



The "Sophisticated" Investor Defense to Suitability Claims; More Frequently Raised Than Proven

by James J. Eccleston, Esq.

It seems everyone is a sophisticated investor, at least when one moves away from the brokerage firm Madison Avenue advertising campaigns (encouraging investors to trust and rely upon their financial advisers), to securities arbitration where investors seek to recover their investment losses. There, brokerage firm counsel routinely argue that the investor is sophisticated, such that the investments were suitable and there should be no recovery.

To put this argument in perspective, one should note the Investor Literacy Research, which the National Association of Securities Dealers ("NASD") published in 2003. The findings of that research include:

1. Only about half (51%) of investors knew the definition of a "junk bond";
2. Only about 40% of investors understood the relationship between bond prices and interest rates;
3. Only 21% of investors correctly identified the definition of a "no load" mutual fund, and 37% would not venture to guess;
4. Only 51% of investors knew that stocks have yielded higher average returns than other investments; and
5. Only 40% of investors selected 10% as a reasonable average annual return on a broadly diversified stock portfolio over the long term.

Accordingly, these findings would tend to suggest that a court or arbitration panel's finding that an investor is "sophisticated" is, or should be, rare.

What factors do brokerage firm counsel typically raise as to sophistication? One typically considers wealth, age, education, professional status, investment experience and business background. However, the NASD has made it clear that wealth is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of the customer's net worth. Likewise, one must consider the scope of sophistication, such that an investor may be sophisticated in some areas of investing, and unsophisticated in others. Additionally, advanced education degrees do not automatically establish that a customer is a sophisticated investor.

It is helpful to compare the NASD's rule with respect to options recommendations to the NASD's rule with respect to non-options transactions. For options recommendations, the NASD requires that the financial adviser have 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 options transaction. By comparison, for non-options recommendations, no such knowledge, or sophistication, requirement exists. Instead, the NASD requires that the (non-options) recommendation be suitable based upon the customer's other security holdings as well as his or her financial situation and needs.

Thus, in the context of a simple negligence action for recommending an unsuitable investment, the sophistication defense is not legitimate. Regulatory decisions support this view. For example, in *James Chase*, Exchange Act Rel. No. 47476 (Mar. 10, 2003), 79 SEC Docket 2892, 2897, the SEC concluded that the mere disclosure of risks did not satisfy the suitability duty. The SEC stated that not only must



The "Sophisticated" Investor Defense to Suitability Claims; More Frequently Raised Than Proven
(Page 2 of 3)

the customer be sufficiently sophisticated to fully understand the risks involved with the investment, the customer also must be able to bear those risks. Of course, the ability to bear risks, standing alone, does not satisfy the suitability rule. In *Re. Dambro*, 51 S.E.C. 513, 517 (1993).

Brokerage firm counsel frequently explore investor sophistication in the context of asserting affirmative defenses. That is because several courts have held that where a sophisticated investor regularly receives information concerning the transactions in his account and fails to object within a reasonable time (or the period specified by contract), he may be barred by the doctrines of waiver, estoppel, laches, or ratification from asserting a claim. E.g., *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1370 (7th Cir. 1983).

However, the threshold for asserting these defenses is relatively high. For example, to show that an investor ratified an action, such as to preclude broker liability, it must be clear from all the circumstances that the customer intended to adopt the trade as his or her own. Knowledge of the pertinent facts and the clear intent to approve the unauthorized action are preconditions of ratification. *Van Syckle v. C.L. King & Associates, Inc.*, 822 F.Supp. 98, 104 (N.D.N.Y. 1993). Consequently, the mere receipt of statements is not dispositive as the ultimate determination depends also on the customer's sophistication and the complexity of the transaction at issue.

As well, even a seemingly sophisticated investor will not be barred from bringing a claim if the information he received from his broker was faulty. For example, a corporate vice-president with a degree in business administration who opened an options trading account was not barred by waiver, estoppel, laches, or ratification from recovering losses due to the fact that he had protested several of the transactions, and that the confirmations often were late or inaccurate. *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1370 (7th Cir. 1983). Likewise, "the disparity in sophistication between the brokerage firm and its customer" is relevant when considering the application of any written notice requirement. *Modern Settings, Inc. v. Prudential-Bache Securities, Inc.*, 936 F.2d 640, 645-946 (2d Cir. 1991) (emphasis added).

As one can see, investor "sophistication" involves a fact intensive inquiry! Counsel for both sides need to understand what is, and what is not, appropriately considered in this important analysis. Counsel for customers need to appreciate that most investors, according to the NASD's Investor Literacy Research, are not, and should not be deemed to be, sophisticated.

James J. Eccleston is a securities attorney, representing customers as well as brokers and brokerage firms nationwide in arbitration, litigation and regulatory matters. He maintains an informative website at www.FinancialCounsel.com. He is an equity partner with Shaheen, Novoselsky, Staat, Filipowski & Eccleston, and can be reached at 312-621-4400.



The "Sophisticated" Investor Defense to Suitability Claims; More Frequently Raised Than Proven
(Page 3 of 3)



[About Us](#) | [News](#) | [Alerts](#) | [Articles](#) | [Newsletter](#) | [Research](#) | [Calendar](#) | [Contact](#) | [Register](#) | [Free Opinion](#)

Sponsored by James J. Eccleston, an attorney representing stockbrokers, financial planners and investors nationwide in arbitration, litigation and regulatory matters, and an equity partner with the law firm Shaheen, Novoselsky, Staat, Filipowski & Eccleston (www.snsfe-law.com). This Web site contains material of general interest. It is neither intended to nor constitutes either legal advice or investment advice. Always consult an attorney and/or investment advisor when building and protecting your wealth.

All content Copyright © 2003 FinancialCounsel.com, Inc. except where noted. All rights reserved.
20 North Wacker Drive, Suite 2900, Chicago, Illinois 60606
Telephone: 312-621-4400 | Fax: 312-621-0268

