

You are a typical brokerage client headed into a typical brokerage firm.¹ You feel that you have a handle on stocks, but bonds strike you as more of a mystery.² You have heard that diversification would be wise, but you do not feel that you know how to go about creating a diversified portfolio.³ The brokerage firm assigns you to the stockbroker of the day.⁴ The broker shows you an investment profile questionnaire that asks you questions about your investment knowledge, investment experience, investment objectives, federal tax bracket,

¹ See National Association of Securities Dealers [NASD] Investor Information: The New Account Agreement (2006), <http://www.nasd.com> (follow “Investor Information” hyperlink; then follow “Investor Protection” hyperlink; then follow “Invest Wisely” hyperlink) (last visited April, 23, 2006) (describing the typical services of a full-service brokerage firm); cf. Peter M. Mundheim, *The Desirability of Punitive Damages in Securities Arbitration: Challenges Facing the Industry Regulators in the Wake of Mastrobuono*, 144 U. PA. L. REV. 197, 242 n.2 (1995) (describing the common brokerage relationship).

² The inverse relationship that bonds have with interest rates can be a mental hurdle for many clients. When interest rates rise, bonds decline in value. The reasoning behind this concept can be made fairly simple through an example. Imagine you purchase a bond paying 5% interest. Interest rates rise and now a bond of the same length and risk as your bond is paying 6%. An investor that comes onto the scene will obviously prefer the 6% bond. Thus, your 5% bond becomes worth less, if sold on the open market, to account for this fact. However, the interest rate movements will not affect the value of your principal if you hold the bond to maturity. If you do not sell your bond on the open market, then you are entitled to the principal and fixed interest rate from the borrower. See generally Vanguard: What the Past Teaches about Rising Rates and Bond Prices (June 9, 2004), https://flagship5.vanguard.com/VGApp/hnw/VanguardViewsArticle?ArticleJSP=/freshness/News_and_Views/news_ALL_risingrates_06092004_ALL.jsp.

³ See *Erlich v. First National Bank of Princeton*, 505 A.2d 220, 236 (N.J. Super. Ct. Law Div. 1984) (stating that the generally accepted industry practice incorporates the principle of diversification into investment recommendations).

⁴ See MSN Money (2005), <http://moneycentral.msn.com/content/P124475.asp> (last visited April, 23, 2006) (implying that walking into a brokerage firm unannounced will often cause you to meet with the inexperienced broker of the day); see also Certified Financial Planner Board of Standards, Inc. 5 (2006), <http://www.cfp.net/Upload/Publications/187.pdf> (noting that “stockbroker” and “registered representative” are synonymous and distinguishing these titles from that of “investment adviser”).

annual income, and liquid net worth.⁵ He suggests that in his experience, it would be valuable to discuss these topics in some depth rather than just have you check off the boxes.⁶ For instance, he notes that checking off “good” for investment experience does not tell him whether you have ever invested in bonds. You hope that the broker will know how to improve your financial situation, so you answer the broker’s questions in blind faith.

This type of common exchange between stockbroker and client often leads to the broker providing the client with specific investment recommendations.⁷ Unfortunately, those recommendations may fail to satisfactorily address the needs of the client, and thus subject the broker to a suitability claim under National

⁵ 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, 274 (1998) (suggesting brokerage firms utilize an investment questionnaire in part because it provides proof of a basis for the broker’s recommendations).

⁶ See NASD Obligations to Your Customer (2006), <http://www.nasd.com> (follow “Registration & Qualifications” hyperlink; then follow “Broker Guidance & Responsibility” hyperlink; then follow “Registered Representatives” hyperlink; then follow “Obligations To Your Customers” hyperlink) (last visited April, 23, 2006) (stating that a broker’s initial responsibilities consist of gaining a clear picture of his client’s financial situation and investment objectives).

⁷ A broker may also find it appropriate to refer the client to other experts, such as an estate attorney, for more specialized financial needs. An estate attorney will often utilize a living trust to help minimize a client’s estate taxes, avoid probate, and provide for a client’s unique estate needs. See Certified Financial Planner Board of Standards, Inc., *supra* note 4, at 3-4 (implying that ethical financial professionals refer clients to estate attorneys when appropriate to perform services such as wills, trusts and powers of attorney). Some brokerage firms offer a designated beneficiary account that can serve to avoid probate, but it will not solve a client’s complex estate planning needs. See [schwab.com](http://www.schwab.com): Designated Beneficiary Plan Application, http://www.schwab.com/cms/P-239303.0/des_ben_plan.pdf?cmsid=P-239303&refid=P-1013592&refpid=P-999739 (last visited April, 23, 2006). See generally Gary C. Randall, *Estate Planning and Community Property*, 28 IDAHO L. REV. 807 (1992). The broker may also refer clients to accountants or insurance agents. See Certified Financial Planner Board of Standards, Inc., *supra* note 4, at 3-4.

Association of Securities Dealers [NASD] Rule 2310.⁸ “Suitability” refers to a broker’s obligation to have reasonable grounds, based on the client’s financial situation, for believing recommendations he makes to the client are appropriate.⁹ The suitability test does not hinge on whether the client requests or consents to the recommendations.¹⁰ Instead, the test centers around whether the stockbroker meets

⁸ NASD Rule 2310 (2006), *available at* <http://nasd.complinet.com/nasd/display/index.html> (follow “Conduct Rules” hyperlink; then follow “2300 Transactions with Customers” hyperlink; then follow “2310 Recommendations to Customers (Suitability)” hyperlink) (last visited April 23, 2006). This rule explains the requirements for the suitability of client recommendations:

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

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

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

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

Id.

⁹ *Id.*; see also NASD Investor Information: Common Investor Problems and How to Avoid Them (2006), <http://www.nasd.com> (follow “Investor Information” hyperlink; then follow “Investor Protection” hyperlink; then follow “Investors’ Best Practices” hyperlink) (last visited April 23, 2006) (noting suitability as one of the four most frequently reported claims).

¹⁰ Nancy E. Reich, *Proof of Unsuitable and Unauthorized Trading by Securities Brokers*, 28 AM. JUR. POF. 3D 87 § 7 (2005).

his fiduciary duty to provide recommendations that are in the best interests of the client, even if those recommendations oppose the client's wishes.¹¹

Suitability claims represent the most common claim among securities laws and perhaps the most difficult claim for arbitrators¹² to get their arms around.¹³ In particular, the challenge for arbitrators and lawyers in accurately assessing suitability is to overlook the common misperception among investors that financial loss represents the best indicator of whether a broker made unsuitable recommendations.¹⁴ In making recommendations, the stockbroker actually has to balance two competing risks: the downside risk of losing capital and the "risk" of

¹¹ See John M. Reynolds, 50 S.E.C. Docket 504 (1991) (finding speculative investments were unsuitable in this case and noting that "a broker is charged with making recommendations in the best interests of his customer even when such recommendations contradict the customer's wishes").

¹² The majority of suitability cases today are heard in arbitration. See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987) (noting courts have a duty to enforce arbitration claims due to favored policy); see also NASD Arbitration & Mediation: Dispute Resolution Statistics (2006), <http://www.nasd.com> (follow "Arbitration & Mediation" hyperlink; then follow "NASD Dispute Resolution" hyperlink; then follow "Statistics" hyperlink) (last visited April 23, 2006) (noting that there were 1,926 suitability cases in 2005). Unfortunately, a written rationale is not required for arbitrator's decisions causing there to be little evidence of arbitrators' reasoning in suitability cases. Lori J. Parker, *Stockbroker Liability Litigation*, 88 AM. JUR. TRIALS 1 § 40 (2005).

¹³ See Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999) (stating that the NASD revealed to its members in 1998 through an Avoidance and Prevention Advisory that suitability claims accounted for 95% of "filings under NASD members' errors and omissions insurance policies . . . [and that] . . . 'they are the most common yet most ambiguous of all client accusations'" (quoting Zarb Urges Broker Dealers to 'Be on Guard' About Suitability, 30 Sec. Reg. & L. Rep. (BNA) No. 22, at 810 (May 29, 1998))).

¹⁴ See *Implication of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission*, 1466 PLI/CORP 209, 266 (2004) (describing how registered investment companies, ironically, may be unsuccessful despite producing positive returns, and successful despite producing negative returns because the returns need to be compared to the overall performance of the market).

not meeting the investor's future goals such as retirement. Growth investments add value by diminishing the second "risk,"¹⁵ but in the past only the first risk has typically been addressed in suitability claims.¹⁶ Because growth investments tend to increase the first risk, fully understanding how growth investments should factor in to the suitability test presents a major hurdle for the legal community.¹⁷ The effect of this lack of understanding is inevitably a reoccurring misapplication of liability and damages in suitability cases.

A broker's liability cannot be understood without appreciating that truly suitable recommendations may consist of more aggressive investments than the client initially desires.¹⁸ An increased awareness in legal circles of the value of aggressive investments is necessary and should have two divergent effects on broker liability. On one hand, a broker who recommends growth investments should find his potential liability has decreased because the legal profession no longer solely focuses on financial loss.¹⁹ On the other hand, a broker who invests

¹⁵ See Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 460 (2004) (suggesting that maintaining a more conservative strategy diminishes an investor's long-term rate of return).

¹⁶ See Tracy A. Miner, *Measuring Damages in Suitability and Churning Actions Under Rule 10b-5*, 25 B.C. L. REV. 839, 840 (1984) (suggesting the standard model for assessing damages under a 10b-5 claim compensated for actual losses sustained because of the fraud).

¹⁷ See Richard W. Nenno, *Planning with Total-Return Trust Statutes*, SK069 ALI-ABA 223, 230 (2005) (stating that despite some declines, equity investments "still offer the best long-term growth prospects").

¹⁸ See Reynolds, *supra* note 11 and accompanying text.

¹⁹ See Miner, *supra* note 16 and accompanying text. See generally NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12 (noting that of the 1,610 arbitration cases

conservatively should discover his liability has potentially increased because his recommendations may not be in the client's best interest.²⁰ The value of both of these effects is that it causes brokers to have a substantially greater incentive to invest aggressively enough to help millions of Americans come closer to their goal of retirement.²¹ To coincide with this suggested new understanding of broker liability, the standard for assessing damages must also adjust. Financial loss should not be the true test for damages.²² The test should focus on the deviation in performance between the unsuitable portfolio and a properly managed portfolio, regardless of whether the client's account increased or decreased in value. Because growth investments tend to increase the risk of financial loss, the recommended change of removing loss from the damages equation would again increase brokers' incentive to recommend growth investments and help clients retire.

Part I of this Comment explains the history of the suitability claim including the relevance of the shift from the federal courts to the arbitration tribunals. Part II

ultimately decided by arbitrators in 2005, clients won monetary damages or non-monetary relief 43% of the time).

²⁰ See Reynolds, *supra* note 11 and accompanying text. See generally NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12; *supra* text accompanying note 19.

²¹ See Arthur Levitt, Former Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Public Pension Investment Policy Conference: The SEC Today: An Accent on Individual Investors (Mar. 20, 1996), available at <http://www.sec.gov/news/speech/speecharchive/1996/spch090.txt> (noting the lack of savings by Americans and suggesting that the actual savings may be invested too conservatively).

²² See Miner, *supra* note 16 and accompanying text.

describes the meaning of growth investments and argues they should have a more prominent role in the suitability test. This section also suggests the universal goal of retirement frequently causes aggressive growth investments to be in clients' best interest. Part III argues the current definition of suitability is inadequate because it fails to provide arbitrators and securities lawyers with an understanding of how stockbrokers consider growth when making a recommendation.²³ Part III then goes on to depict the best and worst practices for utilizing growth in investment recommendations. Part IV demonstrates how the speed of arbitration and mediation increase the need to diminish the ambiguity of the suitability test. Part V recommends a simple solution: expand the definition of the current rule and increase education for arbitrators. This section suggests the solution will properly put growth investments and clients' retirement needs at the forefront in arbitration. Part VI provides real life examples to further demonstrate the problem, apply the solution, and provide insight into concurrent claims that often complicate the basic suitability claim. Finally, Part VII argues that damages are currently misdiagnosed because of a lack of focus on the role of growth investments. Part VII suggests the proper method for assessing damages would ignore whether the client's portfolio increased or decreased in value and focus solely on the portfolio's deviation in performance from a suitable portfolio.

²³ NASD Rule 2310, *supra* note 8.

I. BACKGROUND

Traditionally, NASD Rule 2310 served as merely a starting point for suitability claims. Case law made clear that it would take more than violating the NASD's suitability requirements for a client to have a valid legal claim against a stockbroker.²⁴ To have a valid legal claim, a client typically had to add a claim under Rule 10b-5 of the Securities Exchange Act of 1934.²⁵ Rule 10b-5 compensated clients who had been defrauded through a broker's untrue statement or omission of a material fact.²⁶ Thus, clients not only had to prove their broker's recommendations were unsuitable, but also that they had been defrauded by their broker.²⁷ However, that changed in 1987 when the forum for suitability claims underwent a major shift from the federal court system to the arbitration tribunals.²⁸ As a result of this change, the additional Rule 10b-5 requirement has essentially disappeared.²⁹

²⁴ Carroll v. Bear, Stearns & Co., 416 F. Supp. 998 (S.D.N.Y. 1976).

²⁵ 17 C.F.R. § 240.10b-5 (2004); *see also* Brown v. E. F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993).

²⁶ Parsons v. Hornblower & Weeks-Hemphill, Noyes, 447 F. Supp. 482 (M.D.N.C. 1977).

²⁷ *Id.*

²⁸ *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987) (noting courts have a duty to enforce arbitration claims due to favored policy).

²⁹ *See* Lowenfels & Bromberg, *supra* note 12, at 1584-85 (arguing that the shift to hearing suitability cases in arbitration has brought on "a shift in the legal elements that must be proven to establish a suitability violation, from fraud under Exchange Act section 10(b) and Rule 10b-5 which requires scienter (or at a minimum recklessness) to a nebulous quasi-legal, quasi-ethical test for breaches of standards of duty and care under SRO rules [NASD Rule 2310] which does not require scienter or recklessness"); *see also* Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1272 (1995) (noting that bringing claims that invoke the

Ironically, this easier standard for clients has been initiated by brokerage companies through mandatory arbitration clauses in brokerage account agreements.³⁰ Undoubtedly, the brokerage companies are enticed by the minimal expense and time of an arbitration proceeding,³¹ but it comes with the price of facing an arbitration panel that enforce the NASD Rule 2310 suitability standard without any need for the client to prove fraud.³²

Arbitration has provided an efficient alternative to the federal courts and has sped up the process of resolving suitability claims.³³ However, the advantages of arbitration come with consequences as well. To maintain an expedient process,

antifraud provisions may have become obsolete because in arbitration “just and equitable principles of trade can be the basis for recovery”).

³⁰ See Richard A. Levan, National Regulatory Services 2nd Annual Conference on Suitability For Traditional and Online Brokers: The Arbitration Litigation Landscape- Trends, http://www.rlevan.com/about/nrs/nrs-10_01.htm (Oct. 4-5, 2001) (stating that many people view arbitration under NASD rules as more client friendly than federal court). Sometimes, brokerage firms do not require a client opening a cash account to sign an account agreement. In these cases, the client will not have agreed to the mandatory arbitration provision within the agreement. As a result, any ensuing suitability claim will end up in federal court: making the federal antifraud provisions still relevant. However, this is the exception to the rule; most clients are required to sign the account agreement. Thomas J. McCool, *Securities Arbitration- Action Needed to Address Problem of Unpaid Awards*, GAO/GGD 00-115 ¶ 80 (June 15, 2000). This Comment focuses on arbitration cases because they make up the majority of suitability cases today. See *id.*; see also [schwab.com](http://www.schwab.com/): Investment Account Application 9, <http://www.schwab.com/> (follow “Account Types” hyperlink; then follow “Schwab One Individual Account Download” hyperlink; then follow “Schwab One Account Application” hyperlink) (last visited April 23, 2006) (providing required arbitration disclosures in bold in section 15 of the account agreement).

³¹ See NASD Arbitration & Mediation (2006), <http://www.nasd.com> (follow “Arbitration & Mediation” hyperlink; then follow “Start an Arbitration or Mediation” hyperlink; then follow “Comparison Guide to Electing Mediation or Arbitration” hyperlink) (last visited April 23, 2006) (stating that arbitration is faster and less expensive than litigation).

³² Lowenfels & Bromberg, *supra* note 12, at 1584-85; see also Reich, *supra* note 10 at § 3.

³³ See NASD Arbitration & Mediation, *supra* note 31 and accompanying text.

discovery is limited,³⁴ a written rationale for the decision is not required,³⁵ and oftentimes little information about an expert's credentials is disclosed.³⁶ Because suitability claims regularly endure the shortcuts of arbitration, it is important to ensure that arbitrators have a clear understanding of the intricacies of the suitability claim. In particular, the role of growth investments must be better understood because a stockbroker recommending growth investments increases his chance of subjecting himself to a suitability claim, and yet growth investments have the unique power to put millions of Americans in a better position to retire.

II. THE IMPORTANCE OF GROWTH INVESTMENTS

A. Growth Hides in the Shadows of Risk in Arbitration

The term “growth” represents a specific investment objective listed as one of the choices on a typical brokerage questionnaire.³⁷ A client checking the box for growth on the questionnaire signals to a stockbroker that the client desires to utilize equity (stock) investments in order to achieve higher returns, and further that the

³⁴ See C. Thomas Mason III, *Challenging Experts in Securities Arbitration*, 1196 PLI/CORP 725, 743 (2000).

³⁵ Parker, *supra* note 12.

³⁶ See Mason, *supra* note 34.

³⁷ See Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 588 n.157 (2005) (noting that Charles Schwab & Co., the largest discount brokerage company, lists capital preservation, income, growth, and speculation as the investment objective choices on the account application); see also George V. Cornell, III, *Preparing Your Client for a Securities Arbitration Hearing*, 999 PLI/CORP 251, 255 (1997) (listing growth as a type of an investment objective discussed with one's broker); Rapp, *supra* note 5 and accompanying text.

client will accept the inevitable risk associated with such equity investments.³⁸

Because the client may not recognize that he needs to take on risk to achieve important long-term goals such as retirement,³⁹ the prudent broker may need to direct the client along a more aggressive path than the client initially considered.⁴⁰

The problem is that lawyers⁴¹ and Self-Regulatory Organizations [SROs] such as the NASD⁴² fail to sufficiently support the prudent broker in this “push” to help clients achieve their long-term dreams. In fact, the legal community emphasizes the reverse in assessing suitability and asks whether the broker took on too much capital risk, rather than whether the broker took too little risk to achieve

³⁸ See Nenno, *supra* note 17 and accompanying text.

³⁹ See Bernard Blum, Hearing on SEC Independence Rule Proposal: Outline of Testimony- Retirement and Pension Planning (Sept. 13, 2000), *available at* <http://www.sec.gov/rules/proposed/s71300/testimony/blum1.htm> (noting that retirement planning complete with investment recommendations is one of the most widely offered services amongst financial planners).

⁴⁰ The “more aggressive path” refers to a path of growth investments. Growth differs from speculation. Speculation represents another one of the investment objectives typically listed on an investment questionnaire and is the box that a client should select if they intend to “gamble” in the market. See Reynolds, *supra* note 11 and accompanying text; *cf.* Randall H. Borkus, *A Trust Fiduciary’s Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques*, 36 REALPTJ 127, 142 (2001) (describing how the fiduciary of a trust may breach his duty to future interested parties when utilizing a conservative investment strategy that maximizes current income, yet fails to achieve sufficient growth).

⁴¹ See Securities Arbitration Commentator: Information for Investors, <http://www.sacarbitration.com/framecomm.htm> (last visited April 23, 2006) (stating that due to the fact that securities arbitration requires highly specialized lawyers, there “are relatively few truly qualified advocates in this field”).

⁴² See NASD: Dispute Resolution Offers Alternative to Courts 10 (2005), http://www.nasd.com/web/groups/inv_info/documents/investor_information/nasdw_011944.pdf (noting that the NASD handles close to 90% of all securities arbitration cases involving clients of brokerage firms).

the client's needs.⁴³ Due to the lack of emphasis on risk-taking as a positive and worthy objective in the case of growth, the most important question gets lost in the shuffle: Did the broker have "reasonable grounds"⁴⁴ to take on risk so that he could achieve growth for his client?⁴⁵

The undeserved focus on financial loss in assessing suitability makes the need for growth seem subservient to the need to manage risk.⁴⁶ The public and the brokerage industry would be better served if arbitrators and lawyers fully understood that a prudent stockbroker must reflect on a client's need for growth as well as a client's desire to minimize risk in the portfolio.⁴⁷ Lawyers advocating on behalf of a brokerage firm should be prepared to inform the arbitrators of the depth of these competing interests and persuade the arbitrators that the degree of risk taken was prudent.

The majority of suitability cases focus on the client's financial loss,⁴⁸ yet sometimes a stockbroker's recommendations may negatively affect the client's

⁴³ See Howard R. Elisofon & David M. Elkins, *Evaluation of Arbitration Cases*, 899 PLI/CORP 27, 37 (1995) (positioning the suitability of growth investments as a question of whether the client knew of their inherent risk, rather than asking whether growth investments were necessary to meet the client's stated investment objectives).

⁴⁴ See NASD Rule 2310, *supra* note 8 (defining suitability as a broker's obligation to have reasonable grounds, based on the client's financial situation, for any recommendations made to a client).

⁴⁵ Cf. Elisofon & Elkins, *supra* note 43 and accompanying text.

⁴⁶ Arbitrators generally rely upon the client's actual financial loss to determine damages. Elisofon & Elkins, *supra* note 43, at 34.

⁴⁷ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 652 n.65 (1985) (implying that a suitable portfolio may experience volatility).

⁴⁸ Elisofon & Elkins, *supra* note 43, at 34; see also *supra* text accompanying note 46.

potential for appreciation.⁴⁹ Under these circumstances, the broker may not have had reasonable grounds for believing the investments were suitable if the client had a need for growth to meet his future goals.⁵⁰ Lawyers representing clients should consider initiating more cases in these instances. For this strategy to be effective, arbitrators must not only consider the devastating impact of financial loss but also the long-term effects of lost profits in assessing suitability.⁵¹ The definition of suitability should incorporate the notion that stockbrokers have an obligation to prevent a client's portfolio from being too conservative as well as from being too aggressive.⁵²

B. Hypothetical Brokerage Case

To provide a look into how these competing interests play out in reality, let us return to our hypothetical. The investment discussion begins with you expressing uncertainty to the broker of how to invest a \$50,000 bonus check that you just received. You ask whether he has any suggestions. He responds that it depends on the current mixture of your portfolio, your investment goals, and your

⁴⁹ See, e.g., Borkus, *supra* note 40 and accompanying text.

⁵⁰ See NASD Rule 2310, *supra* note 8; see also *supra* text accompanying note 44.

⁵¹ See Miner, *supra* note 16, at 862 (arguing that policy mandates that loss of market appreciation be included in damages).

⁵² See NASD Rule 2310, *supra* note 8 (requiring that a broker's recommendations be reasonable with respect to the client's financial needs but omitting any reference to the types of needs a broker must consider).

risk tolerance.⁵³ You discuss the questions from the investment questionnaire.

Over the course of the conversation, you reveal that you have \$100,000 in balanced mutual funds at XYZ Brokerage Company.⁵⁴ In addition, you suggest to the broker that you have fifteen years until retirement and your income should allow you to not touch your investments until retirement. Finally, you state that your goal in investing is to make some money.

The broker decides he has enough information to make recommendations. He suggests all aggressive growth mutual funds for your bonus check and recommends you consolidate your XYZ account⁵⁵ so he can also begin to move your balanced investments into aggressive growth mutual funds.⁵⁶ You follow all of his advice, but five years later when you look at your statement for the first time, you realize that you have lost money. You decide to meet with a lawyer and

⁵³ See NASD Prohibited Conduct, <http://www.nasd.com> (follow “Investor Information” hyperlink; then follow “Investor Protection” hyperlink; then follow “Prohibited Conduct” hyperlink) (last visited April 23, 2006) (implicating that suitability depends on the client’s specific financial circumstances).

⁵⁴ See Amy R. Doberman, *Investment Company Names: Rule 35D-1 and Truth in Labeling*, 1250 PLI/CORP 771, 780-81 (2001) (describing the requirements to be labeled a balanced mutual fund).

⁵⁵ One of a broker’s highest sales priorities is to convince a client to consolidate his outside assets to the broker’s firm. Telephone Interview with John D. Keller, former Senior Vice President, UBS, & former Branch Manager, Merrill Lynch (April 5, 2006). The broker then hopes to earn money off of the consolidated investments. The advantages to consolidation include fewer statements, less tax paperwork, and the potential for more premium services. The disadvantages consist of no longer having access to the previous firm’s proprietary products, investment research, and customized advice. *Id.*

⁵⁶ Compare Richard W. Nenko, *Planning With Dynasty Trusts*, SG041 ALI-ABA 1597, 1672 (2001) (laying out a typical approach for aggressive growth with 95% equities and calling it “maximum appreciation”), *with id.* at 1674 (describing a common balanced investment approach with 50% bonds and 50% equities and describing it as “moderate growth”).

question whether you have a cause of action against the broker for unsuitable recommendations.

In our hypothetical, you clearly appear to have a winning argument that the investment recommendations were legally unsuitable. The facts seem fairly straightforward that the broker was at fault for your financial loss. First, a client with average investment experience and average investment knowledge trusted his broker to provide him with appropriate recommendations. Next, the broker made recommendations that increased the risk of the portfolio. Finally, the broker's recommendations caused the client to lose money after five years. However, the presumption that a broker has made unsuitable recommendations if he causes financial loss for a client is fundamentally flawed.⁵⁷

This hypothetical demonstrates the common considerations a stockbroker has to ponder in order to make suitable recommendations. First, the client has some experience in mutual funds,⁵⁸ but he has little understanding of how the

⁵⁷ See *Implication of the Growth of Hedge Funds: Staff Report to the United States Securities and Exchange Commission*, *supra* note 14 and accompanying text.

⁵⁸ An investor with limited experience in mutual funds should at least learn the difference between no-load and load mutual funds. Load mutual funds charge an additional commission on top of any standard charges that may be associated with no-load mutual funds. See Investopedia.com, <http://www.investopedia.com/terms/n/no-loadfund.asp> (last visited April 23, 2006) (noting that studies fail to show that load mutual funds outperform their counterparts, which suggests that no-load mutual funds usually give you more for your money); see also J. Julie Jason, *Mutual Fund Share Classes: Uses and Abuses*, 1327 PLI/CORP 27 (2002) (providing an excellent explanation of the complexity of mutual fund fees and distinguishing Class A, Class B, and Class C mutual fund shares).

bonds in his balanced mutual funds serve to mitigate the overall risk.⁵⁹ Second, despite the client's limited knowledge on the impact of bonds, the client has a fair amount of time and income to sustain more risk in his portfolio.⁶⁰ Third, the client may have tax considerations for the sale of his portfolio,⁶¹ but it may still be in his best interest to accept the tax consequences in order to generate more growth in his portfolio.⁶² Fourth, the client has stated an investment objective of retirement, and thus the broker's recommendations will need to help the client achieve this goal. Finally, in this example, the broker will likely have a fiduciary responsibility to monitor the investments on an ongoing basis,⁶³ and therefore the broker needs to continue to review the portfolio to ensure the initial recommendations have remained suitable.

C. The Supervisor's Obligations for Ensuring Suitability

The supervisor of the brokerage firm also has legal responsibilities to review the broker's recommendations for suitability.⁶⁴ The supervisor is at the

⁵⁹ See Richard L. Sandow, *Risk Analysis in Suitability Cases*, 1440 PLI/CORP 679, 691 (2004) (noting that the interplay between different asset classes can mitigate the overall risk of the investor's portfolio).

⁶⁰ See *Now That The §404(c) Regulations Are Final, Who Cares?*, 1 No. 11 ERISALR 15, 21 (1992) (noting that stocks outperform other investments over time).

⁶¹ See Internal Revenue Service, available at <http://www.irs.gov/faqs/faq10-3.html> (last visited April 23, 2006) (describing how to calculate capital gains when selling a mutual fund).

⁶² See Zelinsky, *supra* note 15 and accompanying text.

⁶³ See *Penato v. George*, 383 N.Y.S.2d 900, 904 (N.Y. App. Div. 1976) (stating that a fiduciary relationship involves a breach of trust or confidence, but its scope cannot easily be defined).

⁶⁴ See NASD Rule 3010(d)(1) (2006), available at <http://nasd.complinet.com/nasd/display/index.html> (follow "Conduct Rules" hyperlink; then follow "3010 Supervision" hyperlink) (noting that a written, internal record should be

disadvantage of not being privy to the conversations between the broker and client. Thus, the supervisor will look for recommendations that seem to fall within the acceptable range of investments given the categories checked by the client on the questionnaire.⁶⁵ If the investments do not seem to fall within the acceptable range, then the supervisor will usually ask the broker for further information to explain the discrepancies between the recommended portfolio and generally acceptable advice given the client's circumstances.⁶⁶ In the above hypothetical, the client suggested he was looking for growth. In many cases, a growth objective would be sufficient for a supervisor to consider the recommendations of aggressive growth mutual funds as suitable.⁶⁷ It would not necessitate further inquiry by the

maintained that documents the reasonable supervisory review of all transactions by the members' registered representatives); *see also* New York Stock Exchange [NYSE] Conduct Rules, Rule 405 (2006), *available at* http://rules.nyse.com/NYSE/NYSE_Rules/ (follow "General Rules" hyperlink; then follow "Operation of Member Organizations" hyperlink) (defining supervisors' obligation as "supervise diligently all accounts handled by registered representatives of the organization").

⁶⁵ The supervisor will also likely consider whether a general pattern exists amongst investment recommendations made by the broker and whether the particular broker requires closer scrutiny. *See* John H. Sturc & Jennifer J. Schulp, *Enforcement Actions Regarding Variable Products*, 884 PLI/COMM 353, 388 (2006) (describing a lack of supervision systems designed to assess patterns of the stockbrokers as a "weak practice" according to examiners).

⁶⁶ *But see Securities Law Developments: Enforcement Developments Recent Failure to Supervise Cases*, 1108 PLI/CORP 33, 41 (1999) (arguing that if the supervisor has reason to be suspicious, then he must investigate the matter extensively rather than solely rely on the broker's explanation).

⁶⁷ *See* Sturc & Schulp, *supra* note 65, at 388 (noting that "sound practices" include requiring stockbrokers to document every recommendation with a "suitability checklist that evidenced the suitability determination"). However, a supervisor may find other information that counteracts this conclusion such as notes by the broker that the client said he could not afford to lose more than 5% of his portfolio. *See id.* at 391-92 (implying that if there are any red flags with respect to the transaction, then the supervisor should look for objective information beyond what he is told by the stockbroker).

supervisor because the recommendations fall within the acceptable range of the growth investment objective.⁶⁸

D. Varying Examples of Growth

Growth symbolizes the client's acceptance of potentially negative returns in order to achieve higher performance.⁶⁹ Growth covers a wide array of portfolios. Consider two distinct portfolios that would both likely be considered growth portfolios: Portfolio A comprised solely of ten individual stocks and Portfolio B consisting of mutual funds with exposure to over 5,000 stocks and bonds. The risk and diversification levels of these two portfolios differ substantially, but both portfolios have the potential to outpace investments offering a fixed return,⁷⁰ such as Certificates of Deposit, Corporate & Municipal Bonds, and Treasuries.⁷¹

⁶⁸ The supervisor must also consider the suitability of the broker's recommendation to sell the balanced mutual funds. Sometimes, a client will be subject to a back-end load and/or redemption fee if a fund is sold earlier than a pre-determined period of time. A prudent supervisor will assess whether the sale will cause the client to experience excessive fees. Heidi Stam & Judith L. Gaines, *Disclosure of Mutual Fund Fees and Expenses*, 1112 PLI/CORP 237, 245 (1999).

⁶⁹ See NASD Invest Wisely: The Investment Decision, available at <http://www.nasd.com> (follow "Investor Information" hyperlink; then follow "Investor Protection" hyperlink; then follow "Invest Wisely" hyperlink) (last visited April 23, 2006) (noting that mutual funds may lose value and higher expected return means higher risk).

⁷⁰ Cf. Jeffrey N. Gordon, *Employees, Pensions, and the New Economic Order*, 97 COLUM. L. REV. 1519, 1521, 1540 (1997) (describing defined contribution plans as a form of pension plan in which employees are the beneficial owners and suggesting that most of the participants in these plans should seek to maximize growth given their long-term investment horizons, but noting that most plans fail to do so because they underweight equity and overweight fixed-income securities and thus invest too conservatively).

⁷¹ See BLACK'S LAW DICTIONARY 240 (8th ed. 2004) (defining a certificate of deposit as "a bank document showing the existence of a time deposit, usu. one that pays interest"); *id.* at 191 (defining a corporate bond as "an interest-bearing instrument containing a corporation's promise to pay a fixed sum of money at some future time"); *id.* at 192 (defining a municipal bond as "a bond issued by a nonfederal government or governmental unit, such as a state bond to finance

Portfolio A and Portfolio B also have the potential to under-perform these fixed instruments,⁷² even producing negative returns. Generally, negative returns operate as the catalyst to clients initiating suitability claims.⁷³

Despite the risks involved in stocks, stockbrokers and their supervisors generally have an understanding that growth may be the most suitable portfolio strategy for clients.⁷⁴ In fact, a client's best interest necessitates a broker sometimes recommend growth investments to a client who initially chooses a more conservative investment objective.⁷⁵ Clients often have a substantial need for growth in their portfolios to satisfy future needs⁷⁶ even if they do not desire the risk associated with stock investments.⁷⁷ For instance, even the most dedicated worker

local improvements"); *id.* at 1539-40 (defining both a treasury note and a treasury bond as a "debt security issued by the federal government . . . considered risk-free, but . . . [that usually pays] relatively little interest").

⁷² See Gordon, *supra* note 70, at 1541 (describing how equity investments may under-perform fixed income investments over a certain period of time).

⁷³ Elisofon & Elkins, *supra* note 43, at 34; see also *supra* text accompanying note 46.

⁷⁴ See A.A. Sommer, Jr., *Corporate Governance: The Search For Solutions*, U.S.F. L. REV. 695, 704-05 (1992) (noting that institutional investors had migrated portions of their portfolios into diversified stock investments, due to research showing that these investments have outperformed fixed income instruments over time).

⁷⁵ See Reynolds, *supra* note 11 and accompanying text.

⁷⁶ Retirement is not the only future need that clients should plan for years in advance. See, e.g., J. Timothy Philipps & Ed R. Haden, *It's Not Love, But It's Not Bad: A Response to Critics of Prepaid College Tuition Plans*, 26 U. RICH. L. REV. 281, 304 (1992) (pointing out the ongoing challenge for parents striving to afford their child's education because "[c]ollege costs have historically risen at a rate about two percent greater than the general inflation rate").

⁷⁷ Therefore, even in the case of a risk-averse investor, the prudent stockbroker has to consider that the client's best interest may be to invest for aggressive growth. See Reynolds, *supra* note 11 and accompanying text.

plans to retire when his health deteriorates.⁷⁸ Retirement planning stands out amongst future needs because of its universal nature. Unfortunately, statistics show that Americans as a whole are only saving one third to one half of what they will need for retirement.⁷⁹ The lack of adequate savings is a rampant problem in the United States.⁸⁰ The general rule is that you will spend approximately 70% of your pre-retirement income per retirement year.⁸¹ Clients seeking to sufficiently fund their retirement stand a much better chance of meeting their goal through growth investments than through more conservative strategies.⁸² Thus, insufficient retirement funding magnifies the need for brokers to adequately incorporate growth into investment recommendations.

E. The Potential Retiree

⁷⁸ See CAO Institute, <http://www.socialsecurity.org/quickfacts/> (last visited April 23, 2006) (stating that “[b]y 2030, there will be 70 million Americans of retirement age—twice as many as today”).

⁷⁹ Levitt, *supra* note 21 and accompanying text.

⁸⁰ Oren Bar-Gill, *Seduction By Plastic*, 98 NW. U. L. REV. 1373, 1375 (2004) (stating “[i]mperfect self-control . . . plagues consumption and savings decisions, accounting for the rampant problem of insufficient saving for retirement”); see also David Wallechinsky, *Is the American Dream Still Possible?*, PARADE, April 23, 2006, at 4, 4 (pointing out how “the savings rate for Americans is the lowest it has been in 73 years”); Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effect on Women, Minorities, and Lower-Income Workers*, 65 MO. L. REV. 341, 403 n.49 (2000) (noting that “according to a 1993 telephone survey by Merrill Lynch Consulting only 30% of women between the ages of 25 and 65 were saving for retirement compared with 47% of men of the same ages”).

⁸¹ Fidelity.com: How Much You May Need at Retirement, <http://www.mysavingsatwork.com/atwork/1081430099016/1084856446098/1107928850703/1108015368833.htm> (last visited April 23, 2006) (suggesting that financial experts estimate you may expect to spend an annual sum of between 60-80% of your pre-retirement income).

⁸² See Zelinsky, *supra* note 15 and accompanying text.

In our hypothetical, the client alluded to his plan to retire in fifteen years. Although the client mentioned his plan to retire in passing, it is unlikely that he is focused on his retirement planning fifteen years in advance.⁸³ Clients do not generally connect their current investment plan with such future goals and long-term needs; rather, they tend to over emphasize short-term performance.⁸⁴ In light of this fact, the broker needs to elicit the future needs of the client through effective questioning. Although the typical stockbroker should not be expected to provide a comprehensive financial plan,⁸⁵ he should consider the client's potential to retire with adequate financial resources before determining the client's appropriate risk/reward level and making recommendations.

⁸³ See Harvey Pitt, Former Chairman, U.S. Sec. & Exch. Comm'n, Written Testimony Concerning Accounting and Investor Protection Issues Raised by Enron and Other Public Companies (Mar. 21, 2002), *available at* <http://www.sec.gov/news/testimony/032102tshlp.htm> (suggesting that in recent years clients have tended to ignore the long-term prospects of investments, and instead expected short-term results).

⁸⁴ *Id.*

⁸⁵ See Certified Financial Planner Board of Standards, Inc., *supra* note 4, at 2-3 (describing how a financial “planner can look at all of your needs including budgeting and savings, taxes, investments, insurance and retirement planning” . . . and stating that “[t]his big picture approach to your financial goals may set the planner apart from other financial advisers”; *see also* U.S. Securities & Exchange Commission: Financial Planners (July 29, 2005), <http://www.sec.gov/answers/finplan.htm> (noting that with respect to financial planners, the services offered, education background of the planner, and compensation structure may all vary widely); Investment Advisers Act Release No. IA – 770, Fed. Sec. L. Rep. (CCH) ¶ 1 (Aug. 13, 1981) (discussing when financial planners are subject to the Investment Advisers Act of 1940). A financial plan usually represents an a la carte product that can be purchased separately. A stockbroker may utilize a financial plan to present a client with a comprehensive view of their financial picture. Certified Financial Planner Board of Standards, Inc., *supra* note 4 (p. 3). The broker may be qualified to deliver the financial plan himself, or he may refer the client to one of his colleagues that specializes in financial plans. *Id.* This in-depth product can complement investment management, but it is neither a substitute for ongoing advice nor a mandatory component of quality investment advisory services. *See id.*

Unfortunately, the typical broker does not have the expertise to weigh all the factors that go into retirement planning before he makes a recommendation.⁸⁶ For instance, whether the client has paid off his mortgage would be a detail best left to a financial planner.⁸⁷ On the other hand, the stockbroker may learn some basic information from the investment questionnaire and the client interaction to help him at least take the client's retirement goals into account. The acquired information should help provide the broker with a general sense of whether the client is on the path to adequately retire. In turn, the broker can approximate the level of growth that will be necessary in the portfolio, and he can use that information to generate appropriate recommendations.

In our hypothetical, the broker learned that you have \$100,000 in balanced mutual funds and \$50,000 in cash. The broker was also told that you expect to retire in fifteen years. Still, the broker needs to ask a few more questions before he can take your retirement needs into account. Suppose that in response to the broker's further inquiries, you reveal that you currently make \$100,000 a year, you

⁸⁶ See Certified Financial Planner Board of Standards, Inc., *supra* note 4, at 2-3, 5; see also *supra* text accompanying note 85. See generally Arthur Levitt, Former Chairman, U.S. Sec. & Exch. Comm'n, Financial Literacy and Role of the Media (April 26, 1999), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch269.htm> (noting that "[S]ixty-five million American households will probably fail to realize one or more of their major life goals because they have not developed a *basic* financial plan") (emphasis added).

⁸⁷ See Jennifer Bayot, *As Bills Mount, Debt on Homes Rise for Elderly*, N.Y. TIMES, July 4, 2004, at A1, available at <http://www.nytimes.com> (follow "Archives" hyperlink; then search under "Headline" for "As Bills Mount") (noting that Americans reaching the retirement age are now less likely to own their homes outright).

live off your entire income, you do not plan on having any future savings, and you do not have any liquid assets⁸⁸ other than the \$150,000 already mentioned and some emergency funds in a bank. The broker can now piece together that you only have \$150,000 to fund your retirement in fifteen years and that you rely on a lifestyle that requires \$100,000 a year in income.

The prudent stockbroker will likely consider your retirement needs in relation to your expressed investment goals. You stated that your investment objective was to make some money, and thus it may seem to the untrained professional that your goals are in line with sufficiently funding retirement. However, as the typical client, you meant that you want to make some money as long as it does not entail much risk.⁸⁹ You feel that you are in a comfortable position because you pay off your credit cards, you make a decent living, you are pleased that you have been able to save \$150,000, and fifteen years strikes you as being far off in the distant future.

⁸⁸ See Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 423 (1987) (explaining that liquid assets consist of those assets that can be rapidly transferable into cash and thus have an easily determinable value).

⁸⁹ See Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 453 (1981) (describing human nature as risk averse when choosing between potential gains). Unfortunately, a client's natural aversion towards risk provides stockbrokers with an incentive to be biased towards conservative investments in hopes of keeping their clients satisfied. See Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767, 799 (2002) (describing how risk aversion psychologically relates to regret, a feeling universally found among investors with suitability claims). This potential bias increases the need for there to be a "push" from the legal community to help clients retire.

The prudent stockbroker sees a different picture. He envisions that you would prefer to be able to invest more conservatively in retirement.⁹⁰ Like most of his other clients, he imagines that you would prefer to invest in fixed income instruments during retirement that provide you with a recurring “paycheck.”⁹¹ To reach your retirement goal, you will need to make approximately 70% of your income, or \$70,000 a year.⁹² Your broker believes that you may need \$1.5 million⁹³ upon retirement to make \$70,000 a year in fixed income if today’s historically low interest rates⁹⁴ do not significantly rise before your retirement. He recognizes that this goal is nearly impossible. He also reasonably believes that you

⁹⁰ See Steven H. Sholk, *ERISA and Federal Income Tax Aspects of Participant Directed Investments in Defined Contribution Plans*, 625 PLI/TAX 459, 626 (2004) (stating that clients often shift their primary investment objective from growth to capital preservation as they near retirement).

⁹¹ A common fixed income strategy is to ladder a bond portfolio such that each individual bond matures in a different year. Ronald Harris, II, *Investing in Municipal Bonds*, 8-AUG. NBA NAT’L B. ASS’N MAG. 9, 32 (1994). Under this approach, the broker will often purchase bonds that pay out interest in different months in order to provide you with recurring income. The principle reason brokers recommend this strategy is in order to reduce interest rate risk. *See id.* Primarily, your broker wants to avoid the possibility of your entire portfolio maturing during a period of lower interest rates and thus causing you to have a low return on your investment when you reinvest. *Id.*

⁹² See Fidelity.com: How Much You May Need at Retirement, *supra* note 81 (suggesting that financial experts estimate you may expect to spend an annual sum of between 60-80% of your pre-retirement income).

⁹³ See Kimberly Lankford, Kiplinger.com: \$1 Million Nest Egg May Not Be Enough (July 30, 2004), available at <http://www.kiplinger.com/personalfinance/about/archive/> (search under “Search the Archive” for “\$1 million nest egg”; then follow the “Kiplinger.com -/ Saving - \$1 Million Nest Egg May Not Be Enough – July 30, 2004” hyperlink).

⁹⁴ See Director of Fixed Income: Schwab Center for Investment Research, *Don’t Fall Short on Bonds* (August 12, 2005), http://www.schwab.com/public/schwab/market_insight/investing_strategies/bonds/dont_fall_short_on_bonds.html?cmsid=P-895998&lvl1=market_insight&lvl2=investing_strategies&refid=P-867031&refpid=P-463189 (demonstrating how despite recent rate hikes by the Federal Reserve, long-term Treasury yields have actually flattened out providing investors with barely over a 4% annual return for Treasury investments of maturities greater than ten years).

will likely have an even greater shortfall if you invest in balanced mutual funds rather than aggressive growth mutual funds.

F. More Challenges for the Potential Retiree

In addition, the prudent stockbroker recognizes more general concerns that increase the need for your portfolio to include growth investments. The failure of Social Security,⁹⁵ inflation, the population's increasing life expectancy,⁹⁶ and humans' general aversion towards risk⁹⁷ all fuel the need for the broker to make it a priority to help you reach your retirement goals.

The first general concern is whether funds from Social Security will be available for anyone in retirement other than today's seniors.⁹⁸ Social Security continues to provide clients with little assurance that it will help with clients' retirement. The plan is expected to have negative resources as early as 2017.⁹⁹ President Bush seeks to provide Social Security participants with the choice to

⁹⁵ See Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B. C. L. REV. 975, 1056 (2000) (noting that private long-term equity investments reflect a more sensible retirement strategy than relying on the poor performing and precarious system ironically named Social Security).

⁹⁶ See BLACK'S LAW DICTIONARY 945 (8th ed. 2004) (defining life expectancy as "the period that a person of a given age and sex is expected to live, according to actuarial tables").

⁹⁷ See Tversky & Kahneman, *supra* note 89 and accompanying text.

⁹⁸ See *Fleming v. Nestor*, 363 U.S. 603, 610-11 (1960) (holding that there is no absolute legal right to Social Security benefits).

⁹⁹ President George Bush, *President Participates in Social Security Conversation in Maryland* (June 23, 2005), available at <http://www.whitehouse.gov/news/releases/2005/06/20050623.html>.

invest in growth in order to make up for the plan's shortfall,¹⁰⁰ but thus far Bush's strategy has failed to gain sufficient support.¹⁰¹ Unfortunately, no other privatization plan for maximizing the return on Social Security funds through investing for growth has been proposed by the legislature.¹⁰² As a result of the expected shortfall and the lack of a widely accepted solution, investors should not rely on Social Security to fund their retirement.

The second widespread effect on clients' retirement funds is inflation. The annual rate of inflation from 1913 to 2005 was 3.39%.¹⁰³ Inflation increases the amount of money that a client needs to have for retirement. For instance, in order to reach your goal of retirement in fifteen years, if you will need \$1.4 million in today's dollars to do so adequately, then inflation will likely cause your true need

¹⁰⁰ See Colleen E. Medill, *Challenging the Four "Truths" of Personal Social Security Accounts: Evidence From the World of 401k Plans*, 81 N.C. L. REV. 901, 912-13, n.39 (2003) (showing the President's Commission to Strengthen Social Security recommends several stock mutual funds).

¹⁰¹ Brooke Oberwetter, *Democrats Block Senate Vote on Personal Accounts 1* (Nov. 18, 2005), available at <http://www.socialsecurity.org/sstw/sstw11-18-05.pdf>; see also Greg Anrig, Jr. & Bernard Wasow, *The Social Security Network: Twelve Reasons Why Privatizing Social Security Is a Bad Idea* (December 14, 2004), available at <http://www.tcf.org/Publications/RetirementSecurity/12badideas.pdf>; John Kerry, <http://kerry.senate.gov/v3/issue/seniors.html> (last visited April 23, 2006) (opposing President Bush's plan because he argues it will create up to \$2.2 trillion in debt). *But see* Cato Institute, <http://www.socialsecurity.org/quickfacts/> (last visited April 23, 2006) (stating that the current rate of return on Social Security Taxes is less than 2% for the average worker).

¹⁰² Bobby Lewis Dexter, *Tax Terrorism: Nasty Truths about Investor Control Theory and the Accommodation of Social Security Privatization*, 57 MERCER L. REV. 553, 579 (2006).

¹⁰³ InflationData.com (2006), http://inflationdata.com/inflation/inflation_rate/AnnualInflation.asp (last visited April, 23, 2006).

to be over \$2.30 million.¹⁰⁴ Another way to look at it is that the actual return you will receive on your investments is lower than the published returns. For instance, the President's Commission to Strengthen Social Security estimated a 6.5% annual return for stocks after inflation.¹⁰⁵ In contrast, the reported average return of the S&P 500 Index,¹⁰⁶ a common measure for stock investments, stands between 10 and 12%.¹⁰⁷ In addition, the Commission estimated just over a 3% annual return for bonds after subtracting inflation.¹⁰⁸

Although both growth and fixed income instruments produce a lower actual return when considering inflation, if a client receives a mere 3% actual return in bonds, then it should become clearer why the client often needs to invest in growth to meet his retirement goals. For instance, let us assume that you expect to retire after 25 years and you plan to invest your \$150,000 in bonds both before and

¹⁰⁴ The figure of \$2.30 million is calculated based on the historic inflation rate of 3.39% remaining constant over the fifteen year period. However, in reality, inflation will vary and the deviations will alter this figure.

¹⁰⁵ Medill, *supra* note 100, at 930.

¹⁰⁶ The S&P 500 Index cannot be perfectly duplicated through an investment. Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 561, 598 n.82 (2006). However, there are two ways to mirror the index's returns: a mutual fund or an Exchange-Traded Fund [ETF]. ETFs trade on the exchange like a stock, and yet they still offer the inherent diversification found in a mutual fund. An investor should consider ETFs over mutual funds when they have a lump sum to invest because the annual operating expense of ETFs tends to be substantially lower. Conversely, an investor repeatedly buying into the market will usually find the cost of commissions on ETFs to be more expensive than buying mutual funds that do not have a transaction fee. *See generally* Peter N. Hall, *Bucking the Trend: The Unsupportability of Index Providers' Imposition of Licensing Fees for Unlisted Trading of Exchange Traded Funds*, 57 VAND. L. REV. 1125, 1126-31 (2004).

¹⁰⁷ Thomas Pavlick, *Analyzing the Effects of Transaction Cost, Leverage and Sector Concentration on Portfolio Performance, Portfolio Risk, and Client Suitability*, 1327 PLI/CORP 9, 15 (2002).

¹⁰⁸ Medill, *supra* note 100, at 930-31.

during retirement. A 3% annual return on \$150,000 would provide you with just over \$314,000 in 25 years.¹⁰⁹ For this plan to be a sound strategy, \$314,000 needs to generate a sufficient income for you in retirement. Unfortunately, a 3% return on \$314,000 would give you only approximately \$9,400 a year in income, and thus this strategy would fall drastically short of providing you with the \$70,000 annual income you will likely need in retirement. This significant shortfall suggests that you will need to save additional funds if you are to completely satisfy your retirement goal. However, even without additional savings, you would have at least been closer to meeting your goal had you invested in riskier investments such as equities, given their historic annual rate of return of 6.5%.

Third, people's life expectancy has dramatically increased to the point that the general population may be expected to live to over 100 years old in the near future.¹¹⁰ Assuming clients do not plan to increase their retirement age, an increase in life expectancy implies that clients must be prepared to fund their living expenses for a much greater period of time. The figures represent a large percentage increase, possibly doubling the number of years clients will have in

¹⁰⁹ The figure of \$314,000 is calculated based on the historic bond rate of 3% remaining constant over the fifteen year period. However, in reality, returns will vary and the deviations will alter this figure.

¹¹⁰ See Dilley, *supra* note 95, at 1054-1055 (stating that “[p]redictions of genetic breakthroughs that promise regular and healthy lifespans of over 100 in the near future mean increased uncertainty about the length of time retirement income will be needed”); see also Kimberly Lankford, Kiplinger.com: Overestimate Your Life Expectancy (Aug. 11, 2004), available at <http://www.kiplinger.com/personalfinance/columns/ask/archive/2004/q0811.htm> (suggesting that many financial planners estimate a life-span of over 100 years).

retirement.¹¹¹ This life-span increase diminishes the chance clients will be able to live off of their principal rather than live off of their return on investment. Thus, the client must have sufficient funds come retirement to generate an adequate return. Growth investments will often be necessary to achieve sufficient funds come retirement.

Finally, social studies have found human nature to be generally risk averse when choosing between potential gains.¹¹² These studies imply that a client left to his own devices will tend to steer clear of investments that entail more risk. Growth investments necessarily include an element of risk because they do not have a fixed rate of return,¹¹³ and yet growth investments are essential in many cases for a client to meet his retirement goals. Thus, the stockbroker plays an important role in keeping a client on track towards meeting his retirement goal, and the suitability test must recognize this role.

III. SUITABILITY

A. NASD Conduct Rule 2310 Drives the Law

Because a prudent stockbroker must strongly consider whether growth investments would help fulfill a client's retirement needs, it seems only natural that

¹¹¹ Assume a client was planning on retiring at 65, and he was previously expected to live until age 80 (15 years). If he was now supposed to live until 100 (20 more years), then there would be over a 100% increase in his number of retirement years.

¹¹² Tversky & Kahneman, *supra* note 89; *cf.* Moore, *supra* note 80, at 357-59 (finding that certain groups such as lower-income workers, women, and blacks may tend to be more risk-averse with their investments than the general population).

¹¹³ See NASD Invest Wisely: The Investment Decision, *supra* note 69.

the suitability test should apply the same principle.¹¹⁴ Therefore, the test should at least note that a broker must weigh a client's need for future retirement funds against the competing interest of managing risk. Unfortunately for members of the legal community untrained in investment advice, NASD Rule 2310 falls short of providing such extensive guidance.¹¹⁵ Nevertheless, NASD Rule 2310 serves as a bridge between the investment community and the legal community for assessing the suitability of investment recommendations. It provides the common law with a general definition of what it means for a stockbroker to have made a suitable recommendation. The rule requires the broker to make reasonable efforts to learn about certain crucial facts concerning the client's financial situation before making any recommendation.¹¹⁶ In addition, the rule demands stockbrokers "have reasonable grounds for believing the recommendation is suitable for such customer upon the basis of the [financial] facts, if any, disclosed by such customer" ¹¹⁷

The NASD test for suitability utilizes the typical legal standard of reasonableness.¹¹⁸ For those professionals well-versed in the investment industry,

¹¹⁴ "Having enough money for retirement is a major problem for today's investors. If the legal system could help by promoting growth for individual investors, then that would be a giant leap forward." Telephone Interview with John D. Keller, *supra* note 55.

¹¹⁵ NASD Rule 2310, *supra* note 8; *see also supra* text accompanying note 44.

¹¹⁶ NASD Rule 2310, *supra* note 8.

¹¹⁷ *Id.*

¹¹⁸ *Cf. Strickland v. Washington*, 466 U.S. 668, 669 (1984) (noting that for the court to find ineffective assistance of counsel, the plaintiff must overcome "a strong presumption that counsel's conduct falls within the wide range of *reasonable* professional assistance" and "show

this serves as an acceptable test. However, the standard provides little guidance, if any, on the competing considerations a broker must weigh when making a recommendation.¹¹⁹ For example, the suitability test leaves out any mention of the obligation of stockbrokers to balance the inherent risk found in growth investments, versus the risk that clients, without sufficient growth investments, will have a shortfall when it comes time to meet their retirement goals. Therefore, the test leaves the legal community out in the cold when trying to determine how a prudent stockbroker analyzes a client's financial circumstances. If arbitrators were provided with more guidance under NASD Rule 2310 to help them understand the analysis that the prudent broker carries out prior to making a recommendation, then they would be more likely to adequately determine whether in fact this broker had "reasonable grounds" for believing the investment was suitable.¹²⁰

Unfortunately, in legal practice and in scholarly articles, the application of the suitability rule has focused too much on the desire to limit risk and too little on

that there is a *reasonable* probability that, but for counsel's unprofessional errors, the result of the proceeding would have been different") (emphasis added).

¹¹⁹ See NASD Rule 2310, *supra* note 8 (requiring that a broker's recommendations be reasonable with respect to the client's financial needs but omitting any reference to the types of needs a broker must consider).

¹²⁰ See Stuart D. Root, *Suitability – The Sophisticated Investor – And Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 292-93, 295-96 (1991) (noting that a 1963 Special Study found that the NASD "should provide further definition of content" with respect to suitability but that the request was "largely ignored by the NASD").

the need for growth.¹²¹ Given that human nature tends to be risk averse,¹²² it should probably come as no surprise that the legal community continues to imply losses are the only real tragedy that comes from unsuitable investment recommendations.¹²³ To the contrary, it is equally tragic when individuals cannot have leisure time to enjoy the fruits of their years of hard work because their investments did not achieve enough growth to adequately retire. Imagine a forty-year veteran of the workforce asks his stockbroker at age 65 whether he has sufficient funds to retire. The broker sadly informs the client that he had been investing conservatively, and due to this rate of return, the client will have to work another fifteen years before he can retire. This risk rings true for many potential retirees, and yet it can be minimized through the broker recommending more suitable investments along the way.

B. Modern Portfolio Theory Drives Investment Strategy

The minimal guidance provided by NASD Rule 2310 leaves ambiguous the question of whether a specific recommendation is unsuitable.¹²⁴ Because the legal standard is ambiguous, the legal profession relies on industry experts to provide

¹²¹ See Pavlick, *supra* note 107; see also Elisofon & Elkins, *supra* note 43, at 34; *supra* text accompanying note 46.

¹²² Tversky & Kahneman, *supra* note 89 and accompanying text.

¹²³ Elisofon & Elkins, *supra* note 43, at 34; see also *supra* text accompanying note 46.

¹²⁴ Lowenfels & Bromberg, *supra* note 13 and accompanying text.

clarification of what is suitable.¹²⁵ Modern Portfolio Theory provides the predominant industry view that every investment should be considered in relation to the whole.¹²⁶ In addition, the theory relies upon asset allocation¹²⁷ to imply that a broker should recommend diversification in the overall portfolio to minimize the client's risk.¹²⁸ Arbitrators can appreciate the need for diversification more easily than the need for growth investments because diversification seeks to minimize the risk of capital loss and capital loss has been the main focus of damages in the past.¹²⁹ However, diversified investments can still be allocated aggressively or conservatively, so whether investments are diversified does not conclude the analysis. Unfortunately, in the end, arbitrators favor brokers that error towards a conservative asset allocation, even when more aggressive investments are in the

¹²⁵ Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599, 1617 (1999).

¹²⁶ Jerry W. Markham, *Privatizing Social Security*, 38 SAN. DIEGO L. REV. 747, 798 (2001) (noting the wide acceptance of Modern Portfolio Theory).

¹²⁷ See Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 796 (2000) (defining asset allocation as the distribution of money between the major asset classes: stocks, bonds, and cash).

¹²⁸ See Bradley P. Rothman, *401(k) Plans in the Wake of the Enron Debacle*, 54 FLA. L. REV. 921, 934 (2002) (implying that Modern Portfolio Theory is used to implement a diversified strategy and minimize risk). Thus, even when investing for growth, the broker should still seek to minimize the inherent risk within growth investments through diversification. Unfortunately, diversification is barely hinted to in the current NASD rule. NASD Rule 2310, *supra* note 8. NASD Rule 2310 should highlight growth investments because they are at odds with the risk of capital loss. In doing so, the rule should note for clarification purposes that the need for growth should not cause a broker to ignore the principle of diversification. See *infra* Part V.

¹²⁹ Michael E. Murphy, *The ESOP at Thirty: A Democratic Perspective*, 41 WILLAMETTE L. REV. 655, 662 (2005); Elisofon & Elkins, *supra* note 43, at 34; see also *supra* text accompanying note 46.

client's best interest.¹³⁰ Furthermore, arbitrators currently have little reason to focus on how aggressive investments help clients retire because a broker's failure to recommend these growth investments does not currently subject the broker to a suitability claim.¹³¹

One way to consider Modern Portfolio Theory is that if you combine aggressive investments with conservative investments, then you will often end up with a moderate portfolio. Adding even some growth investments to a portfolio will increase the client's chances of meeting his future goals such as retirement.¹³² This example demonstrates that under Modern Portfolio Theory, recommending aggressive growth investments may be entirely appropriate for a moderate investor.¹³³

Based on Modern Portfolio Theory, the suitability of growth investments depends on the investments' role within the overall portfolio. Therefore, the recommendation to purchase just three technology growth stocks for a client may seem unsuitable on the surface because the broker's suggestion seems to fail to

¹³⁰ See Miner, *supra* note 16 and accompanying text; see also Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428, 1491 n.126 (2004) (noting that investors "can choose their desired portfolio risk by altering their asset allocation between risky and risk-free assets").

¹³¹ See Miner, *supra* note 16 and accompanying text.

¹³² See Zelinsky, *supra* note 15 and accompanying text.

¹³³ See Rapp, *supra* note 5, at 192-93 (suggesting that under Modern Portfolio Theory a risky, growth investment may not only be deemed suitable for a portfolio with investment objectives of safety and income, but may in fact be a wise recommendation).

utilize asset allocation.¹³⁴ However, if the technology stocks increase the client's exposure in the technology sector to a level that makes the client's overall portfolio consistent with technology exposure in the S&P 500,¹³⁵ then the recommendations may be a very appropriate fit.¹³⁶ This is true even if the client's overall portfolio does not reside with the broker making the recommendations.¹³⁷ In other words, if the broker only manages the three technology stocks for the client, but he is also aware of how these investments balance out the investments at ABC Brokerage Company, then the recommendations may be legally suitable.¹³⁸

For a broker to implement Modern Portfolio Theory, he needs to know about the client's entire portfolio.¹³⁹ Inquiring about a client's other investments is mandatory because NASD Rule 2310 requires the broker to make reasonable

¹³⁴ See Hu, *supra* note 127, at 796 (defining asset allocation as the distribution of money between the major asset classes: stocks, bonds, and cash, and noting that asset allocation accounts for approximately 80-90% of a portfolio's actual performance).

¹³⁵ See Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 803-04 (2002) (implying the S&P 500 represents a broad stock market index covering numerous sectors).

¹³⁶ See Barbara Black & Jill I. Gross, *Economic Suicide: The Collision of Ethics and Risk in Securities Law*, 64 U. PITT. L. REV. 483, 525 (2003) (suggesting that recommending technology stocks may be suitable for an investor with an objective of long-term growth, but that the recommended exposure likely needs to be for a reasonable portion of the portfolio).

¹³⁷ See NASD Rule 2310, *supra* note 8 (stating that the broker should consider other security holdings revealed to him, and omitting any requirement that those investments be directly held by that broker). Because NASD Rule 2310 does not explicitly make the subtle point that the domicile of the investments is immaterial, the broker that recommends all aggressive investments can easily appear reckless in the eyes of the arbitrators. *Id.*

¹³⁸ *Id.*

¹³⁹ See Michael T. Johnson, Note, *Speculating on the Efficacy of "Speculation": An Analysis of the Prudent Person's Slipperiest Term of Art in Light of Modern Portfolio Theory*, 48 STAN. L. REV. 419, 427 (1996) (noting that Modern Portfolio Theory necessarily analyzes investments in relation to the entire portfolio).

inquiries to learn of the client's financial situation.¹⁴⁰ Unfortunately, in some cases, the broker may not be able to acquire enough information about the client's portfolio even after reasonable inquiry.¹⁴¹

In our hypothetical, the client walked into the stockbroker's place of business, presumably with goals in mind. In this case, it was a natural progression for the client and stockbroker to work together to create an overall portfolio strategy.¹⁴² This makes the job easier for the broker to recommend suitable investments. Yet, many stockbrokers have to generate new business through prospecting.¹⁴³ The greatest challenge in applying Modern Portfolio Theory comes from the case of the new client obtained through solicitation by cold-call or

¹⁴⁰ NASD Rule 2310, *supra* note 8.

¹⁴¹ In a new relationship with a broker, fear will often prevent a client from fully trusting the broker. Telephone Interview with John D. Keller, *supra* note 55. The client may fear that if he reveals his outside holdings to the broker, then the broker will pressure him into transferring all of his assets to the broker. *Id.* This is probably a well-founded fear. However, the client's "secrets" prevent the broker from being able to fully understand the client's diversification needs or the tax consequences of a purchase or sale. *Id.* With respect to the latter, realized gains are offset by realized losses, even if they do not come from the same brokerage account.

¹⁴² One of the common obstacles for a broker looking to implement an effective strategy is convincing an investor to diversify a concentrated stock position. A concentrated position is usually considered to consist of 20% or more of your holdings in one individual stock position. Many investors have large stakes in their employer's stock. Sadly, many investors choose to ignore the fact that their employer's stock offers the same type of risk that diversification is designed to avoid. *Id.*

¹⁴³ See Rapp, *supra* note 5, at 217 (suggesting that at the typical brokerage house, stockbrokers are trained more in sales than in how to make suitable investment recommendations).

seminar.¹⁴⁴ In this case, it is the broker that seeks out the client, rather than vice versa.

C. Sales Drive the Stockbroker

When a broker proactively prospects, he may tend to focus on the sale, instead of the client's actual needs. As a result, a danger exists that a broker will recommend growth investments solely for the purpose of proving his worth to the client. It is important to make clear that "the need for growth" does not make every growth recommendation suitable. At a minimum, the recommendation needs to be tied to the client's future goals.

For instance, reasonable inquiries by a broker may uncover little information about the details of a client's actual portfolio because the typical client will be reluctant to trust a solicitor.¹⁴⁵ Still, the client may agree to test the broker out with a small portion of his portfolio to assess the broker's ability to achieve good performance.¹⁴⁶ In this case, the client only wants to see how well the broker knows the market, rather than be given customized recommendations.

¹⁴⁴ Investment seminars usually begin by the stockbroker advertising in a newspaper or through a mailer. The advertisement will usually promote some investment topic thought to be of interest to wealthy prospects, such as estate planning. Ultimately, the broker will attempt to turn the prospect into a client through setting up a one-on-one meeting.

¹⁴⁵ See Easterbrook & Fischel, *supra* note 43, at 651 (suggesting that a client that has not been convinced of a broker's abilities will more likely test the broker by monitoring the broker's decisions). See generally NYSE Conduct Rules, Rule 405, *supra* note 60 (stating the rule known in the industry as "Know Your Customer" because it requires a broker to use due diligence to obtain basic information about every client).

¹⁴⁶ See Easterbrook & Fischel, *supra* note 47, at 651; see also *supra* text accompanying note 145.

Nevertheless, neither the lack of client information available to the broker nor the client's stated objective should change the stockbroker's approach.¹⁴⁷ It is usually considered unsuitable to recommend extremely risky investments for the entire portfolio even when it is the client's desire.¹⁴⁸ Thus, the broker still must apply asset allocation and Modern Portfolio Theory to the extent possible.¹⁴⁹ This ensures that the advice is tailored to the client's unique circumstances¹⁵⁰ and that the client's risk is kept to a minimum.¹⁵¹

A standard sales pitch in the investment industry has been for a broker to ask a prospect to give the broker a chance based on one stock.¹⁵² In this case, the broker does not learn enough about the client's outside assets in order to properly

¹⁴⁷ The broker's approach still needs to consist of attempting to learn at least the client's basic financial circumstances. Arbitrators should not tolerate "loose cannon" brokers that recommend un-customized growth investments to win business.

¹⁴⁸ See Reynolds, *supra* note 11 and accompanying text.

¹⁴⁹ A broker who has very little information about the client's outside assets has to treat the client's portfolio as completely devoid of diversification. The broker must assume that none of the client's outside assets will balance out the broker's recommended investments. This conservative approach avoids any risk of the broker making false assumptions about the client's diversification needs.

¹⁵⁰ Even though the broker is in the dark about the client's outside assets, he still needs to learn some basic information about the client in order to utilize Modern Portfolio Theory and asset allocation. The broker will have to uncover the basic information of the client's true risk tolerance, overall investment objective, and time-frame. This will guide the broker in determining between asset allocation models such as moderate and aggressive. If the broker can not learn this information from the client, then he is not in a position to make any recommendations.

¹⁵¹ See generally Johnson, *supra* note 139 (noting that Modern Portfolio Theory necessarily analyzes investments in relation to the client's entire portfolio while seeking to reduce overall volatility).

¹⁵² See Gedicks, *supra* note 37, at 555 (noting that the typical broker/client relationship starts with the broker utilizing salesmanship to sell a particular investment).

utilize Modern Portfolio Theory.¹⁵³ He simply recommends one “hot” growth stock without regard to the rest of the portfolio.¹⁵⁴ Seemingly, the need for growth in this one stock is tied to proving the broker’s worth as an expert, not the client’s future needs such as retirement.¹⁵⁵ The broker has incentive to recommend a risky investment and hope that it will achieve high performance and impress the client.

Even if the broker eventually plans to advise the client prudently, the idea that the broker needs to prove his ability to predict market performance may be doing the client a disservice. It is highly unlikely that even a stockbroker has the capabilities to outthink the market, and thus he should not pretend to have a “crystal ball” ability in order to win business.¹⁵⁶ The broker should provide the client with reasonable expectations about how he may help. He should explain that his expertise derives from his ability to implement an investment strategy based on

¹⁵³ See Rapp, *supra* note 5, at 272-73 (arguing that Modern Portfolio Theory and real world practices such as cold-calling demand that the suitability test be understood to apply differently to stand-alone and portfolio recommendations).

¹⁵⁴ See William O. Fisher, *Does the Efficient Market Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 898 (2005) (implying that chasing hot stocks is an investment strategy reserved for amateurs).

¹⁵⁵ See *Newman v. Rothschild*, 651 F. Supp. 160, 163 (S.D.N.Y. 1986) (stating that when a stockbroker talks about hot stocks or how his primary objective is to make money for the client, a reasonable investor should interpret that as nothing more than a sales pitch).

¹⁵⁶ See Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1037 n.9 (1992) (explaining that advocates of the Efficient Capital Market Hypothesis [ECMH] believe the efficiency of the marketplace makes it nearly impossible for anyone to outperform the market, and noting that a sub-theory of ECMH, the Random Walk Theory, holds that future market movements are random).

the client's financial circumstances.¹⁵⁷ This is in fact what the suitability test calls for from the broker.¹⁵⁸

IV. THE CHALLENGE IN ARBITRATION & MEDIATION

Claims against brokerage firms are typically decided by arbitration¹⁵⁹ through the NASD.¹⁶⁰ Arbitrators typically have as little as two to three days to hear the evidence on whether the broker made suitable recommendations.¹⁶¹ The speed of arbitration magnifies the risk that any lack of understanding on the part of arbitrators will lead to an incorrect decision. Thus, an important question remains

¹⁵⁷ A stockbroker may hold more than the basic licenses or certifications necessary to recommend investments. These designations are not required for a broker to do his job, but they do demonstrate that he has enhanced education in his field. For instance, a broker may be a Certified Financial Planner (CFP) or a Chartered Financial Analyst (CFA). A CFP has expertise in reviewing areas typically found in a financial plan, such as estate planning, but this certification is unnecessary to deliver financial plans. A CFA has expertise in analyzing individual stocks. There are three levels of CFA, yet none of these levels are necessary for a broker looking to recommend the purchase or sale of a stock. *See* Certified Financial Planner Board of Standards Inc., <http://www.cfp.net/> (last visited April 23, 2006); *see also* CFA Institute, <http://www.cfainstitute.org/> (last visited April 23, 2006).

¹⁵⁸ *See* NASD Rule 2310, *supra* note 8 (defining suitability as a broker's obligation to have reasonable grounds, *based on the client's financial situation*, for any recommendations made to a client) (emphasis added).

¹⁵⁹ *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987) (noting courts have a duty to enforce arbitration claims due to favored policy). *See generally* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is it Just?*, 57 STAN. L. REV. 1631, 1636-37 (2005) (describing the shift towards enforcing mandatory arbitration in the securities industry).

¹⁶⁰ *See* NASD: Dispute Resolution Offers Alternative to Courts, *supra* note 42; *see also* Rapp, *supra* note 5, at 191 (noting that suitability claims consistently rank amongst the top claims against brokerage firms).

¹⁶¹ *See* SEC, NASD and Securities Law Information Center, <http://www.sec-nasd-regulations.com/process.htm> (last visited April 23, 2006) (noting that the average arbitration case takes between six to twelve months from start to finish, and that most hearings only last between two to three days); *see also* Saxis S.S. Co. v. Multifacs Int'l Traders, Inc., 375 F.2d 577, 582 (2d Cir. 1967) (noting that the basic purpose of arbitration is to quickly resolve cases and avoid extended litigation); NASD Arbitration & Mediation, *supra* note 31 (stating that arbitration is "faster, less expensive, and less formal than litigation").

whether arbitrators have a clear understanding about the need for growth in clients' portfolios.¹⁶² To evaluate this question, let us return to our hypothetical.

Unfortunately, you put blind faith in your stockbroker five years ago, and his advice has caused your portfolio to decline in value over that stretch of time. Now, five years later, you find yourself awaiting arbitration to bring a claim against your broker for recommending unsuitable investments. While the date for your arbitration hearing is pending, your lawyer suggests that you utilize mediation to attempt to reach a fair settlement and circumvent the ensuing costs of arbitration.¹⁶³ In mediation, a neutral third party trained in negotiation will help both sides come to a mutual agreement.¹⁶⁴ You realize that this means you need to rely on your lawyer to fully appreciate the value of your claim. If your lawyer does not realize the strengths of your claim, then you may not reach a fair settlement. If your

¹⁶² See Securities Arbitration Center: Unsuitability, <http://www.securitiesarbitration.us/stockbrokerdisputes.htm.html> (last visited April 23, 2006) (stating that “[a]rbitrators often struggle with unsuitability claims”). *But cf.* NASD Investor Education: When Should You Complain?, https://apps.nasd.com/Investor_Information/Complaints/complaintCenter.asp (last visited April 23, 2006) (demonstrating that the NASD appreciates that even if a client lost money, that fact does not necessarily indicate that the stockbroker engaged in any misconduct at all).

¹⁶³ See NASD Mediation, <http://www.nasd.com> (follow “Arbitration & Mediation” hyperlink; then follow “Mediation” hyperlink; then follow “Mediation Myths & Realities” hyperlink) (last visited April 23, 2006) (noting that mediation may run concurrent with pending arbitration and most parties agree that mediation results in time savings and cost savings); *see also* NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12 (showing that only 24% of arbitration cases were decided by arbitrators in 2005, while 54% were completed by settlement: either directly by the parties or via mediation).

¹⁶⁴ NASD Mediation, <http://www.nasd.com> (follow “Arbitration & Mediation” hyperlink; then follow “Mediation” hyperlink; then follow “Mediation: An Alternate Path” hyperlink) (last visited April 23, 2006).

lawyer does not realize any weaknesses in your claim, then the other side may balk at the offer and force you to pay additional arbitration costs. In other words, if opposing counsel fully appreciates the need for growth in investments but your lawyer does not, then your decision to hire this lawyer could be a costly mistake.

You choose not to settle at mediation, so you and your attorney have to prepare for arbitration. Your lawyer explains to you that arbitration still has advantages over litigation because it is faster and less expensive.¹⁶⁵ To get ready for the arbitration hearing, your lawyer has helped you gather all documentation necessary to prove your case including your brokerage statements, a copy of the initial investment questionnaire you had completed, and any emails you received from your broker.¹⁶⁶ Your lawyer informs you that besides documentation it will come down to a battle of experts. The experts will opine on the suitability of the investment recommendations.¹⁶⁷

The expert plays an even more pivotal role in arbitration cases than in litigation because of the limited time involved for just a few arbitrators to come to

¹⁶⁵ See NASD Arbitration & Mediation, *supra* note 31.

¹⁶⁶ See BrokerBuster.com, <http://www.brokerbuster.com/articles.html#Anchor-Suitability-43266> (last visited April 23, 2006) (providing a long list of items that are helpful for a client looking to prove a suitability claim). *But see* Constantine N. Katsoris, *Should McMahon Be Revisited?*, 59 BROOK. L. REV. 1113, 1154 n.199 (1993) (suggesting that the brokerage firm typically holds better access to the necessary documentation).

¹⁶⁷ Booth, *supra* note 125.

a conclusion about suitability.¹⁶⁸ There is tremendous potential for experts to have undue influence on arbitrators. As one Certified Financial Planner put it:

Unfortunately, too many securities arbitrators today don't know what weight an expert's testimony deserves. The picture of the arbitrator as a neutral informed person experienced in the securities field is a myth. Some arbitrators apparently have never held a brokerage account However well-intentioned they are, many arbitrators are unable to discern how they are being bamboozled by a polished, smooth expert with impeccable credentials.¹⁶⁹

The risk of a mistaken decision is greatly enhanced by the limited information experts are forced to provide about their credentials in arbitration relative to litigation. In litigation, an expert must provide a written report prior to trial expressing his qualifications and any compensation that he will receive.¹⁷⁰ The report also must include the opinions the expert will articulate and the rationale and data behind any of his opinions.¹⁷¹ Furthermore, any expert expected to present at trial must submit to a deposition.¹⁷² These pre-litigation procedures provide the other side with time to challenge any suspect expert testimony. Conversely, in arbitration none of these initial procedures are required. The opposing lawyer is usually provided with little information about the expert's credentials or

¹⁶⁸ See NASD Code of Arbitration Procedure: Composition of Arbitration Panel 6 (2005), http://www.nasd.com/web/groups/med_arb/documents/mediation_arbitration/nasdw_013098.pdf (noting that claims under \$50,000 are usually overseen by one arbitrator and claims above \$50,000 are usually overseen by three arbitrators).

¹⁶⁹ Mason, *supra* note 34, at 741-42.

¹⁷⁰ FED. R. CIV. P. 26(a)(2).

¹⁷¹ FED. R. CIV. P. 26(a)(2).

¹⁷² FED. R. CIV. P. 26(b)(4).

opinions.¹⁷³ Even the little information provided about the expert may become entirely worthless if arbitrators continue to allow counsel to change experts at the last minute.¹⁷⁴ In addition, arbitration provides no remedy when arbitrators mistakenly accept unreliable or irrelevant expert testimony.¹⁷⁵

Experts have an opportunity to play a major role in arbitration cases in part because of the limited experience of arbitrators. Neither litigation experience nor brokerage experience are required to become an arbitrator. In fact, a majority of the arbitrators in a dispute with a client are required to be from outside the brokerage industry.¹⁷⁶ Arbitrators consist of your typical working professionals. The NASD's goal is "to recruit arbitrators from different backgrounds, such as educators, accountants, lawyers, business and securities professionals, and

¹⁷³ Mason, *supra* note 34, at 742-43.

¹⁷⁴ *Id.* at 743. The objective for arbitration is to speed up the process of litigation, and yet the goal is still an accurate result. NASD Arbitration & Mediation, *supra* note 31. When arbitrators allow experts to be changed just before a hearing, it prevents opposing counsel from being able to effectively cross-examine the expert, and thus get to the truth. Allowing such flexible rules does expedite the process, but the only way this late change of experts can lead to a satisfactory result is if the arbitrators and lawyers have a very clear understanding of what goes in to making an investment recommendation suitable.

¹⁷⁵ See David A. Gehn, *Voir Dire the Silver Bullet to Neutralize "Hired Gun" Testimony of "Expert" Witnesses in Securities Arbitration*, 1502 PLI/CORP 335, 345 (2005) (noting the multiple levels of protection designed to prevent sub-par expert testimony in litigation, all of which are not present in arbitration). Most notably, arbitrators are not trained in the law of evidence.

¹⁷⁶ NASD Arbitration & Mediation, <http://www.nasd.com> (follow "Arbitration & Mediation" hyperlink; then follow "Resources for Arbitrators and Mediators" hyperlink; then follow "Arbitrator Recruitment" hyperlink; then follow "Frequently Asked Questions About Becoming an NASD Arbitrator" hyperlink) (last visited April 23, 2006); see also NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12 (noting that there are currently available 3,692 public arbitrators and 2,648 industry arbitrators for a combined total of 6,340).

others.”¹⁷⁷ Furthermore, these professionals do not need to be seasoned veterans. The NASD only requires arbitrators to have five years of business or professional experience and two years of college-level credits.¹⁷⁸ Therefore, even if some arbitrators have substantial knowledge and experience, the minimum threshold suggests at least some arbitrators may be duped by a sophisticated expert.

Lastly, the finality of the arbitration process increases the importance of getting the decision right. Arbitration decisions are almost never overturned.¹⁷⁹ The reviewing court cannot overturn a decision it believes to be incorrect or even unreasonable.¹⁸⁰ Magnifying the concern of an erroneous decision, arbitrators are not even required to disclose their reasoning.¹⁸¹ This makes it more challenging for the reviewing court to assess the validity of the decision and provides the losing party little assurance that the decision was made correctly.¹⁸² The court may only overturn an arbitration decision based on misconduct amounting to fundamental

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ See *Corey v. New York Stock Exchange*, 691 F.2d 1205, 1212 (6th Cir. 1982) (noting that Section 10 of the Arbitration Act “provides that an award may be vacated if it was procured by fraud, corruption or undue means, where there has been evident partiality or corruption in the arbitrators, where there has been misconduct or misbehavior by which the rights of any party may have been prejudiced and where the arbitrators exceeded their powers”); see also *Parker*, *supra* note 12 (noting that arbitrators may not change their decision even if new evidence surfaces and in only very limited circumstances may the decision be vacated).

¹⁸⁰ See *James Richardson & Sons v. W. E. Hedger Transportation Corp.*, 98 F.2d 55, 57 (2d Cir. 1938) (holding the “court is without power to amend or overrule merely because of disagreement with matters of law or facts determined by the arbitrators”); see also *Corey*, 691 F.2d at 212.

¹⁸¹ *Parker*, *supra* note 12.

¹⁸² *But cf. Katsoris*, *supra* note 166, at 1153 (suggesting the General Accounting Office has found no bias towards the brokerage industry in arbitration decisions).

unfairness in the proceeding or a misapplication of the law that would be obviously recognized by the average arbitrator.¹⁸³ Still, all of these same drawbacks also provide the stated benefits of greater speed and less cost that make arbitration a useful alternative to litigation. Therefore, the underlying message is not that the arbitration system needs to be revamped,¹⁸⁴ rather, the NASD needs to make it easier for arbitrators to accurately interpret the suitability rule and avoid blindly relying on experts.

V. THE SIMPLE SOLUTION

The solution to the challenge of making the arbitration process more effective in suitability cases is through an easy three-step process. First, the NASD needs to add one simple bullet point to Rule 2310: (d) “A member shall consider growth investments when appropriate to help clients’ achieve long-term goals such as retirement. Growth investments necessarily include some level of risk. The suitability of every individual growth recommendation shall be analyzed in relation to the client’s overall portfolio.”¹⁸⁵

¹⁸³ See *Trafalgar Shipping Co. v. International Milling Co.*, 401 F.2d 568, 572-73 (2d Cir. 1968) (noting that an arbitration award can be reviewed for “misbehavior of the arbitrators or manifest disregard of the law”); see also *Parker*, *supra* note 12.

¹⁸⁴ *But cf.* Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N. C. L. REV. 123, 126 (2005) (arguing that “serious reforms are necessary in securities arbitration before one can support the claim that this system provides a principled alternative to adjudication”).

¹⁸⁵ See NASD Rule 2310, *supra* note 8; see also NASD Securities Dealers Manual (CCH) ¶ 2001, at 2001 (5-89) (Article VII of the NASD By-Laws, Sec. 1.(a)) (stating that “the Board of Governors, shall have the authority to: (1) adopt for submission to the membership, as

Second, the NASD must require prospective arbitrators to become educated on the revised rule before hearing their first suitability case. Currently, the American Arbitration Association [AAA] requires everyone new to the national roster of arbitrators to complete general requirements of both an at-home study course and a two-day classroom training within six months of signing on to the roster.¹⁸⁶ Unfortunately, these education requirements mostly focus on the basic duties and authority of the arbitrator.¹⁸⁷ In addition, the education requirements should include more specialized training on the particular subject matter of the cases that will be referred to the arbitrators such as suitability.¹⁸⁸ The solution would be easy because the arbitrators' suitability education and general education requirements could be administered simultaneously.

hereinafter provided, such By-Laws, Rules of Fair Practice and changes or *additions thereto as it deems necessary or appropriate*") (emphasis added).

¹⁸⁶ *AAA Offers New Training for Arbitrators*, 55-JAN. DISP. RESOL. J. 5 (Jan. 2001). *See generally* McCool, *supra* note 30 at ¶ 46 (stating that according to the NASD, some form of general education has been required of new securities arbitrators since 1993).

¹⁸⁷ *See AAA Offers New Training for Arbitrators*, *supra* note 186.

¹⁸⁸ *See* Judith S. Kaye, NEW YORK STATE COURT ALTERNATIVE DISPUTE RESOLUTION PROJECT, STATE OF NEW YORK UNIFIED COURT SYSTEM, COURT REFERRED ADR IN NY STATE, FINAL REPORT OF THE CHIEF JUDGE'S NEW YORK STATE COURT ALTERNATIVE DISPUTE RESOLUTION PROJECT 51-53 (May 1, 1996), *noted in* Lela P. Love & James B. Boskey, *Should Mediators Evaluate? A Debate Between Lela P. Love*, 1 CARDOZO ONLINE J. CONFLICT RESOL. 1, 1 n.16 (Dec. 10, 1997) (recommending "a minimum of 8 hours training in the substantive and procedural matters related to arbitration of cases in the specific subject area of the case that will be referred to them").

Third, the NASD must keep the arbitrators' understanding of suitability fresh through continuing education.¹⁸⁹ Fortunately, the AAA already includes a continuing education requirement designed to keep arbitrators up to date with any revisions to laws that affect arbitration.¹⁹⁰ Still, the continuing education needs to go deeper than to "acquaint" the arbitrator with the revised rule.¹⁹¹ The arbitrator needs enhanced continuing education to acquire a clearer understanding of the mental process that the prudent broker goes through before making an investment recommendation. The process of implementing enhanced continuing education with respect to suitability should be seamless because the NASD Institute at Wharton already offers a course in "Suitability Issues."¹⁹² In addition, continuing education could be implemented with minimal cost if the NASD provides arbitrators with a video of the class.

¹⁸⁹ See *id.* (suggesting "attendance at continuing education classes of a minimum of 8 hours every 2 years"); cf. Charles Pou, Jr., *Assuring Excellence or Merely Reassuring? Policy and Practice in Promoting Mediator Quality*, 2004 J. DISP. RESOL. 303, 335, 340-41 (2005) (noting that continuing education in mediation is at least as critical to promoting quality as upfront certifications and that some state programs require between eight to fifteen hours a year of continuing education for mediators).

¹⁹⁰ *AAA Offers New Training for Arbitrators*, *supra* note 186.

¹⁹¹ See *id.*

¹⁹² See NASD Institute: Suitability Issues I, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_006444 (last visited April 23, 2006). See generally NASD Institute at Wharton, <http://www.nasd.com> (last visited April 23, 2006) (follow "Education & Programs" hyperlink; then follow "NASD Institute" hyperlink) (explaining that NASD classes such as "Suitability Issues" traditionally have been offered for individuals looking to become Certified Regulatory and Compliance Professionals).

The three-step solution will force arbitrators and securities lawyers to address the conflicting interests that stockbrokers must weigh when making investment recommendations. The conflicting interests consist of the downside risk of losing capital and the risk of not meeting the investor's future goals such as retirement. Arbitrators will be on alert of these competing forces due to their expanded education and the prominence of this new fourth bullet point in the concise NASD Rule 2310.¹⁹³ Securities lawyers will follow suit because they will need to prepare to discuss the brokers' balancing act when arguing a case. As a result of the increased focus on growth investments, all legal professionals will be in a better position to assess whether the broker had reasonable grounds, based on the client's financial situation, for any recommendations made to the client.¹⁹⁴

To demonstrate how the solution would apply in practice, consider a 40 year old client with only \$100,000 saved. Assume the client cannot afford to save very much going forward, can leave the money invested for a minimum of ten years, and has the conflicting interests of being risk averse and wanting to retire at 60 years old. If the broker invests this client in Treasury notes¹⁹⁵ because of their low risk, then he should be subject to a suitability claim because the historically low

¹⁹³ In the absence of the recommended bullet point, arbitrators will likely enter into cases similar to this Comment's hypothetical with the misguided presumption that the client has a winning argument. *See supra* pp. 15.

¹⁹⁴ *See* NASD Rule 2310, *supra* note 8.

¹⁹⁵ *See* BLACK'S LAW DICTIONARY, *supra* note 71, at 1539-40 (defining a treasury note as a "debt security issued by the federal government . . . considered risk-free, but . . . [that usually pays] relatively little interest").

return of these investments is not in the best interest of his client given that they will not help him retire.

Before the recommended solution, this broker would never even have to consider suitability because Treasury notes are very unlikely to result in financial loss.¹⁹⁶ Furthermore, the securities lawyer and the arbitrator would have laughed at this case for the same reason. Today, once the solution is applied, the client's lawyer will suggest that he bring a suitability claim because the lawyer has heard of the changes to NASD Rule 2310.¹⁹⁷ The arbitrator hearing the case will recognize that this is clearly the type of case that had caused bullet point (d) of Rule 2310¹⁹⁸ to be added. The arbitrator's new education program will have enforced this idea in his mind.¹⁹⁹ The arbitrator will likely find for the client and do so quickly to save everyone additional costs. This client will be left in a better position to retire. Even more critical, this broker will make sure in the future that he and all his broker friends place more emphasis on recommending investments that put his clients in a better position to retire.

VI. CONCURRENT CLAIMS AND THE SOLUTION APPLIED

A. Breach of Fiduciary Duty

¹⁹⁶ Elisofon & Elkins, *supra* note 43, at 34; *see also supra* text accompanying note 46.

¹⁹⁷ *See supra* pp. 46.

¹⁹⁸ *See supra* pp. 46.

¹⁹⁹ *See supra* pp. 47-48.

Generally, clients do not just state a cause of action under suitability; they also bring interrelated actions.²⁰⁰ Interrelated actions increase the complexity of the suitability case, and therefore they may distract arbitrators from focusing on the role that growth investments play in broker recommendations.

For instance, a client may choose to bring a common law claim for a breach of fiduciary duty to enhance the strength of his suitability claim.²⁰¹ When applicable, a fiduciary duty requires the stockbroker to act with the utmost good faith and integrity.²⁰² A broker owes a fiduciary duty to all clients, but the extent of that duty depends on the specific facts of the case.²⁰³ Relevant factors include the sophistication and experience of the client²⁰⁴ and whether the relationship is discretionary or non-discretionary.²⁰⁵ In addition, facts that demonstrate the client placed trust in the broker's expertise will increase the chance that a court will view the broker as a fiduciary.²⁰⁶ For instance, in our hypothetical, the client failed to

²⁰⁰ Because suitability claims are typically brought concurrently with other related claims, the most realistic approach for applying the recommended solution is in that context. *See* NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12 (stating that cases are coded to contain up to four controversy types).

²⁰¹ *Twomey v. Mitchum, Jones & Templeton, Inc.*, 69 Cal. Rptr. 222 (Cal. Dist. Ct. App. 1968).

²⁰² *Id.* at 236.

²⁰³ Root, *supra* note 120, at 335.

²⁰⁴ *See* Roger W. Reinsch, J. Bradley Reich & Nauzer Balsara, *Trust Your Broker?: Suitability, Modern Portfolio Theory, and Expert Witnesses*, 17 ST. THOMAS L. REV. 173, 185 (2004) (stating that the client's sophistication impacts the level of duty owed by the broker to the client).

²⁰⁵ *See* *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1217 (8th Cir. 1990) (noting that discretionary power to make trades in the client's account is a factor but not a prerequisite for a broker to be subject to a fiduciary duty).

²⁰⁶ *See Twomey*, 69 Cal. Rptr. at 235 (suggesting a fiduciary relationship exists whenever the client places his faith in the broker).

look at his statement for five years. This fact points towards the view that the client had placed complete faith in his broker.

A breach of fiduciary duty often occurs when a broker has an ongoing relationship with a client and fails to address the client's change in financial circumstances or investment objectives.²⁰⁷ Material changes to the client's financial situation must be documented and the broker must re-assess the client's investments for suitability upon learning of the new information.²⁰⁸ For instance, returning to our hypothetical, imagine after six months of being invested in the aggressive growth mutual funds, you tell your broker that you plan to get married within a year and will need \$25,000 of the \$150,000 investment to pay for the wedding. After learning this information, your broker has a fiduciary obligation to review whether either the wedding or the ensuing marriage impacts your portfolio's suitability.²⁰⁹

Your broker should first inquire whether marriage itself has changed your investment goals or desired risk tolerance for your portfolio.²¹⁰ For instance, you may wish to have your investment strategy become more consistent with that of

²⁰⁷ *But see* Kwiatkowski v. Bear Stearns & Company, Inc. 306 F.3d 1293, 1302 (2d Cir. 2002) (stating that a non-discretionary, commission based account ordinarily does not require ongoing monitoring or advice on the part of the stockbroker).

²⁰⁸ Rapp, *supra* note 5, at 279 n.155.

²⁰⁹ *See* State ex rel. PaineWebber, Inc. v. Voorhees, 891 S.W.2d 126, 130 (Mo. 1995) (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²¹⁰ *See id.*

your fiancée's.²¹¹ However, even assuming you do not change your overall outlook, the broker must still reassess his recommendations given that you have now expressed two contrasting investment objectives: a long-term and a short-term goal.²¹²

Upon analysis, your broker will likely determine that investing \$125,000 in growth investments still seems to be a wise choice because your long-term goal has not changed for these funds.²¹³ As a result, your broker does not necessarily need to reallocate the \$125,000, and thus he has no new suitability obligations for this portion of the portfolio.²¹⁴ On the other hand, the broker should recognize that your objective has changed for the remaining portion of your portfolio.²¹⁵ You have a short-term goal to preserve \$25,000 for wedding expenses and thus growth investments that were once suitable, now seem to be too risky.²¹⁶

²¹¹ See Susan J. Stabile, *Enron, Global Crossing, and Beyond: Implications for Workers*, 76 ST. JOHN'S L. REV. 815, 828 (2002) (noting that studies show women tend to be more conservative investors than men).

²¹² See *Voorhees*, 891 S.W.2d at 130 (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²¹³ See *Nenno*, *supra* note 17 accompanying text.

²¹⁴ See *Voorhees*, 891 S.W.2d at 130 (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²¹⁵ See *id.*

²¹⁶ Growth investments require a long-term investment horizon. See *Office of General Counsel*, 1105 PLI/CORP 13, 168 (1999) (suggesting that the Securities & Exchange Commission [SEC] has a "longstanding position that mutual fund shares are generally suitable only as long-term investments").

In light of your new financial circumstances, the broker should consider selling some of the aggressive mutual funds²¹⁷ to preserve capital.²¹⁸ However, it is not necessarily true that he must reallocate the portfolio to meet his fiduciary obligation.²¹⁹ This may not even be the wisest strategy. For instance, before selling any of the funds, he should analyze the tax consequences and early redemption costs.²²⁰ Furthermore, in this case, the broker should consider that even without reallocation and regardless of market conditions, you will likely have \$25,000 at the end of the year to pay for your wedding expenses.²²¹ Thus, paying for your wedding does not mandate shifting \$25,000 into a capital preservation strategy.²²² In addition, the broker should take into account whether you are down from your initial investment because shifting \$25,000 towards capital preservation at this time may in fact be taking away from the overall goal of retiring.²²³ In

²¹⁷ See *id.* and accompanying text.

²¹⁸ Capital preservation represents one of the investment objectives typically listed on an investment questionnaire. See Rapp, *supra* note 5 and accompanying text.

²¹⁹ See *Voorhees*, 891 S.W.2d at 130 (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²²⁰ See James N. Benedict, Sean M. Murphy, C. Neil Gray & Carrie A. Bassel, *Current Developments & Strategies in Litigation Under the Investment Company Act of 1940*, 1483 PLI/CORP 469, 554 (2005) (discussing how many mutual funds have established early redemption fees to discourage short-term trading).

²²¹ See NASD Rule 2310, *supra* note 8; see also *supra* text accompanying note 158.

²²² See *Voorhees*, 891 S.W.2d at 130 (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²²³ There is an old adage "buy low, sell high," which accounts for popular and sophisticated investment strategies such as "dollar-cost averaging." Dollar-cost averaging refers to automatically buying mutual funds at regular intervals to avoid market timing and avoid the risk of always buying high. Telephone Interview with John D. Keller, *supra* note 55. In this hypothetical, suitability should not mandate that the client sell low if he already bought high.

essence, a prudent stockbroker's recommendation may be that you should not change the portfolio at all to stay on track for retirement.²²⁴ Thus, arbitrators reviewing this hypothetical case should find the broker met his fiduciary duty as long as he documented the client's change in circumstances, regardless of whether he suggested changes to the portfolio.²²⁵ Because this decision is not intuitive from reading the recommended new bullet point of NASD Rule 2310, this analysis should be taught to arbitrators through the recommended education program.²²⁶

In contrast to the above hypothetical facts, assume the upcoming wedding expenses amounted to a high percentage of the client's portfolio such that aggressive investments risked the client having sufficient funds to pay for the wedding. In that case, arbitrators should find that for the broker to meet his fiduciary duty, he must recommend reallocating the majority of the portfolio to more suitable short-term investments given the client's adjusted time horizon.²²⁷ Once again, arbitrators should learn this subtle distinction through the recommended education program.²²⁸

The client may be better off waiting out the remaining time that he has left, now that he is already entrenched in the growth investments. Arbitrators need to consider that a broker faced with this dilemma who decides not to shift his client's portfolio from a growth strategy to a more conservative strategy may be legitimately concerned about market timing.

²²⁴ See *Voorhees*, 891 S.W.2d at 130 (noting that a fiduciary duty requires the broker to manage the account in accordance with the client's needs and objectives).

²²⁵ See *id.*

²²⁶ See *supra* Part V.

²²⁷ See *Office of General Counsel*, *supra* note 216 and accompanying text.

²²⁸ See *supra* Part V.

The next common method of breaching a fiduciary duty is for the broker to fail to monitor the client's portfolio on an ongoing basis. In cases of an ongoing relationship, the client will often reasonably expect the stockbroker to monitor the client's positions. In earlier brokerage days, brokers had a major incentive to monitor the portfolios because coming up with new positions to sell and buy helped them get paid through commissions.²²⁹ The transition of the industry from a commission based structure into fee based compensation provides the broker with different incentives to monitor the portfolio.²³⁰

Under a fee based compensation plan, the broker's incentive is to increase the value of the client's portfolio which in turn will increase the dollar value associated with the broker's percentage compensation. For instance, you hire a broker to manage your \$100,000 portfolio and agree to compensate the broker 1.5% of the entire portfolio. In Year One, the broker makes 1.5% of \$100,000 or \$1,500. After the first year, the value of your portfolio increases to \$110,000. Now, in Year Two, the broker has increased his compensation to 1.5% of \$110,000 or \$1,650. This example demonstrates that stockbrokers and clients are on the same side under fee based compensation plans. However, paradoxically, that does not mean that the broker has a significant enough incentive that he will actively

²²⁹ *But cf.* M & B Contracting Corp. v. Dale, 795 F.2d 531, 533 (6th Cir. 1986) (defining churning as "excessive [trading] in light of the customer's investment objectives").

²³⁰ See Patricia C. Foster, *Fee-Based Accounts: The Broker's Role Determines the Rule*, 1503 PLI/CORP 189, 191 (2005) (noting the dramatic transition in the structure of broker's compensation that has taken place in the past twenty five years).

monitor your portfolio. The reason for this paradox is that there is an opportunity cost for the broker in monitoring your diversified portfolio rather than utilizing that time to solicit new business.

On the one hand, the incentive to closely monitor your portfolio is minimal because active portfolio management has not proven to significantly outperform simple passively managed strategies such as index funds.²³¹ Conversely, the incentive for soliciting new business is high because stockbrokers can utilize similar investment strategies with each new client that they add on. A broker will often choose to spend his time soliciting new business because a newly acquired client allows him to increase revenues with little exertion of energy. These developments in the brokerage industry provide another opportunity for the recommended education program to provide arbitrators with the necessary background knowledge to make an informed decision in a suitability case.²³²

B. Related Causes of Action

There are a couple of additional claims that clients will often bring in conjunction with suitability claims and their relevance should be explained in the continuing education program.²³³ First, the client will likely bring a claim for

²³¹ See W. Brantley Phillips, Jr., Note, *Chasing Down the Devil: Standards of Prudent Investment Under The Restatement (Third) of Trusts*, 54 WASH. & LEE L. REV. 335, 344 (1997) (noting that actively managed investment strategies rarely outperform passively managed strategies).

²³² See *supra* Part V.

²³³ *Id.*

failure to supervise against the brokerage firm, unless the case clearly involves a broker deviating from the standard practices of the firm.²³⁴ However, the Securities Act of 1933 and the Securities Exchange Act of 1934 provide brokerage firms with safe harbor provisions under which the firm is not held responsible if the firm acted in good faith, had no knowledge or reasonable ground to believe in the facts that would otherwise make it liable, or followed established supervisory procedures reasonably expected to be effective.²³⁵ These safe harbors put the brokerage firm at odds with the stockbroker, and yet the same lawyer often represents both parties.²³⁶ This conflict of interest, combined with the focus on financial loss in suitability cases,²³⁷ serves as a major disincentive for the broker who desires to help his client retire by recommending the necessary level of growth for his portfolio.

Second, clients sometimes bring a common law cause of action for negligence. Negligence alone does not suffice for a client to have a valid cause of action, but it may be brought concurrently with a suitability claim, and may serve

²³⁴ See NASD Arbitration & Mediation: Dispute Resolution Statistics, *supra* note 12 (listing “failure to supervise” as one of the interrelated controversies in arbitration cases).

²³⁵ 15 U.S.C. § 78o(b)(4)(E) (2002); see also Pete S. Michaels & Derek C. Anderson, *A Case Study of Two Hedge Funds: A Regulatory Framework and Its Lessons for the Broker-Dealer Litigator*, 1503 PLI/CORP 259, 270 (2005) (quoting 15 U.S.C. § 78t(a) (2005)).

²³⁶ R. Gina Renee, *How to Survive in Arbitration Nation*, available at http://www.researchxtra.com/uploads/features/2006/0601_fs_cover_arbitration.asp (last visited April 23, 2006) (quoting Thomas O’Keefe, President of the National Association of Investment Professionals: “Brokers getting sued like this think that their firm’s attorney represents them: They need to realize that the big firms . . . are the defense attorney’s customer . . .”).

²³⁷ Elisofon & Elkins, *supra* note 43, at 34; see also *supra* text accompanying note 46.

as evidence of whether the broker was reasonable under NASD 2310.²³⁸ Although actual negligence provides evidence of a broker's wrongdoing, arbitrators and lawyers may mistakenly believe the broker was negligent when the broker was merely factoring in the client's need for growth.²³⁹

VII. DAMAGES

Once a client proves that a stockbroker has made unsuitable recommendations, the arbitrators must decide how much to assess in damages. Section 28a of the Securities Exchange Act of 1934 limits recovery to actual damages.²⁴⁰ The main theory for assessing damages for suitability actions is the out of pocket model²⁴¹ which compensates the client for the actual losses sustained during the time the client held unsuitable investments.²⁴² Unfortunately, this method does not accurately assess the client's true damages because actual losses do not equate to actual damages.

In many cases, regardless of whether the client made or lost money, the broker will have made unsuitable investments because he departed in some manner from the appropriate asset allocation model. However, the out of pocket model fails to take this into account because it does not consider market appreciation or

²³⁸ Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 697 F. Supp. 1224, 1227 (D.D.C.1988).

²³⁹ See Easterbrook & Fischel, *supra* note 47 and accompanying text.

²⁴⁰ 15 U.S.C. § 78bb(a) (1982).

²⁴¹ The theory is also known as the recissory model.

²⁴² See *generally* Miner, *supra* note 16 and accompanying text.

depreciation. The theory compensates the client for all losses, not just those attributable to the unsuitable investments. As a result, clients that lose money due to unsuitable investments are often over-compensated under this approach.

Another strategy for assessing damages that has been proposed is the loss of bargain recovery model which compensates a client for the money that he would have earned had the money not been mismanaged.²⁴³ Regrettably, the reluctance to consider market performance in assessing damages has led to the concern that bargain theory recovery damages are too speculative.²⁴⁴ Although some courts have acknowledged the possibility that clients could be entitled to lost profits under the right circumstances,²⁴⁵ few courts have awarded damages under the loss of bargain theory.²⁴⁶ Therefore, clients that receive recommendations that are too conservative based on their investment objectives may not have a legal recourse to obtain adequate compensation. This problem may arise even in cases where the broker's unsuitable recommendations kept the clients from meeting their future needs.

²⁴³ See *Stevens v. Abbott, Proctor, and Paine*, 288 F. Supp. 836, 849 (4th Cir. 1968) (arguing that the bargain recovery model is too speculative).

²⁴⁴ See *McMahan & Co. v. Warehouse Entertainment, Inc.*, 65 F.3d 1044, 1050 (2d Cir. 1995) (finding that if damages were not too speculative, then the loss of bargain theory could be invoked).

²⁴⁵ See *Smith v. Fahnstock & Co., Inc.*, 2002 WL 334511 (S.D.N.Y. 2002) (denying the plaintiff's request for summary judgment in a suitability case even though the client had received gains in his portfolio).

²⁴⁶ See *Krull v. SEC*, 248 F.3d 907 (9th Cir. 2001) (affirming a decision to compensate clients for lost profits due to unsuitable recommendations, despite the injured clients having gains in their account).

Despite the fear that intertwining damages with the stock market is too speculative, market indexes should help provide specific measures that can be tied to the proper asset allocation. Index returns are published, and thus no speculation is involved in obtaining these figures. It is true that the proper asset allocation for the client may be hard to distinguish between fine lines such as aggressive, and moderately aggressive. However, experts can make recommendations of the appropriate asset allocation level and arbitrators can ultimately make that decision.²⁴⁷ The fair level of damages for all cases in which recommending asset allocation was appropriate should be the difference, over the apt time period, between the client's actual market performance and the appropriate index's performance as determined by the arbitrators.²⁴⁸ For example, if the arbitration board determines that the client's proper asset allocation would have been approximately a 50% equity and 50% bond portfolio, then pre-determined equity and bond indexes should be utilized to calculate the client's portfolio had it been invested properly.

An award for damages should put the client back in the position he would have been in had the broker provided suitable recommendations instead of the

²⁴⁷ Arbitrators will be less likely to be "bamboozled" by experts once they have a clearer understanding of the role of growth investments. *See supra* Part V (providing three steps that will increase arbitrators' understanding).

²⁴⁸ *See* Miner, *supra* note 16, at 841 (concluding, wisely, that damages should also factor in dividend activity, cash withdrawals, and cash deposits).

unsuitable recommendations.²⁴⁹ This approach implies that it should not make a difference whether the client lost or made money in the market. The question merely becomes what was the deviation in performance between the unsuitable portfolio and a properly managed portfolio. Therefore, there should be no distinction between the out of pocket model and the loss of bargain model, but rather one model that assesses market performance in relation to the client's actual returns. Yet again, the recommended education program can explain to arbitrators the process for accurately assessing damages.²⁵⁰

VIII. CONCLUSION

Growth investments refer to a wide variety of equity strategies all designed for a client to achieve higher portfolio performance, while taking on some risk. A prudent stockbroker utilizes growth investments to help clients meet future needs such as the universal, yet challenging, goal of retirement. When growth investments are utilized in relation to a diversified strategy and meet a client's objectives, a supervisor at a brokerage firm will often find the investments to be suitable.

Accordingly, arbitrators should focus on the need for growth in clients' portfolios when evaluating the suitability of investments and interrelated claims

²⁴⁹ See generally *id.* at 839-40 (stating that in 10b-5 actions damages should place the client in the position he would have been in had the fraud not occurred).

²⁵⁰ See *supra* Part V.

such as breach of fiduciary duty. The importance of growth investments may not only explain how prudent advice led to a client's financial loss, but it also may help arbitrators understand why the broker might have felt there was a need to take on some risk in the first place.

In addition, lawyers serving as advocates in arbitration proceedings have a duty to emphasize the need for growth investments in their arguments when appropriate. Securities lawyers should recognize that brokerage firms may have a valid defense that the recommended investments were proper in light of the client's need for growth in his portfolio. On the other hand, lawyers should advise prospective clients that they are not limited to bringing suitability cases for financial loss. Lawyers should inform clients that they may also have a case when they indicated a preference for growth and their investments were allocated too conservatively.

In any case, the speed and finality of the arbitration process and the inexperience of arbitrators make it especially important for all legal professionals working in the securities industry to have a clear understanding of the need for growth in a client's portfolio. This clear understanding is necessary to avoid the otherwise inevitable misapplication of liability and damages in suitability cases. Therefore, the NASD should add a bullet point to the suitability rule. It would clarify how the need to invest for growth impacts whether a broker had reasonable

grounds to make a particular recommendation. In addition, the NASD should take steps to ensure that arbitrators familiarize themselves with the applications of this rule. Ultimately, if arbitrators determine the recommended investments were unsuitable given the client's circumstances and investment objectives, damages should be assessed in relation to the appropriate market index, regardless of whether the client's portfolio increased or decreased in value.