industry aspires. The Suitability Interpretation recognizes that when a suitability obligation is imposed on a broker, it means that this aspiration is being taken seriously.

The Suitability Interpretation identifies the institutional customers to which a brokerage firm owes a suitability duty on the basis of the investment sophistication of the institution's financial officers. It accurately reflects the reality, which has been ignored by some courts and legal writers, that many institutional investors lack both sophistication and the financial resources to hire sophisticated financial officers. At the same time, the interpretation relieves a broker-dealer of any responsibility for the suitability of the recommendations that it makes, once the broker-dealer has satisfied itself that the financial officer is capable of evaluating the broker's recommendations. In view of the public responsibilities of broker-dealers and the difficulty in determining whether an institution is sophisticated, this is questionable public policy, to which I will return later in this article.[159]

4. Suitability rules of other SROs

Most securities-industry SROs have suitability rules, but these rules have neither the importance nor the influence of the NASD rule. The Municipal Securities Rulemaking Board ("MSRB"), which is the SRO established by the SEC pursuant to its authority under the 1934 Act to regulate the activities of dealers in municipal securities,[160] has a suitability rule similar to the NASD rule. The MSRB rule places an affirmative duty of inquiry on the dealer with respect

individuals. Among the services it offers are "asset allocation advice and the evaluation, recommendation and ongoing analysis of investment managers." UBS/PaineWebber, *Corporate & Institutional Services Homepage*, *at* http://www.ubspaineWebber.com/index.html (last visited Nov. 12, 2001).

159. For a favorable comment on the NASD's Suitability Interpretation, suggesting that the Interpretation is applicable not only in NASD disciplinary actions but also in resolving disputes between institutions and brokers, see Wallance & Carron, *supra* note 20, at 1.

> Although these guidelines are not intended to provide a "safe harbor" for dealers who sell securities to institutional customers, they provide a balanced and realistic framework for resolving suitability disputes between institutional customers and their brokers. Their most innovative feature is the recognition that an institutional investor that can evaluate the risks of its investments and make independent decisions is in a better position than a broker to judge the suitability of its investments.

Id. at 1 (footnote omitted).

160. Securities Exchange Act of 1934, 15 U.S.C. § 78o-4 (1994).

to recommendations to non-institutional accounts. In addition, a dealer is required to make a suitability determination before recommending a municipal security transaction to (or exercising discretion on behalf of) any account, including an institutional account.[161]

The New York Stock Exchange does not have a general suitability rule, but the exchange's "know your customer" rule requires member firms to use "due diligence to learn the essential facts relative to every customer [and] every order."[162] Although this rule was originally designed to protect stock exchange members from dishonest or insolvent customers, it is presently regarded as protecting investors from being induced to purchase securities whose risks they can ill afford.[163] The NYSE "leaves to the member organization's judgment the determination of which facts are 'essential' in the varying circumstances of each new account."[164] By its terms, the "know your customer" rule applies to institutional as well as individual accounts, and to transactions initiated by a customer as well as transactions recommended by the broker.[165]

Because of the complexity and special risks inherent in put and call options, the SROs on which options are traded have adopted special suitability rules for customers' option accounts.[166] Institutional customers are not excluded from the rules' coverage. These rules require that a broker, in recommending an "opening transaction" (i.e., a transaction that establishes or increases the customer's long or short position in an option), must have a reasonable basis for believing "that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is finan-

161. Mun. Sec. Rulemaking Bd., MSRB Rule G-19, MSRB MANUAL (CCH) ¶ 3591 (1994).

162. N.Y. Stock Exchange, NYSE Rule 405, NYSE GUIDE (CCH) 3696 (2000).

163. LOUIS LOSS, "FRAUD" AND CIVIL LIABILITY UNDER THE FEDERAL SECURITIES LAWS 31 (1983); Sam Scott Miller & Robert D. Popper, *Discount Brokers' Obligations Under the "Suitability" Doctrine*, 5 No. 11 INSIGHTS 7 (Nov. 1991).

164. N.Y. STOCK EXCHANGE, PATTERNS OF SUPERVISION 41 (1982).

165. A booklet prepared by the NYSE to assist its members in fulfilling their supervisory responsibilities lists thirty-one items of information that "may be included in the new account form of an institutional client, if deemed 'essential' for the particular account." *Id.* at 44.

166. Options have been a popular form of investment since 1973, when trading in standardized listed options commenced on the Chicago Board Options Exchange (CBOE). For a description of the listed options market, *see* Poser, *supra* note 62, at 585–92. Curiously, the SROs have not adopted special suitability rules for the sale of derivatives (other than options). However the NASD Suitability Interpretation may be considered to be such a rule.

cially able to bear the risks of the recommended position in the option contract."[167] Thus, the SROs' suitability rules expressly require that opening options transactions be recommended only to customers with sufficient investment sophistication.

In conclusion, it may be said that although the suitability rules of the NASD and other SROs, and the NYSE's "know your customer rule," do not give rise to a private cause of action, these rules have established standards of conduct for the securities industry, which are relevant in lawsuits brought for violation of SEC Rule 10b-5 or for breach of fiduciary duty. Thus, the NASD's Suitability Interpretation is likely to have an influence on courts and arbitrators in determining whether a broker should be liable for recommending an unsuitable security to an institutional investor.

B. Suitability Under Rule 10b-5

Rule 10b-5 is the general antifraud rule of the SEC. It prohibits deceptive conduct and misstatements and omissions of material fact by any person, if the conduct is in connection with the purchase or sale of a security.[168] Although Rule 10b-5 does not expressly give a private plaintiff a cause of action, the Supreme Court has held that there is an implied private right of action based on a violation of the rule.[169] In order to establish liability under 10b-5, it is not enough for a plaintiff to prove that the defendant violated the NASD (or other SRO) suitability rule; the plaintiff must prove all the required elements of a 10b-5 violation. These elements are: (1) a misstatement or omission, or other fraudulent device; (2) a purchase or sale of a security in connection with the fraud; (3) scienter (i.e., intentional or reckless conduct) by the defendant; (4) materiality of the misstated or omitted fact; (5) justifiable reliance by the plaintiff; and (6) damage resulting from the misstatement, omission, or fraudulent device.[170]

167. *See* N.Y. Stock Exchange, NYSE Rule 723, NYSE GUIDE (CCH) 4561 (1999); *see also* Chicago Board Options Exchange R. 9.9, CBOE CONSTITUTION AND RULES (CCH) 2140 (1999).

168. For the text of Rule 10b-5, see *supra* note 8.

169. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("[A] private right of action under § 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure.").

170. *See* Platsis v. E.F. Hutton & Co., 946 F.2d 38, 40 (6th Cir. 1991).

The federal courts have held for over twenty years that a broker's unsuitable recommendation to a customer may constitute a violation of Rule 10b-5. In 1978, in *Clark v. John Lamula Investors, Inc.*,[171] the Second Circuit held that a broker's intentional recommendation of an unsuitable security to an individual customer was "an act, practice or course of business which [operated] as a fraud or deceit" upon the customer, in violation of subsection (c) of Rule 10b-5. The *Clark* court held that, in order to establish a 10b-5 claim for unsuitability, the customer must prove that (1) the recommended securities were unsuitable for her even though the broker knew or reasonably assumed that the securities were unsuitable; (2) the broker intended for the customer to rely on his recommendation; and (3) the customer relied on the broker's recommendation.[172]

Clark did not explicitly deal with the question of how an unsuitable recommendation satisfies the requirement of Rule 10b-5 that, in order to violate the rule, there must be a misstatement, omission, or other fraudulent device.[173] Later federal cases, however, have adopted two alternative theories of liability in suitability cases.[174] The first theory is that the broker misrepresented to his customer that the recommended security was suitable or (owing a duty to disclose) failed to disclose to the customer that the recommendation was unsuitable.[175] The second theory is that the broker engaged in fraud by

171. 583 F.2d 594, 599 (2d Cir. 1978).

172. *Id.* at 598. *See In re* Richards, Case No. 4-88-04402 TS6 Chapter 7, 1990 Bankr. LEXIS 607, at *17 (N.D. Cal. Mar. 6, 1990).

173. The Supreme Court held in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), that deception was an essential element of a violation of Rule 10b-5: "Thus," the Court ruled, "the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." *Id.* at 473–74. The Supreme Court subsequently held that conduct cannot be manipulative unless it also is deceptive. *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

174. *See* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992); City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991).

175. Under this theory, the broker is liable because he made a misstatement of, or omitted to state, a material fact. An omission of a material fact gives rise to liability if the omission makes an otherwise truthful statement misleading. *See* Rule 10b-5(2). Even if the broker made no statement at all to the customer, his omission to disclose the unsuitability of a recommended security may be the basis for liability if the broker had a duty to speak—a duty that arose from the relationship of trust and confidence between broker and customer. Chiarella v. United States, 445 U.S. 222, 230–31 (1980). Such a duty may arise from the existence of a fiduciary relationship. Dirks v. SEC, 463 U.S. 646, 654–55 (1983).

his conduct, because recommending a security to a customer with the knowledge that it is unsuitable, or with reckless disregard for its suitability, is an inherently deceptive act and constitutes a "device, scheme, or artifice to defraud" the customer, or an "act, practice, or course of business which operates or would operate as a fraud or deceit" on the customer.[176] Institutional investors, however, have not had much success in asserting suitability claims under either of these two theories of liability.

1. The misrepresentation/omission theory of liability: The problem of justifiable reliance

An institutional investor who claims that a broker-dealer misrepresented (or failed to disclose) the unsuitability of the securities that it sold to the institution must prove that it justifiably relied on the misrepresentation or omission. Under the majority view of the courts, the plaintiff, whether an individual or an institution, must show not only that it actually relied on the defendant's misrepresentation or omission, but also that the reliance was justifiable. In order to recover, the plaintiff must demonstrate that it exercised due care and reasonable diligence in ascertaining the truth about the investment.[177] Even an unsophisticated investor may not be able to overcome this requirement,[178] but for a sophisticated investor the requirement is likely to be insuperable.

A 10b-5 unsuitability claim that is based on the "misrepresentation/omission" theory is considered to be a subset of an ordinary

176. *See* Rule 10b-5(a) and (c); *see also* O'Connor, 965 F.2d at 897.

177. Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1030–31 (2d Cir. 1993); Myers v. Finkle, 950 F.2d 165, 167 (4th Cir. 1991); Laird v. Integrated Res., Inc., 897 F.2d 826, 837–38 (5th Cir. 1990); Bruschi v. Brown, 876 F.2d 1526, 1529 (11th Cir. 1989); Kennedy v. Josephthal & Co., 814 F.2d 798, 805 (1st Cir. 1987); Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991).

178. In *E.F. Hutton*, several presumably unsophisticated, income-oriented customers sought to recover losses suffered as a result of purchasing risky limited partnership interests, asserting that these securities were unsuitable for them. The court affirmed the district court's dismissal of the action on the ground that the plaintiffs' reliance on the defendants' oral misstatements was not justifiable as a matter of law, because the plaintiffs had been provided with a prospectus that contained accurate written disclosures of the risks of the investment. *E.F. Hutton*, 991 F.2d at 1032.

Other circuits, however, have held that, depending on the circumstances, a plaintiff's reliance on oral misrepresentations may be reasonable even where the misrepresentations were contradicted by contemporaneous written disclosures. *See Myers*, 950 F.2d at 167–69 (4th Cir. 1991); *Bruschi*, 876 F.2d at 1529–30 (11th Cir. 1989).

misrepresentation or omission claim under the rule.[179] A plaintiff who brings such an action must plead and prove that (1) the recommended securities (or securities purchased for a discretionary account) were unsuited to the investor's needs; (2) the defendant knew or reasonably believed that the securities were unsuitable; (3) the defendant, with scienter, recommended (or purchased for the customer) the securities anyway; (4) the defendant made a misstatement of (or, owing a duty to the plaintiff, failed to disclose) material information; and (5) the plaintiff justifiably relied to its detriment on the defendant's fraudulent conduct.[180]

In a suitability lawsuit brought by an institutional investor based on the misrepresentation/omission theory, a major roadblock to establishing liability under Rule 10b-5 is the need to prove that the plaintiff's reliance was justifiable.[181] The rule requiring justifiable reliance by the plaintiff is said to be based on two policy reasons: first, that only those who have pursued their own interests with care and good faith should qualify for the judicially created 10b-5 remedies; and, second, that requiring plaintiffs to invest carefully promotes the antifraud policies of the federal securities laws and engenders stability in the markets.[182]

Although the federal circuits have defined the standard for determining whether the plaintiff's reliance was justifiable in different ways, the prevailing standard is, at least ostensibly, one of recklessness, i.e., "whether the plaintiff . . . refused to investigate in disre-

179. Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1032 (4th Cir. 1997); *City of San Jose*, 1991 WL 352485, at *2.

180. *E.F. Hutton*, 991 F.2d at 1031.

181. The justifiable reliance requirement applies to any misrepresentation claim brought under Rule 10b-5, not only to a suitability claim. The courts are not unanimous, however, in imposing a duty of inquiry on the plaintiff. *See* Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1546 (7th Cir. 1990) (disallowing the securities buyer recovery unless it has tried to verify the seller's statements would impede the disclosure objective of the securities laws).

The justifiable reliance requirement can, alternatively, be viewed as a materiality requirement. In other words, defendant's misstatements "were such obvious hooey that no reasonable investor would have been taken in," or would have viewed the defendant's misstatements or omissions "as altering the 'total mix' of information made available." *Astor Chauffered Limousine*, 910 F.2d at 1546 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)); *see also Westcap II*, 230 F.3d 717, 727–33 (5th Cir. 2000) (finding no 10b-5 liability because defendant's prediction of future trend of interest rates was not a material misstatement, and defendant's failure to warn plaintiff about risk was not a material omission).

182. Dupuy v. Dupuy, 551 F.2d 1005, 1014 (5th Cir. 1977).

gard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow."[183] Since the Supreme Court has held that the defendant in a 10b-5 action can be liable only if he acted with scienter (i.e., either intentionally or recklessly),[184] it would be anomalous to bar a plaintiff from recovery if his conduct rose only to the level of negligence. Nevertheless, some of the cases appear to apply a negligence standard to the plaintiff. Thus, some courts, instead of requiring that the plaintiff justifiably relied on the defendant's misrepresentation, have instead framed the requirement as one requiring that the plaintiff exercise "due diligence" in handling her investments. The due diligence standard, somewhat confusingly, can be interpreted as either one of recklessness or negligence.[185]

In *Zobrist v. Coal-X, Inc.*,[186] a leading case on the subject of the plaintiff's reliance requirement under Rule 10b-5, the Tenth Circuit stated: "Only when the plaintiff's conduct rises to a level of culpable conduct comparable to that of the defendant's will reliance be unjustifiable. In this circuit, such conduct must amount to at least reckless behavior."[187] The court listed the following "relevant factors" for determining whether reliance was justifiable:

> (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing 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) whether the

183. Laird v. Integrated Res., Inc., 897 F.2d 826, 837 (5th Cir. 1990) (citing Stephenson v. Paine, Webber, Jackson & Curtis Inc., 839 F.2d 1095, 1098 (5th Cir. 1988); *Dupuy*, 551 F.2d at 1020)); *see also* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1517 (10th Cir. 1983) ("At a minimum, though, 'a plaintiff may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable.'") (quoting Holdsworth v. Strong, 545 F.2d 687, 694 (10th Cir. 1976)). For a comprehensive rundown of the cases on plaintiff's reliance in a 10b-5 action, see WANG & STEINBERG, *supra* note 55, § 4.1 n.11.

184. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

185. *See* Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1015–16 (2d Cir. 1989) ("A showing of reliance may be defeated . . . where defendant establishes that plaintiff should have discovered the true facts. This has been called the due diligence test, to which, traditionally, a negligence standard has applied. . . . [H]owever, the degree of diligence to which plaintiffs are held has been diminished to minimal diligence. More specifically, a plaintiff bears only the burden of negating his own 'recklessness,' once the issue of diligence is raised by defendant.") (citations omitted); *see also Dupuy*, 551 F.2d at 1014.

186. 708 F.2d 1511 (10th Cir. 1983).

187. *Id.* at 1516 (citations omitted).

plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.[188]

However, the court diluted the usefulness of its list of factors by adding the comment that "[n]o single factor is determinative; all relevant factors must be considered and balanced to determine whether reliance was justified."[189]

The majority view is that the plaintiff has the burden of proving that its reliance was justifiable (or that it performed due diligence).[190] The test of whether the reliance is justifiable is said to be a subjective one, based on whether it would be justifiable for an investor with the attributes of the plaintiff, rather than the average investor.[191] The first of the *Zobrist* list of relevant factors, the plaintiff's sophistication, is probably the most important in a 10b-5 suitability case because a reasonable person who is a sophisticated investor may be expected to investigate the risks of each security that a broker recommends to it.[192] Consequently, it is unlikely that any reliance by a sophisticated investor on the broker's misrepresentation would be justifiable.[193] If investment officers of institutions are presumed to be sophisticated, then institutions cannot bring a successful 10b-5 action unless they can overcome the presumption. If the presumption is deemed to be a conclusive one, they cannot succeed under any circumstances.

188. *Id.*

189. *Id.* at 1516–17.

190. *See* Jackvony v. RIHT Fin. Corp., 873 F.2d 411 (1st Cir. 1989); Harsco Corp. v. Segui, 91 F.3d 337 (2d Cir. 1996); Sowell v. Butcher, 926 F.2d 289 (3d Cir. 1991); Cooke v. Manufactured Homes, Inc., 998 F.2d 1256 (4th Cir. 1993); Schlesinger v. Herzog, 2 F.3d 135 (5th Cir. 1993); Wright v. Nat'l Warranty Co., 953 F.2d 256 (6th Cir. 1992); Grubb v. FDIC, 868 F.2d 1151 (10th Cir. 1989); Ross v. Bank S., N.A., 885 F.2d 723 (11th Cir. 1989).

191. Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir. 1977).

192. One court has stated that a plaintiff's reliance will not be presumed to be unreasonable just because the plaintiff was a sophisticated investor, but that the plaintiff's knowledge and experience will be examined in light of the defendant's misrepresentations and omissions. Nye v. Blyth Eastman Dillon & Co., 588 F.2d 1189, 1197 (8th Cir. 1978).

193. "[T]he most relevant [of the *Zobrist* factors] to a suitability claim would seem to be the sophistication and expertise of the plaintiff in financial and securities matters, the existence of 'longstanding business or personal relationships,' the existence of a fiduciary relationship, the opportunity to detect the fraud, and the generality or specificity of the misrepresentations." Bar of N.Y., *supra* note 83, at 88.

Because the private right of action under section 10(b) and Rule 10b-5 was not in the legislative enactment but was subsequently implied by the courts, Congress did not indicate whether reliance (let alone justifiable reliance) by the plaintiff was an essential element of the cause of action.[194] The courts have overwhelmingly held that a plaintiff must have justifiably relied on the defendant's misrepresentations or omissions or, alternatively, that the plaintiff acted with due diligence in the handling of its investments.[195] This requirement is troubling, since, as described above, many courts seem to equate due diligence with non-negligent conduct. Moreover, the justifiable reliance requirement, as so interpreted, is inconsistent both with the common law of torts and with the investment-protection purpose of the federal securities laws.[196] "At common law, contributory negligence [has never been] a defense to an intentional tort, on the ground that D's purpose to harm and P's failure to take protection were wrongs of a wholly different order."[197] Under comparative negligence principles, which now operate in nearly every state, a plaintiff's negligence may be used by the defendant to mitigate damages, even where the defendant acted recklessly, but is not a complete bar to recovery.

194. The "justifiable reliance" requirement, like the other elements of the private right of action under Rule 10b-5, derives from the common law tort of deceit. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 846 (4th ed. 2000).

Although the courts have uniformly held that reliance by the plaintiff is an essential element of a 10b-5 claim, the Supreme Court has attempted to ease the difficulties of proving reliance. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1971), the Court held that where a 10b-5 violation involves "primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material. . . ." Thus, it would appear that a plaintiff claiming that a broker failed to inform it that recommended securities were unsuitable would not be required to prove reliance. Nevertheless, very few of the suitability cases discussing the question of justifiable reliance contain any reference to *Affiliated Ute*. *See* cases cited *supra* note 177. *But see* Memphis Hous. Auth. v. Paine, Webber, Jackson & Curtis, Inc., 639 F. Supp. 108, 113 (W.D. Tenn. 1986) (noting that *Affiliated Ute* requires the court to assume reliance if there were material omissions).

195. *Dupuy*, 551 F.2d at 1014.

196. In *Dupuy*, the court recognized that the relevant policies behind tort law and the federal securities laws are similar: to deter intentional misconduct, to protect investors against fraud, and to promote ethical standards of honesty and fair dealing in the securities markets. *Id.* at 1018–19.

197. RICHARD A. EPSTEIN, TORTS 212 (1999). In fact, even where the defendant was merely negligent almost all of the states have abandoned contributory negligence in favor of a system of comparative negligence. *Id.* at 211. Thus, in a negligence case, a plaintiff who was negligent may be entitled to some recovery whereas, anomalously, a negligent plaintiff who was the victim of an intentional securities fraud is likely to be denied any recovery.

Section 10(b) and Rule 10b-5 are antifraud provisions, under which there can be no liability unless the defendant acted with scienter, i.e., intentionally or recklessly.[198] As Judge Easterbrook has stated: "[S]ecurities fraud is an intentional tort, and . . . contributory negligence (failure to investigate independently) is not a defense when the tort is intentional."[199] If a negligent victim of a defendant's negligent conduct can recover, a negligent victim of a fraud certainly should not be barred from recovery. According to the Restatement: "The recipient of a fraudulent misrepresentation of fact is justified in relying upon its truth, although he might have ascertained the falsity of the representation had he made an investigation."[200] The majority of jurisdictions have held the plaintiff's negligence should not defeat a fraud claim and that the plaintiff is not required to conduct a due diligence investigation when the misrepresentation concerned matters peculiarly within the defendant's knowledge.[201] Two principal reasons have been cited for this rule: first, the policy of deterring intentional misconduct outweighs the policy of deterring negligent behavior; and, second, considerations of equity dictate that where one party is more culpable than the other, the more culpable party should bear the loss.[202] Nevertheless, decisions interpreting Rule 10b-5 deny recovery to a negligent plaintiff who is victimized by a defendant acting with intent to defraud or recklessly, although "[b]oth tort law and federal securities policy support imposing on the plaintiff only a standard of care not exceeding that imposed on the defendant."[203]

It is at least debatable whether a 10b-5 plaintiff should be limited by common law precepts. While traditional tort law can supply some guidance to the courts when interpreting the federal securities laws, the courts are not bound by it. The Supreme Court has stated that the securities laws were enacted "to rectify perceived deficiencies in the available common law protections by establishing higher stan-

198. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

199. Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp., 910 F.2d 1540, 1546 (7th Cir. 1990).

200. RESTATEMENT (SECOND) OF TORTS § 540 (1976).

201. *Id.* § 540 app. (1989) (citing Mallis v. Bankers Trust Co., 615 F.2d 68, 80 (2d Cir. 1980)).

202. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1018 (5th Cir. 1977); Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1516 (10th Cir. 1983); *see also* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985); *infra* text accompanying note 226.

203. *Dupuy*, 551 F.2d at 1020.

dards of conduct in the securities industry."[204] As the Second Circuit stated in an early securities fraud case: "We need not stop to decide . . . how far common-law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor."[205] It is inconsistent with the overriding investor-protection purpose of the securities laws to deny recovery to a municipality, college, or other institutional investor, where a broker earned enormous commissions by intentionally or recklessly recommending unsuitable securities, even where the institution's investment officers did not exercise due diligence, owing to overwork, gullibility, insufficient experience, or simply negligence. Furthermore, the psychological "chemistry" and interaction between the broker and the investment officer may not be adequately described by conventional legal terms such as justifiable reliance or due diligence. It has been pointed out that some brokers, tempted by "subtle opportunism," will manipulate the motivation of their institutional customers to take inappropriate risks in order to create demand for the investment products they are selling.[206] Such manipulation is a fraud because it violates the implied representation that a broker makes that he will place the economic interests of his customers ahead of his own.[207]

The securities laws have broad remedial purposes that go beyond remedying individual wrongs.[208] One of these purposes is enhancing the confidence of the investing public in the honesty and stability of the securities markets. The private right of action is a powerful tool that is used to enforce the securities laws and to deter brokers from making unsuitable recommendations. Moreover, there is a strong policy reason for protecting institutional investors from fraudulent

204. Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) (stating that the securities laws were designed to add to protections provided to investors by common law). The Supreme Court has, however, referred to common law principles when interpreting Rule 10b-5 in other cases. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 227–28 (1980).

205. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943); *see also* LOSS & SELIGMAN, *supra* note 194, at 850 ("The fact is that the courts have repeatedly said that the fraud provisions in the SEC Acts . . . are not limited to circumstances that would give rise to a common law action for deceit.").

206. *See* Langevoort, *supra* note 20, at 641.

207. *See* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266 (3d Cir. 1998).

208. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1971); J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964).

sales practices, even where the financial officers of the institutions may not have exercised sufficient care in making their investment decisions. The beneficiaries of these institutions are taxpayers, shareholders, pensioners, depositors, and the like, who should not bear the burden of losses suffered as a result of unsuitable recommendations made intentionally or recklessly. Yet, ironically, the federal securities laws, which were enacted to give a plaintiff additional protections not afforded by the common law, today may give less protection than the common law of torts to an institutional investor to whom a broker recommended an unsuitable investment.[209]

The Supreme Court has considered the question of the plaintiff's reliance in a private suit brought under Rule 10b-5 only on two occasions. In both instances it relaxed the requirement by allowing a presumption of reliance under some circumstances.[210] It is certainly possible that, if the question of whether a plaintiff in a suitability suit must prove justifiable reliance or due diligence were presented to the Court, the Court would similarly relax the requirement.

2. Borrowing from sections 11 and 12(a)(2) of the 1933 Act

Although section 10(b) does not indicate whether a plaintiff's reliance, justifiable reliance, or due diligence is a necessary element of a private suit, the Supreme Court has provided guidance as to how a court should proceed in determining the extent of a plaintiff's implied rights under section 10(b) and Rule 10b-5. In two cases decided during the 1990s, the Supreme Court filled such gaps in the statutory scheme by borrowing provisions from analogous express civil liability provisions of the securities laws. In so doing, the Court hypothesized that if Congress had created a private right of action under section 10(b), it would have used similar provisions. In *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[211] the Court borrowed the one- and three-year statute of section 9(e) of

209. *See* Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985).

210. In *Affiliated Ute*, the Court held that, in a case involving primarily a failure to disclose, reliance would be presumed if the facts withheld were material. 406 U.S. at 153–54. In *Basic Inc.*, the Court upheld the "fraud on the market" theory, which states that, where a company's stock is traded in an open and developed market, a person will be held liable for misleading statements even though the purchaser of the company's stock does not directly rely on the misstatement. Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988).

211. 501 U.S. 350 (1991).

the 1934 Act as the proper statute of limitations for a private lawsuit brought under Rule 10b-5.[212] Similarly, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[213] one of the Court's grounds for rejecting any implied liability for aiding and abetting a 10b-5 violation was that the express-liability provisions of the 1933 and 1934 Acts do not impose liability on aiders and abettors.

If a similar borrowing technique is used to determine what obligations should be placed on a plaintiff asserting a 10b-5 claim, including a suitability claim, it can be plausibly argued that the closest analogies are sections 11[214] and 12(a)(2),[215] the express-liability provisions of the 1933 Act.[216] These provisions give an investor in a public offering of securities the right to recover his losses from a defendant who has made misstatements or omissions of material fact. Neither of these express-liability provisions conditions a plaintiff's recovery on reliance (whether justifiable or not) on the misstatements or omissions; nor do sections 11 or 12(a)(2) impose any duty of due diligence on the plaintiff.[217] These provisions bar a plaintiff from re-

212. The Securities Exchange Act of 1934 provides an express right of action to a person who suffers harm as the result of a violation of section 9, which prohibits various kinds of manipulative conduct. 15 U.S.C. § 78I(e) (1994).

213. 511 U.S. 164 (1994).

214. 15 U.S.C. § 77k (2000). Section 11 provides that where a registration statement filed under the Act contains an untrue statement or omission of material fact, the purchaser of a registered security may sue certain designated persons, including the issuer of the security, any signer of the registration statement, any director, and any underwriter of the security.

215. 15 U.S.C. § 77*l*(a)(2) (2000). Section 12(a)(2) provides that a person who offers or sells a security by means of a prospectus or oral communication that contains an untrue statement or omission of material fact is liable to the purchaser of the security.

216. The other possible express-liability analogies are sections 9(e) and 18(a) of the 1934 Act. Section 9(e) provides an express right of action to a person who purchased or sold a security at a price that was affected by a violation of the anti-manipulative provisions of section 9(a), (b), or (c). Section 9(e) does not include a plaintiff's-reliance requirement. Section 18(a) provides a private right of action to any purchaser or seller of a security against any person who made a false statement or omission in a document filed with the SEC. This provision requires that the plaintiff have relied on the false statement or omission but does not require that the reliance be justifiable or that the plaintiff have exercised due diligence. Sections 9(e) and 18(a) are provisions of narrow scope, which are seldom used by litigants. Neither is as closely analogous to Rule 10b-5 as sections 11 and 12(a)(2) of the 1933 Act, which, like Rule 10b-5, contain broad prohibitions against misstatements and omissions of material fact.

217. Section 11(a) allows a plaintiff to recover his losses from the issuer and certain specified categories of persons "unless it is proved that at the time [he acquired the securities] *he knew of [the] untruth* or omission." 15 U.S.C. § 77k(a) (1994) (emphasis added). Section 11(a) imposes a reliance requirement on the plaintiff only in the event that he acquired the security at least twelve months after the effective date of the registration statement, under very limited circumstances. Section 12(a)(2) allows a purchaser of a security to recover losses from

covery only if he actually knew of the untruth or omission at the time he acquired the security.

Congress's decision not to impose a duty of justifiable reliance or due diligence on a plaintiff in sections 11 and 12(a)(2) is consistent with the underlying purposes of the securities laws: to protect investors and to ensure the maintenance of fair and honest markets.[218] Significantly, sections 11 and 12(a)(2), unlike section 10(b) of the 1934 Act and Rule 10b-5, do not premise the defendant's liability on scienter (i.e., intentional or reckless conduct). These express-liability sections subject a defendant to liability based on negligence.[219] Congress did not allow the contributory negligence of the plaintiff to be raised as a defense under these express-liability provisions; there are even stronger policy reasons in favor of allowing even a negligent 10b-5 plaintiff to recover, where liability exists only if the defendant was guilty of intentional or reckless conduct. Using the same method of statutory interpretation, the Supreme Court might well hold that a plaintiff bringing a suitability claim under Rule 10b-5 should not be required to prove justifiable reliance on the defendant's false statements or omissions regarding the suitability of the recommended securities, but should be barred from recovery only if it actually knew that the securities were unsuitable.

3. *Bateman Eichler*: The *in pari delicto* defense

Placing a duty on the plaintiff, whether articulated as a requirement of justifiable reliance or of due diligence, is an anomaly in the federal securities laws, in that it may in fact impose a higher standard of conduct on the plaintiff than it does on the defendant. A merely negligent plaintiff may be barred from recovering losses from a defendant who acted intentionally or recklessly. This result seems inconsistent with the Supreme Court's holding that the considerations of equity and investor protection, on which Rule 10b-5 is based, may allow recovery by a plaintiff who acts illegally or otherwise

the seller, the only proviso being: "*the purchaser not knowing of such untruth or omission*." 15 U.S.C. § 77*l*(a) (1994) (emphasis added).

218. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78b (1994).

219. A defendant in a section 11 case, other than the issuer, has a defense if he exercised due diligence. The issuer, however, does not even have a "due diligence" defense under section 11(b). A defendant in a section 12(a)(2) case has a defense if he can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission." Securities Exchange Act of 1934, 15 U.S.C. § 77*l*(2) (1994).

wrongfully. In *Bateman Eichler, Hill Richards, Inc. v. Berner*,[220] the Court held that even a 10b-5 plaintiff who himself was engaged in wrongful conduct is not barred from suit by the common law doctrine of *in pari delicto* unless two conditions are met: first, the plaintiff's misconduct must be at least substantially equal to that of the defendant and, second, "preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."[221]

Although *Bateman Eichler* involved the defense of *in pari delicto*,[222] and not the requirement that the plaintiff justifiably rely on the defendant's misstatements, the public policy issues involved are similar. In fact, the argument for allowing recovery by a plaintiff whose only fault was a failure to exercise due diligence is stronger than for one who was guilty of wrongful conduct. In *Bateman Eichler*, the Supreme Court emphasized that there is a strong policy reason for allowing recovery and pointed out that "implied private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'"[223]

The suitability doctrine has a public purpose that goes beyond enabling a plaintiff to recover its losses. Broker-dealers act as conduits of information between the markets and public investors, and the stability and efficiency of the markets depends on brokers making honest and well-informed recommendations. Although an institution may be at fault for allowing incompetent persons to make investment decisions, it is inconsistent with the policy underlying the *Bateman Eichler* decision to bar an institutional plaintiff from suit under Rule 10b-5 because its agents did not justifiably rely on the defendant's intentional or reckless misstatements or omissions, or did not exercise due diligence in managing their investments.

220. 472 U.S. 299 (1985).

221. *Id.* at 310–11.

222. The name of the defense is an abbreviation of the Latin phrase "*in pari delicto potior est conditio defendentis*," which means "'[i]n a case of equal or mutual fault . . . the position of the [defending] party . . . is the better one.'" *Id.* at 306 (quoting BLACK'S LAW DICTIONARY 711 (5th ed. 1979)).

223. *Id.* at 310 (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).

4. The "fraudulent conduct" theory of liability: The problem of control of the account by the broker

The second theory that supports a suitability claim under Rule 10b-5 is that recommending unsuitable securities is an inherently deceptive practice, and thus fraud by conduct. The few courts that have discussed the fraudulent-conduct theory have suggested that the plaintiff be required to prove and plead that the broker who recommended the unsuitable securities "controlled" the institutional investor's account. The control requirement would greatly increase the difficulty that an institutional investor making this kind of claim would face.

As stated above, The Second Circuit's decision in *Clark v. John Lamula Investors, Inc.*[224] was the first time any appellate court held that a recommendation of unsuitable securities violated Rule 10b-5. *Clark* was based on the theory that such a recommendation constituted fraudulent conduct, in violation of subsection (c) of Rule 10b-5, which prohibits conduct that would operate as a fraud or deceit on any person. The fraud arises from an implied representation made to the customer by the broker that he will act in the customer's interest, and that making an unsuitable recommendation violates that implied representation.[225] This rationale is known as the "shingle theory," a theory developed by the SEC in the early days of federal securities regulation[226] and upheld by the courts up to the present time.[227] The shingle theory posits that when a broker-dealer hangs out its shingle (i.e., holds itself out as doing business with the public), it makes an implied representation to its customers that it will deal with them fairly and in accordance with professional standards of conduct.[228] If the broker-dealer fails to act in this manner, it has violated the implied representation that it made, and has, therefore,

224. 583 F.2d 594 (2d Cir. 1978).

225. *See* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, 135 F.3d 266 (3d Cir. 1998) (holding that broker-dealer's failure to execute an order in a manner consistent with its duty of best execution is deceptive because the broker-dealer's conduct contradicts an implied representation to the customer that it will act in such a way as to maximize the customer's economic gain).

226. *In re* Duker & Duker, 6 S.E.C. 386 (1939).

227. *See, e.g.*, Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943); Grandon v. Merrill Lynch & Co., 147 F.3d 184, 192 (2d Cir. 1998); *see also* Allen D. Madison, *Derivatives Regulation in the Context of the Shingle Theory*, 1999 COLUM. BUS. L. REV. 271.

228. *See* POSER, BROKER-DEALER LAW, *supra* note 1, § 3.01[A], at 3-4 to 3-5.

committed a fraud on its customers.[229] The deception requirement that the Supreme Court established in *Santa Fe Industries, Inc. v. Green*[230] is thus satisfied, even though the defendant did not make a misrepresentation or omission of a material fact.[231]

In *O'Connor v. R.F. Lafferty & Co.*,[232] the Tenth Circuit suggested that a plaintiff claiming that an unsuitable recommendation violated Rule 10b-5 under the "fraudulent conduct" theory of liability would face an additional difficulty. It will be recalled that in *Clark* the Second Circuit held that a broker who, acting with scienter, makes an unsuitable recommendation to a customer is deemed to have engaged in deceptive conduct in violation of Rule 10b-5.[233] The *O'Connor* court stated that, in addition to these requirements, the plaintiff must plead and prove that the broker exercised control over the customer's account.[234] In dictum,[235] the court reasoned that

229. It has been held to be a fraud for a broker-dealer to recommend a security if the broker does not have a reasonable basis for the recommendation. Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969).

230. 430 U.S. 462, 473–74 (1977). In *Santa Fe*, the Court stated that section 10(b) and Rule 10b-5 were not violated in the absence of "any *deception*, misrepresentation or nondisclosure." *Id. at* 476 (emphasis added). Thus, it is possible that deceptive conduct can give rise to a 10b-5 violation.

231. The shingle theory has thus far survived the Supreme Court's holding in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), that in order to be liable under section 10(b) and Rule 10b-5, a defendant must have acted with scienter, or "intent to deceive, manipulate or defraud." *Id.* at 188. Given that all of the circuit courts that have considered the question have interpreted scienter as encompassing reckless as well as intentional conduct, misconduct by broker-dealers such as making unsuitable recommendations is likely to pass the test of scienter. *See* POSER, BROKER-DEALER LAW, *supra* note 1, § 3.01[D][4], at 3-34. Furthermore, scienter can be inferred from a broker-dealer's conduct that violates the broker-dealer's implied representation to its customer that it will maximize the customer's economic gain. Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 273 (3d Cir. 1998). For a view that the Supreme Court would probably reject the shingle theory today if a proper case were presented to it, see Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271 (1995).

232. 965 F.2d 893 (10th Cir. 1992).

233. *See supra* notes 171–72 and accompanying text.

234. *O'Connor*, 965 F.2d at 898. The court analogized a suitability claim to a "churning" (i.e., excessive trading) claim, for which control by the broker is a necessary element. *Id.* The court reasoned that if control were not required, a plaintiff in a churning case could evade the control requirement by framing it as an unsuitability case. *See also* City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991). The same reasoning has been used in suitability cases brought under state securities laws. *See* Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 180 (Minn. 1994) (holding that an unsuitability claim under the Minnesota Securities Act requires the three *O'Connor* elements of unsuitability, scienter, and control).

235. *See O'Connor*, 965 F.2d at 898–99 (dismissing the 10b-5 claim on the ground that

the additional element of control "is essential to satisfy the causation/reliance requirement of a § 10(b), Rule 10b-5 violation."[236] Although the court did not explain this statement, it was apparently based on the assumption that if the broker does not control the account, it may be supposed that the customer exercised her own judgment in making the investment decision. Thus, the causal chain between the broker's recommendation and the customer's loss would be broken.[237] This view, however, does not take into account the possibility that a customer who retains control of her account may nevertheless accept her broker's recommendations because she places her trust and confidence in the broker's superior knowledge and expertise in investment matters. In that case, the causal connection between the unsuitable recommendation and the plaintiff's loss would not be broken.

To be sure, an institutional investor with an unsuitability claim is likely to have difficulty establishing that the broker controlled its account. Control by a broker is most easily shown where the customer has given the broker formal written discretionary authority to decide on the securities to be bought and sold in the account. It is relatively rare for an institutional investor to give a broker such discretion. Many institutions use several brokers to obtain investment advice and execute transactions for them, so it is unlikely that any one broker can be said to control an institutional account. Furthermore, financial officers of institutions are in some sense professionals, whose responsibility it is to manage the institution's investments. It seems inconsistent with that responsibility for the officer to turn over the authority to trade the account to a broker.

Nevertheless, even where a broker does not have formal trading discretion, he may still have de facto control over a customer's account. In *Follansbee v. Davis, Skaggs & Co.*,[238] a leading case on the question of what constitutes control in this context, the Ninth Circuit took the position that a broker does not control a customer's nondiscretionary account simply because the customer routinely follows the broker's recommendations. More is required:

defendant did not act with scienter).

236. *Id.* at 898.

237. This view does not take account of the possibility that a customer who retains control of her account may nevertheless accept her broker's recommendations because she relies on the broker's superior knowledge and expertise in investment matters.

238. 681 F.2d 673 (9th Cir. 1982).

> If a broker is formally given discretionary authority to buy and sell for the account of his customer, he clearly controls it. Short of that, the account may be in the broker's control if his customer is unable to evaluate his recommendations and to exercise an independent judgment. . . .
>
> The touchstone is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable.[239]

Assuming that "sufficient intelligence and understanding to evaluate the broker's recommendation" means the same thing as sophistication,[240] the control requirement makes it difficult, if not impossible, even for an unsophisticated investor to recover under the "fraudulent conduct" theory of liability for an unsuitable recommendation under Rule 10b-5.[241] If an institutional investor were presumed to be sophisticated, it would therefore be difficult for the investor to satisfy the control requirement.

The foregoing discussion of liability under Rule 10b-5 for unsuitable recommendations demonstrates that under current 10b-5 jurisprudence, an institutional investor plaintiff has substantial, if not insuperable, obstacles to overcome. If the plaintiff alleges that the broker-dealer intentionally or recklessly made a misrepresentation or omission of a material fact, under the lower federal courts' interpretation of Rule 10b-5 the plaintiff must be able to demonstrate that it justifiably relied on the misrepresentation or omission or, in some jurisdictions, that it exercised due diligence. If, on the other hand, the plaintiff alleges that the broker-dealer, by making an unsuitable recommendation, engaged in deceptive conduct, there is some authority supporting the proposition that the plaintiff must be able to show that the broker-dealer controlled its account. The degree of difficulty in showing either justifiable reliance or control by the broker will depend to a large extent on whether the institution is considered to be a sophisticated investor.

239. *Id.* at 676–77.

240. *Id.* Arguably, even an unsophisticated investor could have sufficient intelligence and understanding to evaluate a broker's recommendation.

241. *See* Memphis Hous. Auth. v. Paine, Webber, Jackson & Curtis, Inc., 639 F. Supp. 108, 115 (W.D. Tenn. 1986) (finding that question of whether a broker's failure to advise an institutional customer of the risks eliminated the customer's control over the account was for the jury to decide).

On the other hand, Supreme Court has suggested (at least by implication) that it would not interpret Rule 10b-5 so narrowly in a suitability case. The requirement imposed by the majority of the lower federal courts that in order to recover, the plaintiff must have justifiably relied on the defendant's misstatements or omissions is inconsistent with the policy underlying the Court's holding in *Bateman Eichler*, and with the Court's technique of "borrowing" from express-liability provisions when construing elements of the 10b-5 implied right of action. Furthermore, the supposed requirement that the plaintiff in a "deceptive conduct" suitability case prove that the broker exercised control over the account, while not implausible, is supported by little more than dictum and does not seem necessary in order to establish the causative connection between the defendant's misconduct and the plaintiff's loss.

C. Suitability Under the Common Law

1. Breach of fiduciary duty

There is a substantial body of law that states that a broker who recommends an unsuitable security breaches its fiduciary duty to his customer.[242] The source of this duty is the common law of agency, which holds that an agent, by virtue of his relationship to his principal, is considered a fiduciary with respect to all matters within the scope of his agency.[243] A fiduciary is subject to duties that "go beyond mere fairness and honesty; they oblige him to act to further the beneficiary's best interests."[244] The Supreme Court of Colorado, for example, has held that if a broker makes a recommendation, or merely brings a possible investment to the attention of the customer,

242. An unsuitable recommendation may also be a common law fraud if the broker makes an express or implied representation to his customer that the security is suitable for him. One of the earliest suitability decisions (involving the sale of an insurance policy, not a security) contains a highly interesting discussion of common law fraud in this context. Anderson v. Knox, 297 F.2d 702 (9th Cir. 1961).

243. *See* THE LAW COMMISSION, FIDUCIARY DUTIES AND REGULATORY RULES, CONSULTATION PAPER NO. 124, 28 (1992). Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800–01 (1983); Langevoort, *supra* note 20, at 675–80; Eileen Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 908–10.

244. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882.

the broker may be in breach of its fiduciary duty to the customer if the broker ignores the unsuitability of the investment, even if the customer assents to the transaction.[245]

State law is not consistent, however, on the question of whether the relationship between a broker and its customer is fiduciary in nature. In general, a fiduciary relationship exists where one person reposes trust and confidence in another and where the other person encourages or accepts the trust and confidence.[246] In New York, the broker-customer relationship is considered to be a fiduciary one, with the proviso that the broker's fiduciary obligation is limited to the matters entrusted to the broker by the customer.[247] The California courts have also held that the customer-broker relationship is fiduciary in nature.[248] The Massachusetts courts, on the other hand, state that a "simple stockbroker-customer relationship" is considered not a fiduciary but rather a business relationship, unless the customer, with the broker's consent, has given the broker discretionary authority to trade the account.[249] In other jurisdictions, the relationship between a broker and its customer is a fiduciary one only under special circumstances, as where the broker exercises discretion in selecting securities for the customer's account; where the broker, even lacking discretionary authority, nevertheless has control over the account; or where the customer reposes trust and confidence in the broker.[250]

2. Broker-Dealers' common law duties

Regardless of whether or not the broker-customer relationship is labeled as fiduciary, a broker may be under a common law duty not

245. Rupert v. Clayton Brokerage Co., 737 P.2d 1106, 1109 (Colo. 1987).

246. *See* 37 C.J.S. *Fraud* § 2, at 213 (1987).

247. For example, if a customer does not depend on his broker for investment advice but does depend on him for execution of transactions, the broker may be considered to be a fiduciary with respect to the latter activity but not the former. *See* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999); *see also* Conway v. Icahn & Co., 16 F.3d 504, 510 (2d Cir. 1994) ("The relationship between a stockbroker and its customer is that of principal and agent and is fiduciary in nature, according to New York law.").

248. Duffy v. Cavalier, 259 Cal. Rptr. 162, 171 (Cal. Ct. App. 1989).

249. *See* Brine v. Paine, Webber, Jackson & Curtis, Inc., 745 F.2d 100, 103 (1st Cir. 1984); Carr v. Warner, 137 F. Supp. 611 (D. Mass. 1955).

250. For a survey of the cases discussing the circumstances under which the broker-customer relationship is considered to be a fiduciary one, see POSER, BROKER-DEALER LAW, *supra* note 1, §§ 2.01–.02, at 2-3 to 2-47.

to recommend unsuitable securities. In *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[251] a case that is frequently cited for its detailed discussion of a stockbroker's common law duties, the district court strongly suggested the existence of such a duty. The court stated that a broker exercising investment discretion on behalf of its customer "becomes the fiduciary of his customer in a broad sense" and must "manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history."[252] Even as to a nondiscretionary account, the broker has a duty "to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis" and "to inform the customer of the risks involved in purchasing or selling a particular security."[253] The broker's explanation of these risks will depend on the sophistication of the customer:

> For example, where the customer is uneducated or generally unsophisticated with regard to financial matters, the broker will have to define the potential risks of a particular transaction carefully and cautiously. Conversely, where a customer fully understands the dynamics of the stock market or is personally familiar with a security, the broker's explanation of such risks may be merely perfunctory.[254]

Although the court did not expressly characterize the duties of a broker for a nondiscretionary account as fiduciary duties, the duties cited in *Leib* are among those that agency law imposes on an agent, as applied in the particular context of the customer-broker relationship. Thus, the Restatement of Agency states that an agent is required to exercise care and skill in performing his duties and "to give his principal information relevant to affairs entrusted to him."[255] Another district court has suggested that a broker's unsuitable recommendation may constitute negligence, since it is a breach of the broker's duty to its customer to use due care to ensure that its investment advice is competent.[256]

251. 461 F. Supp. 951 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981).

252. *Leib*, 461 F. Supp. at 953.

253. *Id.* (citing Cash v. Frederick & Co., 57 F.R.D. 71 (E.D. Wis. 1972); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1989)).

254. *Id.* at 953.

255. RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

256. Baker v. Wheat First Sec., 643 F. Supp. 1420, 1430–31 (S.D. W. Va. 1986).

The California Court of Appeals has held that a broker's unsuitable recommendation to an institutional customer may be a breach of fiduciary duty, even if the account is nondiscretionary and even if the customer's representative tells the broker that he wishes to engage in transactions that would be unsuitable for the institution. In *Duffy v. Cavalier*,[257] the trustee of a company's employee profit-sharing plan asked a stockbroker if it would trade in options for him on behalf of the plan. The court held that the relationship between a broker and its customer is fiduciary in nature, and that the broker had breached its fiduciary duty to the plan by recommending unsuitable securities, even though the institution's agent had expressed a wish to trade in these securities.[258] In this regard, the court adopted a broad view of the extent of a broker's duties:

> [W]here an apparently unsophisticated investor expresses a desire to engage in speculative investments with the objective of making large profits, the stockbroker cannot simply carry out the customer's wishes. Rather, the stockbroker has a *fiduciary duty* (1) to ascertain that the investor understands the investment risks in the light of his or her *actual* financial situation; (2) to inform the customer that *no* speculative investments are suitable if the customer persists in wanting to engage in such speculative transactions without the stockbroker's being persuaded that the customer is able to bear the financial risks involved; and (3) to refrain completely from *soliciting* the customer's purchase of any speculative securities which the stockbroker considers to be beyond the customer's risk threshold. As long as these duties are met, if the customer nevertheless insists on purchasing speculative securities, the stockbroker is not barred from *advising* the customer about various speculative securities and purchasing for the customer those securities which the *customer* selects.[259]
>
> . . .
>
> A stockbroker's fiduciary duty requires more than merely carrying out the stated objectives of the customer; at least where there is evidence . . . that the stockbroker's recommendations were invariably followed, the stockbroker must "determine the customer's ac-

257. 259 Cal. Rptr. 162 (Cal. Ct. App. 1989) (citing Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222 (Cal. Ct. App. 1968)).

258. *Id.*; *see also* Conway v. Icahn & Co., 16 F.3d 504, 510 (2d Cir. 1994).

259. 259 Cal. Rptr. at 169 (citing *Twomey*, 69 Cal. Rptr. at 222).

> tual financial situation and needs." If it would be improper and unsuitable to carry out the speculative objectives expressed by the customer, there is a further obligation on the part of the stockbroker "to make this known to [the customer], and [to] refrain from acting except upon [the customer's] express orders." Under such circumstances, although the stockbroker can advise the customer about the speculative options available, he or she should not *solicit* the customer's purchase of any such speculative securities that would be beyond the customer's "risk threshold."[260]

Other courts and arbitrators have agreed that a broker's unsuitable recommendation to an institutional investor constitutes a breach of fiduciary duty. In *MidAmerica Federal Savings & Loan Ass'n v. Shearson/American Express, Inc.*,[261] the defendant brokerage firm recommended the purchase of GNMA securities to the plaintiff, a savings and loan institution, but failed to explain to its representatives some of the crucial terms of these securities. The Tenth Circuit affirmed a jury verdict in favor of the plaintiff, on the ground that the recommendation breached the defendant's fiduciary duty. The court found that the defendant was in a position of strength because it had held out its agent (the broker) as an expert. The plaintiff, which happened to be temporarily without the services of an in-house financial advisor, relied on the agent's advice and was thereby lulled into a false sense of security.[262]

Furthermore, basic principles of agency law suggest that a broker is under a duty not to recommend an investment to an entity that is not legally permitted to make the investment. Professional standards of conduct also require the broker to make some inquiry as to whether the investment may legally be made. Institutional managers themselves have fiduciary obligations to the owners or beneficiaries of the institution (or to the taxpayers, in the case of government entities), and a broker who recommends an investment to an institution may not aid and abet a manager's breach of fiduciary duty. As one commentator has observed, although courts will not shift liability to a broker for executing trades in unsuitable investments made at

260. *Duffy*, 259 Cal. Rptr. at 173.

261. 886 F.2d 1249 (10th Cir. 1989).

262. *Id.* at 1258; *see also In re* Westchester Jewish Ctr., 1994-004243, 1994 NYSE Arb. Dec. LEXIS 615 (June 28, 1995) (holding brokerage firm liable to synagogue for failing to disclose the nature of the CMOs it recommended, and for recommending unsuitable investments, in light of claimant's investment objectives).

the direction of a trustee for the account of a trust,

> it is reasonable and prudent, however, to require the broker (a) to ensure that the fiduciary is capable of understanding and assessing in an investment context the information and recommendations that the broker provides and (b) to present to the fiduciary only those investments that are legally permissible under state law and the trust instrument.[263]

Imposing such a fiduciary requirement on a broker is consistent with the NYSE's "know your customer" rule, which establishes a professional standard for the securities industry, even though the rule itself does not specify the documents or information that the broker must obtain in performing his due diligence.[264] It is reasonable to interpret the "know your customer" rule to require a broker-dealer who recommends a security to an institutional investor to ascertain any legal restrictions and risk parameters that limit the institution's permissible investments. If the broker has any reason to believe that a recommendation would involve the institution in illegal or *ultra vires* conduct, the broker has an obligation to make an inquiry into the matter before making the recommendation.

It may be insufficient for a broker-dealer to rely on what he is told by a institutional customer's financial officer or other representative. If the broker-dealer has a fiduciary duty, the duty is to the institution itself, not to the financial officer. This duty would presumably require the broker-dealer to examine applicable requirements or prohibitions of law regarding investments, the institutional customer's enabling instrument, and any written investment policy that the institution's governing board has adopted. Although the "know your customer" rule is not itself a legal requirement, it establishes an industry standard of conduct, which is highly relevant in a suit based on breach of fiduciary or negligence.[265] The policy reasons in favor of imposing such a requirement on a broker-dealer go beyond recompensing the customer for the losses it has suffered, although that is a worthwhile goal; it will promote stable and honest markets by deterring brokers from making unsuitable recommendations to institutional customers.

263. James S. Shorris, *Suitability Obligations of Broker-Dealers for Trust Accounts: Who Is the Customer?*, 7 SEC. NEWS, No. 1 (1997) at 33.

264. N.Y. Stock Exchange, NYSE Rule 405, NYSE GUIDE (CCH) 3696 (2000).

265. Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981).

3. Judicial interpretation of the common law duty

Despite this background, in recent years several decisions have demonstrated indifference, if not downright hostility, to institutional investors bringing common law suitability claims. Three recent decisions have rejected such claims on the ground that the relationship between broker and customer is not of a fiduciary character. In a widely noted case, *State v. Morgan Stanley & Co.*,[266] the State of West Virginia sued in state court to recover heavy market losses sustained by its Consolidated Fund (the "Fund"), a state investment pool established in order to put idle monies of the State, its agencies, and local governments to work.[267] The State charged Morgan Stanley with aiding and abetting state officials in a breach of fiduciary duty, by speculating in the market for U.S. government securities, and with constructive fraud.

Although the Fund had earlier engaged in a limited amount of trading in short-term securities, in 1985 it began buying and selling securities with maturities of up to thirty years. Such long-term securities are sensitive to fluctuations in interest rates and carry with them substantial market risk.[268] Furthermore, the State bought options, which greatly magnified the risks. In fact, some of the Fund's trading activities were essentially bets on the future direction of interest rates, and these bets were made with the help and encouragement of Morgan Stanley. The transactions included the sale to Morgan Stanley of a "put" on seven-year Treasury notes and the purchase of $1.2 billion in "when issued" seven-year Treasury notes. Morgan Stanley also lent money to the State to allow it to pursue its aggressive trading strategy. Morgan Stanley provided "investment information to the State and it aggressively pursued the State as a customer."[269] "In the spring of 1987, the . . . bond market took an unexpected . . . nosedive and [the Fund] . . . sustained enormous losses,"[270] whereupon the State sued Morgan Stanley.

On the eve of jury deliberations, the trial court granted summary judgment to the State on its claim that Morgan Stanley had know-

266. 459 S.E.2d 906 (W. Va. 1995).

267. *Id.* at 908.

268. *Id.* at 909 & n.5.

269. *Morgan Stanley*, 459 S.E.2d at 910. For a detailed description of these transactions, see Leslie Wayne, *Big Risks, Big Losses, Big Fight*, N.Y. TIMES, Apr. 23, 1995, § 3, at 1.

270. 459 S.E.2d at 909.

ingly aided and abetted State officials in violating the West Virginia Code, which provides that persons managing State funds must exercise

> that degree of judgment and care, under circumstances then prevailing, which men of experience, prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived.[271]

The trial court awarded the State $52 million in damages. The State's separate claim that Morgan Stanley had committed constructive fraud was submitted to the jury, which found in favor the State and awarded it $4.9 million.[272] The West Virginia Supreme Court reversed the trial court's grant of summary judgment on the aiding and abetting claim, and it also set aside the jury verdict on the constructive fraud claim on the ground that the trial judge had given erroneous instructions to the jury.[273] Although the court's opinion did not expressly refer to the suitability doctrine, it appeared to reject the doctrine by implication. The court stated:

> Morgan Stanley was not at any time a fiduciary of the State of West Virginia; Morgan Stanley was a co-principal, which bought and sold notes and bonds from and to the State . . . , bought and sold put and call options from and to the State . . . , and lent money to the State . . . (secured by bonds owned by the State) to allow the State to pursue its aggressive trading strategy.[274]
>
> . . .

271. *Id.* at 911 (citing W. VA. CODE § 12-6-12 (1978)).

272. The tort of constructive fraud is closely related to a breach of fiduciary duty. The California Court of Appeals has defined it as follows:

> Constructive fraud arises on a breach of duty by one in a confidential or fiduciary relationship to another which induces justifiable reliance by the latter to his prejudice. . . . Such a confidential relationship may exist whenever a person with justification places trust and confidence in the integrity and fidelity of another.

Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222, 237 (Cal. Ct. App. 1968).

273. Without specifying the portion of the instruction on constructive fraud that was erroneous, the Supreme Court stated that the "instruction, combined with the trial court's instruction informing the jury that Morgan Stanley had violated West Virginia law by aiding and abetting 'speculation,' was tantamount to directing a verdict against Morgan Stanley on the constructive fraud claim." *Morgan Stanley*, 459 S.E.2d at 913.

274. *Id.* at 910.

> Notwithstanding that Morgan Stanley sedulously cultivated good customer relations with the State of West Virginia, Morgan Stanley was nonetheless a principal in the transactions at stake, not a broker, and Morgan had the right to trade with the State without undertaking the obligation to insure the State against its elected officers' lack of wisdom. "Sophistication", as that term is used in the investment law, should never be confused with intelligence, prudence or good luck.[275]

The court went further, opining that the state officials were sophisticated investors and, therefore, not deserving of protection from the court:

> It is hard to find fraud—constructive or otherwise—when officials at the State Treasury were: (a) sophisticated investors; and (b) audited by other State officials, including the State Legislative Auditor. The Board of Investments approved the actions that are at issue . . . ; to say that Morgan Stanley could not reasonably have relied on [the State officials'] undisputed and very earnest representations that deviation [from the guidelines of the State Board of Investments] was permitted by the Board is tantamount to confessing that West Virginia officials must at all times be treated as either children or incompetents. We are unwilling to accede to this proposition . . . [C]ompetent adults who do not need to be led around on a leash do, occasionally, buy a piece or two of blue sky.[276]

The *Morgan Stanley* court here touched on the most compelling policy argument against applying the suitability doctrine to institutional investors: the paternalistic nature of the doctrine.[277] Financial officials of a State or other government entity are indeed not children or incompetents, and they have presumably been appointed because the governing board or managers of the institution believe they have some ability and expertise in investments. It has been argued that applying the suitability doctrine in this kind of situation would encourage public officials to take greater risks and would deter brokers from entering into transactions with public entities.[278] This argument, however, avoids the most important question con-

275. *Id.* at 913 (footnote omitted).

276. *Id.* at 913 n.17.

277. *See* Markham, *supra* note 20, at 369 (arguing that the suitability rule is "a very paternalistic approach to customer protection").

278. Roberts, *supra* note 20, at 834.

cerning the transaction and the relationship between customer and broker: Did the state's officials rely on Morgan Stanley for advice, and did the Morgan Stanley brokers accept the role of advisors?[279] It also begs the question as to whether the taxpayers of a state should bear the losses, where aggressive, skillful, highly paid (and, therefore, highly motivated) securities salesmen are able to persuade the state's financial agents to buy unsuitable securities? As Professor Langevoort has observed: "[I]n many circumstances it is both natural and foreseeable for professional investment agents to rely wrongly on the representations and recommendations of securities salespeople. There is no reason to believe that the principal is somehow at fault simply because its agent was tricked."[280]

This is not to say that an incompetent or careless financial officer should be exonerated. In many or most cases where an institution suffers heavy losses owing to an unsuitable recommendation, the responsible officials of the institution are punished by losing their jobs or even by suffering civil or criminal liability. The question, rather, is whether a State's taxpayers or the brokerage firm should bear the losses, where a broker-dealer recommends securities that it knows (or should know) to be unsuitable for a public entity.

4. A broker-dealer acting as principal can be a fiduciary

Where liability for an unsuitable recommendation rests on a theory of breach of fiduciary duty, the defense is sometimes raised that a broker who sells the securities to the customer as a principal and not as an agent is not a fiduciary and, therefore, cannot breach a fiduciary duty to the customer. In suitability cases involving institutional customers, the relationship between broker and customer is said to be an ordinary business relationship. Some courts have accepted this reasoning, while others have stated that the capacity in which the broker acts is just one factor and is not determinative of the nature of the relationship.

Morgan Stanley rests on the premise that there cannot be a fiduciary relationship between a broker and an institutional customer

279. Professor Gibson states flatly that "the relationship between derivatives dealers and end-users is not an advisory relationship." Gibson, *supra* note 20, at 571. The cases that I have discussed in this article should indicate that Professor Gibson's unqualified assertion is unjustified.

280. Langevoort, *supra* note 20, at 696.

where the broker acts as a principal, selling a security *to* its client, rather than as an agent, buying the securities *for* its client. Under this view, the broker was, therefore, dealing at arm's length with its customer and was under no obligation to inform the customer that the securities were unsuitable for it. Other recent decisions have agreed with the dubious proposition that parties who trade with each other as principal cannot have a fiduciary relationship. In *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*,[281] the Fourth Circuit affirmed the dismissal of a foreign bank's claim that a brokerage firm's recommendation of CMOs violated the broker's fiduciary duty. In finding that the relationship was not fiduciary, and that the plaintiff, therefore, could not have a suitability claim based on the breach of a fiduciary duty, the court reasoned as follows:

> Epley [the brokerage firm's salesman] and Alex. Brown were not the agents of the Bank, but rather interacted with the Bank at arm's length in principal-to-principal dealings, and no common law fiduciary duty was ever created.
>
> . . .
>
> [T]he defendants did not act as agents for the Bank, but rather conducted their business at arm's length in a principal-to-principal relationship. There was accordingly no formal relationship giving rise to a fiduciary duty, and the record reveals no informal relationship which could allow the imposition of such a duty.[282]

The assertion that no fiduciary duty can arise where a broker sells securities to a customer as principal, rather than as agent, was also made in *Procter & Gamble Co. v. Bankers Trust Co.*[283] A very large publicly held company sued a comparably large broker-dealer for declaratory relief and damages with respect to losses suffered from two interest rate swaps that the company had executed with the broker-dealer.[284] Although Procter & Gamble ("P&G") did not allege un-

281. 132 F.3d 1017 (4th Cir. 1997).

282. *Id.* at 1030, 1038.

283. 925 F. Supp. 1270 (S.D. Ohio 1996).

284. "A swap is an agreement between two parties . . . to exchange cash flows over a period of time. Generally, the purpose of an interest rate swap is to protect a party from interest rate fluctuations." For example, one party will agree to pay a fixed rate of interest, while the other party "assumes a floating interest rate based on the amount of the principal of the underlying debt. . . . [T]his amount does not change hands; only the interest payments are exchanged." *Id.* at 1275.

suitability as a separate claim, it appeared to be at least one of the bases for the suit.[285] The district court held that the swaps were not securities and, therefore, were not covered by the federal securities laws and, further, that they were exempt from regulation under the Commodity Exchange Act.[286] As to P&G's claim of breach of fiduciary duty, the court applied New York law:

> New York law is clear that a fiduciary relationship exists from the assumption of control and responsibility and is founded upon trust reposed by one party in the integrity and fidelity of another. No fiduciary relationship exists . . . [where] the two parties were acting and contracting at arm's length. Moreover, courts have rejected the proposition that a fiduciary relationship can arise between parties to a business relationship.[287]

The court concluded that the relationship between the parties was not of a fiduciary nature: "P&G and BT were in a business relationship. They were counterparties. Even though . . . BT had superior knowledge in the swaps transactions, that does not convert their business relationship into one in which fiduciary duties are imposed."[288]

In these three decisions—*Morgan Stanley*, *Banca Cremi*, and *Proctor & Gamble*—the courts regarded the relationship between the broker and its institutional customer as a "business relationship" rather than a fiduciary relationship, because the broker-dealer dealt

285. The complaint alleged fraud, misrepresentation, breach of fiduciary duty, negligent misrepresentation, negligence, and violations of the federal securities and commodity statutes, the Ohio blue sky laws, and the Ohio Deceptive Trade Practices Act. *Id.* at 1274.

286. *Id.* at 1283–85.

287. *Id.* at 1289 (quoting Beneficial Commerce Corp. v. Murray Glick Datsun, Inc., 601 F. Supp. 770, 772 (S.D.N.Y. 1985)).

288. *Id.* at 1289. The court nevertheless held that, even in the absence of a fiduciary duty, under New York law a party may be under an implied contractual duty to make disclosures to the other party. "Such a duty may arise where (1) a party has superior knowledge of certain information; (2) that information is not readily available to the other party; and (3) the first party knows that the second party is acting on the basis of mistaken knowledge." *Id.* at 1290. Thus, Bankers Trust had a duty to disclose material information to P & G both before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions. Since the claim was one of fraud (i.e., failure to disclose material information), the plaintiff had to prove its case by clear and convincing evidence, not mere preponderance of the evidence. Furthermore, the plaintiff had no claim for negligent misrepresentation in the absence of a "special relationship" between the parties. Since the parties were both sophisticated corporations whose dealings were on a business level, there was no special relationship between them. *Id.* at 1289–91.

with its institutional customer as a principal, not as an agent.[289] These courts do not explain what they mean by the term "business relationship" or why one party to a business relationship cannot also owe fiduciary duties to the other party.

Courts have repeatedly held, however, that a broker-dealer can have a fiduciary relationship with an institutional customer, if the customer reposes trust and confidence in the broker-dealer, and if the transaction that is the subject of the dispute is relevant to the matters entrusted to the broker.[290] It is true that the existence of a fiduciary relationship (as opposed to an ordinary business relationship) is derived from agency law, and that a broker-dealer who sells a security to a customer as principal is not acting as in the capacity of an agent.[291] Nevertheless, the federal courts have long held that the capacity in which a broker-dealer acts is not determinative of whether or not a fiduciary relationship exists. In the recent case of *Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*,[292] the district court rejected the broker-dealer's argument that a broker-dealer who acted as principal in transactions with its institutional customer could not, as a matter of law, have a fiduciary relationship with the customer. The court stated:

> At base, the existence of a fiduciary relationship is a factual question. It "cannot be determined 'by recourse to rigid formulas;' rather, 'New York courts typically focus on whether one person has

289. *See, e.g.*, Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1030 (4th Cir. 1997); *Procter & Gamble*, 925 F. Supp. at 1289–90; State v. Morgan Stanley, 459 S.E.2d 906 (W. Va. 1995).

290. *See* Press v. Chem. Inv. Serv. Corp., 166 F.3d 529, 536 (2d Cir. 1999); Union Bank of Switzerland v. HS Equities, Inc., 457 F. Supp. 515 (S.D.N.Y. 1978) (Weinfeld, J.) (finding that broker owed a fiduciary duty to large Swiss bank to keep the bank fully informed as to material matters that could affect the bank's judgment with respect to transactions which were the subject of its account); Memphis Hous. Auth. v. Paine, Webber, Jackson & Curtis, Inc., 639 F. Supp. 108 (W.D. Tenn. 1986).

291. Professor Gibson states:

> As a principal to the transaction, the derivatives dealer assumes the risks associated with the trade, just as the end-user assumes the attendant risks. Further, in derivatives transactions, the dealer and end-user are both referred to as counter-parties, a title which suggests that both parties are at counter-positions, transacting business at arm's length.

Gibson, *supra* note 20, at 572. However, neither the fact that the dealer may assume certain risks nor the title by which the parties are known negates the possibility that there is a fiduciary relationship between the parties.

292. No. 94 Civ. 8301 JFK, 2000 WL 1702039 (S.D.N.Y. Nov. 13, 2000).

> reposed trust or confidence in another who thereby gains a resulting superiority or influence over the first."
>
> Courts in this District have found that a fiduciary relationship could potentially arise in a "principal-to-principal" arm's-length relationship based upon the degree of trust that exists in that relationship.[293]

Although broker-dealers usually act in the capacity of agent when they execute transactions for customers in listed securities on stock exchanges, they frequently act as principals in transactions in the over-the-counter market.[294] The over-the-counter market is considered a dealer market, in which broker-dealer firms frequently sell securities to customers out of their own inventory.[295] Even when a broker-dealer does not have an inventory in a security that it is selling to a customer, it nevertheless may choose to act as a principal, rather than as agent, by buying the security from another broker-dealer acting as a market maker in the security and then reselling it to the customer as principal.[296] An "integrated" firm, which acts both as a wholesale market maker and as a retail broker in a particular security, will normally deal as principal with both its individual and institutional customers. Furthermore, a broker-dealer that sells

293. *Id.* at *26–*27 (quoting Scott v. Dime Sav. Bank, 886 F. Supp. 1073, 1078 (S.D.N.Y. 1995), *aff'd*, 101 F.3d 107 (2d Cir. 1996)).

294. As two experts explained:

> Over-the-counter trades are most commonly transacted on a *net price* basis. (That, again, is because your "broker" acts as a dealer or principal, not an agent.) You do not pay a commission; instead the securities dealer builds a profit margin or *markup* into the price you're asked to pay. Similarly, when you sell, the dealer buys from you at a price that subtracts a *markdown* from the market's current wholesale or *inside price*.

LOUIS ENGEL & HENRY HECHT, HOW TO BUY STOCKS 130 (8th ed. 1994).

A study done by the SEC in the 1960s showed that 62.5 percent of all over-the-counter purchases by institutional customers and 35.8 percent of all purchases by individual customers were principal transactions. SEC SPECIAL STUDY, *supra* note 140, pt. II, at 612. The over-the-counter market is any market in which securities transactions are conducted through a telephone and computer network, rather than on the floor of a stock exchange. DOWNES & GOODMAN, *supra* note 32, at 427.

295. Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 894 (1981).

296. *Id.* This type of transaction is called a "riskless transaction," because the broker does not take on the risks of ownership of the security, even though he deals as a principal, not as an agent, with the customer. SEC SPECIAL STUDY, *supra* note 140, pt. II, at 611; *see also* JOHN DALTON, HOW THE STOCK MARKET WORKS 87, 175 (1988).

to a customer an OTC derivative instrument that it has itself created is most likely to do so in a principal transaction, since it automatically owns the security that it has created. In over-the-counter transactions, the broker-dealer may choose to execute transactions with its customer in a principal capacity, regardless of whether the customer has reposed trust or confidence in the broker-dealer and whether the broker-dealer has accepted or encouraged such trust or confidence.

Given the fact that a broker-dealer is usually able to decide unilaterally whether it will deal with its customers as agent or as principal, it would be anomalous if the broker were allowed to avoid fiduciary obligations simply by choosing to act as principal. This has been the view of the courts. For example, in a recent case, the Third Circuit held that a broker-dealer has a duty to execute customers' transactions at the best available price, whether it is acting as principal or agent.[297] And one district court has stated:

> [T]he choice of function . . . cannot be (and was never intended to be) a means by which a broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction. . . . What is decisive in the end is that the facts of the case disclose an "agency" relationship in the most basic and unmistakable sense of both the common law and securities law.[298]

The duties that a broker owes its customer should not depend on the broker-dealer's choice of capacity, but rather on the usual factors that determine whether a fiduciary relationship exists, particularly the trust and confidence placed in the broker by the customer, the dependence of the customer on the broker's skill and knowledge, the equality or inequality of access to information, and the complexity of the security being sold.[299]

297. Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 n.1 (3d Cir. 1998) (en banc), *cert. denied sub nom.* Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Kravitz, 525 U.S. 811 (1998).

298. Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 675 (S.D.N.Y. 1966); *see also* Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949) (holding that broker-dealer that is also an investment advisor with respect to transactions in which it acts as principal cannot deny its fiduciary status).

299. *See* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1226–1228 (1995); DeMott, *supra* note 244, at 882.

IV. CONCLUSION

An institutional investor that institutes a lawsuit or an arbitration against a brokerage firm to recover losses suffered as a result of an unsuitable recommendation must overcome great difficulties under existing legal decisions. These difficulties stem from the largely unexamined premise that every institution is a sophisticated investor and able to fend for itself, even against a skillful securities salesperson who misrepresents or fails to disclose the risk of a security. As a result, there are few cases where an institutional investor has been successful in asserting a suitability claim. An action based on common law breach of fiduciary duty is likely to fail on the ground that no fiduciary relationship exists between the broker and the institution. A suitability claim based on securities fraud is likely to fail on one of two grounds: either that the institution did not justifiably rely on the broker's misrepresentations or omissions (or, in some circuits, did not exercise due diligence), or that the broker, even if it engaged in deceptive conduct, is not liable because it did not control the institution's account.

The assumption that the financial officers of institutional investors are always sophisticated is a mistaken one. The officers of many institutions lack sophistication, at least when it comes to complex derivative securities. Skillful and unscrupulous salespeople can manipulate even sophisticated financial officers. Furthermore, even where an institution's financial officer makes investments despite awareness that the securities recommended to him by a broker-dealer are unsuitable for the institution, the broker-dealer has an obligation to its institutional customer under professional securities industry standards not to recommend unsuitable securities. A broker-dealer is also obliged to take affirmative steps to learn the legal limitations on the institution's permissible investments and its investment objectives, as reflected in its formal investment policies.

Under traditional principles of securities law, a broker who intentionally or recklessly makes an unsuitable recommendation to an institutional investor should be liable to the institution for any losses that the institution incurs if the institution can show that the recommendation was a contributory cause of its losses. A broker who recommends a security without taking reasonable steps to learn the investment objectives and risk tolerance (as established by its governing board within the framework of applicable law) of his institutional customer can be deemed to be acting recklessly. Such due diligence would include a discussion of the institution's investment objectives and risk tolerance with the institution's investment officer. It would normally also include a review of any written investment policy of the institution, the institution's governing instrument, and any applicable legal restrictions on investments. Imposing these duties would not shift to the broker the responsibility for institutional investments that go wrong or make the broker a guarantor of the success of the institution's investments.[300] It would simply make a broker-dealer, as a trained professional in the securities industry, responsible for making affirmative recommendations that it knows or ought to know are unsuitable for its institutional customers.

Placing the responsibility on the broker for the suitability of its recommendations would promote efficiency, fairness, and the honesty of the markets. The rule would be efficient because the broker-dealer is usually in a better position than the customer to learn the essential facts and degree of risk concerning a security that it is recommending, and can do so at a lower cost. In the case of over-the-counter derivative instruments, the broker-dealer may well have created the security that it is selling to the institution and, thus, is sure to be more familiar with it than is the customer. An institutional investor is unlikely to have access to all of the information relating to a security that a broker-dealer possesses. Although the institution is likely to be more familiar with its own risk preference than the broker would be, under well established securities industry standards, every brokerage firm has an obligation to take reasonable steps to know its customer. Nevertheless, it is extremely unlikely that a broker would be held liable for recommending a security which, after making a reasonable inquiry, it reasonably believed was suitable for its institutional customer.

A rule that imposes liability on the broker-dealer for unsuitable

300. This author is aware of, but disagrees with, the statement in a recent report of the New York City Bar Association that in the absence of a rule presuming institutional investors to be sophisticated, dealers would become guarantors of their institutional customers' investments. Bar of N.Y., *supra* note 83, at 96. Perhaps, as the report states, "it is easy (and tempting) to view any losing investment as, in hindsight, unsuitable." *Id.* Unsuitability, like any other legal concept, will sometimes be difficult to define and apply; however, as I argue in this article, that is not sufficient reason to create a presumption that institutional investors are sophisticated, and then to bar their claims on that basis. Further, most of the decisions rejecting liability do not do so on the ground that the recommendation was suitable for the institutional investor, but rather that the institution should bear the responsibility for its investment decisions.

recommendations to an institution would be a fair rule under most circumstances. A broker-dealer who intentionally or recklessly recommends unsuitable securities to a customer is more at fault than an institution's financial officer who fails to exercise sufficient diligence in managing the institution's investments, or than an institution that failed to hire a sufficiently sophisticated investment officer.[301]

A rule imposing liability on broker-dealers who recommend unsuitable securities to institutional investors also is consistent with public policy, principally because it would deter brokers from intentionally or recklessly recommending unsuitable securities. Although encouraging investors to exercise diligence also is an important public policy, in the area of institutional investment it is hardly necessary to limit brokers' liability in order to achieve that goal: institutional investors' financial officers are sufficiently deterred from negligent conduct and over-reliance on brokers' representations by the likely prospect of being demoted or losing their jobs, or even being criminally prosecuted, regardless of whether the institution is eventually able to recover its losses in a lawsuit or arbitration. Until the commission system of compensation that is used in the securities industry, a system which is the engine that drives high-pressure and dishonest selling, is reformed, the most effective way to deter broker-dealers and their employees from making unsuitable recommendations to institutional investors is the credible threat of a private lawsuit or arbitration.

301. *See supra* text accompanying notes 222–23 (discussing Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985)).