

OBJECTIVE STANDARDS OF SUITABILITY DETERMINATION

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INTRODUCTION

ONE ARBITRATION LAWYER'S PERSPECTIVE ON SUITABILITY (2007)

I began my securities law practice in 1974 as an Assistant Attorney General for the State of Georgia. My principal responsibility in that job was to represent the Georgia Securities Commissioner. Legally empowered by the Georgia Securities Act, and politically empowered by the Secretary of State of Georgia, we pretty much had our way with those whom we identified as “bad guys.”

I also had the opportunity as an Assistant Attorney General for the State of Georgia to represent the Teacher's Retirement System of Georgia in a federal securities fraud claim against a failed REIT and the broker who sold Fifteen Million Dollars worth of its subordinated debentures to my client. We brought claims under Sections 12(2) and 17 of the Securities Act of 1933 and under Rule 10b-5. We survived two years of motion practice. During this two years, we conducted discovery and uncovered some really rank and obvious financial misrepresentations and omissions that we could never have learned about without discovery. We settled the case for \$15M worth of real property, despite the fact that there was several hundred millions dollars of secured bank debt senior to us. This was the power of the federal securities laws in the early 1970s.

When I went into private practice in 1976, I continued to bring federal securities law cases in federal court. During the 1970s, the law and the courts continued to be very investor friendly, and the SEC, NASD and my former Georgia Securities Commissioner compatriots looked upon us private securities plaintiff's attorneys as partners.

As the 1970s progressed into the 1980s, the defense of federal securities law cases became much more robust and sophisticated. By 1984, I had come to the conclusion that the cost of motion practice and discovery made a private securities law claim for less than \$100,000 economically unfeasible, and I was searching for a way to continue to bring meritorious claims of less than that amount. Quite by accident, I stumbled on the fact that the NASD maintained an arbitration system. As a trial balloon, I brought a NASD arbitration claim on behalf of a classic defrauded widow lady. The result was gratifying. The result was so gratifying that Shearson "appealed" the arbitration to the United States District Court. I then read the Federal Arbitration Act for the first time, and discovered that they could not appeal an arbitration award. I moved to dismiss and brought a Rule 11 claim. Before we started the motion hearing, the Judge advised Shearson's attorney that he had better go out in the hall and settle with me. He took that advice.

I thereby became completely enamored with arbitration. From then on, I brought any claim in arbitration that I could get into arbitration. I thus was not very upset when in 1987, the U. S. Supreme Court in *Shearson/American Express Inc. v McMahon*, 483 U.S. 1056 (1987) reversed the previously existing law and

declared that brokerage firms could compel arbitration under mandatory arbitration agreements.

One thing about this decision did concern me. I saw that the existence of mandatory arbitration agreements was likely to become universal. I also foresaw that one of the results of this would be that customer versus broker cases would no longer be decided in court. Therefore, there was not going to be any further customer versus broker case law developed. This has turned out to be a much larger problem than I anticipated at the time.

Beginning with *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), which held that scienter was an element of a 10b-5 case, the difficulty of maintaining a federal securities law case in federal court has increased exponentially. The developing case law, though it has developed almost entirely in the context of class actions, has bled back into the arbitration practice. I have not pled a federal securities law claim in arbitration in many years based on my experience that such claims do not put any money in my client's pockets and give the brokerages an opportunity to introduce a lot of evidence and argument about issues which it does not benefit my client to discuss.

So if you are not going to plead violations of federal securities law, what do you say in your statement of claim and closing argument to provide the arbitrators with a legal/equitable/moral basis for ordering a broker to pay your client money? Quite often, my core answer to that question has been to cast my case as a suitability case.

There is no express federal securities law statutory basis for a suitability case. There is no SEC rule or regulation dealing with suitability, though SEC pronouncements sometimes refer to the concept. The only tangible basis for a “suitability” claim is the NASD Conduct Rules.

The core NASD suitability rule is Rule 2310:

2310 Recommendations to Customers (suitability).

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

(b) Prior to the execution of a transaction recommended to 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 objective; and (4) such other information you can use or consideration to be reasonable by such member or registered representative in making recommendations to the customer.

NASD Conduct Rule 2860 relating to options provides longer (if not clearer) provisions about suitability:

(19) (A) No member or person associated with the member shall recommend to any customer any transaction for the purchase or sale (writing) of an option contract unless such member or person associated therewith has reasonable grounds to believe upon the basis of information furnished by such customer after reasonable inquiry by the member or person associated therewith concerning the customer’s investment objectives, financial situation and needs, and other information known by such member or associated person, that the recommended transaction is not unsuitable for such customer.

(B) No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of

making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

Conduct Rule 2865(19) provides a very similar suitability test for recommendations relative to a security future.

What all of these NASD regulations and NASD and SEC suitability decisions have in common, is they set forth the issues but do not establish any standards of measurement. This has meant, historically, that suitability, like pornography, is in the eye of the beholder. There has seldom been a suitability case in which the broker could not find some expert to testify that everything was suitable. There is also no scarcity of claimant's experts who can testify that any given transaction or set of transactions is unsuitable. The problem in presenting a suitability case was that there were no objective measurements by which the attorney evaluating the case or the arbitrator deciding the case could determine which opinion was correct.

Because unsuitability can be anything, it can also be nothing. Frustrated by this intangibility and inspired by Dan Solen's presentation at a PIABA Annual Meeting several years ago, I set out to see if I could find a way to give some substance to this ephemeral subject of suitability. What I learned was that economists deal with a very similar and complimentary concept, "value at risk." The virtue of the economist's concept is that it can produce numbers. One of the most interesting numbers that it can often produce is a probability of failure calculation. This is something that you as an attorney can get your teeth into. It

can provide a basis for some really telling questions to the broker's expert. It can provide the arbitrators with a measurable basis for awarding money to your client. The economist's concept of value at risk is not exactly co-terminus with the NASD concept of suitability, but they are close enough that you can get neutrals and even opposing counsel to begin to talk and think in the language and concepts of value at risk and probability of failure. If you can get over that advocacy threshold, you can try a suitability case based upon objective measurable considerations rather than as a battle of expert opinions that have no objectively evaluatable basis for their opinions.