St. Thomas Law Review

Volume 17
Issue 2 *Winter 2004*

Article 2

2004

# Trust Your Broker: Suitability, Modern Portfolio Theory, and Expert Witnesses

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# TRUST YOUR BROKER?: SUITABILITY, MODERN PORTFOLIO THEORY, AND EXPERT WITNESSES.

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The death of the "dot coms" in the late 1990's left many investors questioning investment advice.[2] Specifically, they began to question the direction, interests, and professional competence of their stockbrokers. Investors who felt their stockbrokers failed them are increasingly resorting to litigation, pursuing what has become known as "suitability" claims, claims based on the argument that brokers recommended or purchased securities that were not suitable for an investor's profile. The issues in and surrounding suitability claims are complex, yet surprisingly little has been written on this topic. This article seeks to foster a much needed discussion and will examine the legal and ethical rules that govern stockbroker portfolio decisions, the causes of actions that clients may bring against their brokers[3] based on suitability, and the use of expert witnesses in suitability litigation.

There are two central components in this article, the Suitability Doctrine, and Modern Portfolio Theory. The Suitability Doctrine requires that stockbrokers know their clients and that any investment portfolio they create is suitable to their client's specific objectives and circumstances. Modern Portfolio Theory ("MPT") is a set of formulas used to determine, objectively, whether a portfolio is suitable for a particular client's objectives and circumstances.

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2. *See, e.g.*, Michelle Lore, *Lawsuits Against Brokers Over Bad Investments Are on the Rise*, MINN. LAWYER, Sept. 19, 2001; *A Policy Review: Civil Liability of Dealers of Financial Instruments for "Suitability" Claims in the Institutional Market*, 53 THE RECORD 62 (Jan./Feb. 1998) [hereinafter *Policy Review*].

3. To avoid confusion on the part of the reader, the term "broker" will be used throughout the paper to refer to both brokers and dealers.

## I. THE STOCK PORTFOLIO: ASSESSING APPROPRIATENESS FOR AN INVESTOR

### A. THE SUITABILITY DOCTRINE

Simply put, any discussion of the Suitability Doctrine must begin with the Suitability Rules because the Doctrine is a product of the Rules. The Suitability Rules come from various sources[4] and are enforced in disciplinary proceedings brought by various Self Regulatory Organizations ("SROs") or the Securities and Exchange Commission ("SEC").[5]

The pre-eminent Suitability Rule is Rule 2310 of the NASD:[6]

> 2310. Recommendations to Customers (Suitability)
>
> (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.
>
> (b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
>
> (1) the customer's financial status;
>
> (2) the customer's tax status;
>
> (3) the customer's investment objectives; and
>
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[7]

Even though the Suitability Rules are ethical rules they have evolved into a legal principle, the Suitability Doctrine.[8] The Suitability Doctrine

4. The foremost authorities include the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE).

5. These disciplinary proceedings against brokers are for violating ethical, not legal, rules. However, as we shall see, these suitability rules may also be presented as the basis for recovery of damages in private actions brought by aggrieved customers against brokers.

6. Most securities-industry SROs have suitability rules, but we will base our discussion on the NASD rule because it is the most commonly used rule in suitability claims.

7. NASD Conduct Rules, 2310: Recommendations to Customers (Suitability), (Amended May 2, 1990 eff, for accounts opened and recommendation made after Jan. 1, 1991; *amended by* SR-NASD-95-39 eff, Aug. 20, 1996), *available at* http://www.cchwallstreet.com/nasd/nasd.asp?print=1&printnode=3.35&SelectedNode=3&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml (last visited Oct. 15, 2004).

8. *See generally* Norman S. Poser, *Liability of Broker-Dealers for Unsuitable*

requires "a broker to make a customer-specific determination of suitability and tailor her recommendations to the customer's financial profile and investment objective."[9] A broker must understand the investor's financial needs in order to determine what would suit those needs.[10] In order to do that, the broker must complete an investor profile. The profile consists of what the client wants the investment to accomplish and the level of risk the investor is willing to undertake.[11] Rule 2310 and the other suitability rules require a broker to create an accurate "investor profile" and then use that profile to make proper investments or recommendations.[12]

The industry importance of the Suitability Doctrine has been demonstrated in several cases. The first case of significance was *Erlich v. First National Bank of Princeton.*[13] The *Erlich* court held that "the obligation of the investment manager to give prudent advice is the standard of care to be applied . . . ."[14] The court held that "[p]rudent advice includes: (1) knowing the customer, his assets and objectives; (2)

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*Recommendation to Institutional Investors*, 2001 BYU L. REV. 1493 (2001) [hereinafter Poser]; *Policy Review*, *supra* note 2; LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3d ed. 1989).

9. 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, 190 (1998) [hereinafter Rapp]. *See also* Renee Barnett, *Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1100 (2000).

10. The suitability rules may be violated in two different ways. First, a broker may violate the suitability rules if he fails so fundamentally to comprehend the consequences of his own recommendation that such recommendation is unsuitable for any investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics. More commonly, however, the suitability rules will be violated by a recommendation that might be suitable for some investors but is unsuitable for a specific investor to whom the recommendation is directed. *See* F.J. Kaufman & Co., Exchange Act Release No. 34-27535, 50 S.E.C. 164 (Dec. 13, 1989).

11. *See* Rapp, *supra* note 9, at 212-17.

12. *See* NASD Conduct Rules, 2310, *available at* http://www.cchwallstreet.com/nasd/nasd.asp?print=1&printnode=3.35&SelectedNode=3&FileName=/nasd/nasd_rules/RulesoftheAssociationmg.xml.

13. 505 A.2d 220 (N.J. Super. Ct. Law Div. 1984). The plaintiff, Erlich, opened a Custodian Management Account with the defendant bank. *Id.* at 226. Erlich had invested in securities for about 15 years prior to opening this account. It was a nondiscretionary account requiring written authorization from the plaintiff prior to any sales or purchases. *Id.* at 227. The bank only made recommendations. *Id.* Plaintiff's investment objectives were in dispute at the trial, but the Bank's New Account Information Sheet only said "growth." *Id.* Eventually with Erlich's agreement the bank purchased a large amount of ICS stock (a company that was highly recommended). *Id.* Over the next several years there was a substantial decline in the value of the ICS stock. *Id.* at 229. Eventually, Erlich closed his account which at the time had only four stocks in its portfolio. *Id.* at 231. The portfolio had almost no diversity and the plaintiff filed the lawsuit. *Id.* at 225.

14. *Id.* at 235.

diversifying investments; (3) engaging in objective analysis as the basis for purchase and sale recommendations and (4) making the account productive."[15] The court then went on to discuss the standard for a broker when diversifying investments stating "[t]he investment manager has an obligation to the customer to exercise prudence in diversifying investments in order to minimize the risk of large losses.... [D]iversification of investment is a fundamental principle of portfolio management . . . [and] diversification [is] necessary to minimize risk."[16]

*Erlich* set the stage for two cases from the Seventh Circuit. In 1988, that court reasoned that

> [w]hen investment advisors make decisions, they do not view individual investments in isolation. Rather, the goal is to create a diversified portfolio that balances appropriate levels of risk and return for the investor. The risk of a given investment is neutralized somewhat when the investment is combined with others in a diversified portfolio. The risk inherent in the entire portfolio is less than that of certain assets within that portfolio. Ideally, after diversification only market risk remains. Likewise, the return from a portfolio over time should be more stable than that of isolated investments within that portfolio.[17]

Two years later, in the case of *Central National Bank v. United States Department of Treasury*,[18] the court concluded that whether a security recommendation is consistent with the acceptable level of risk is not assessed in terms of the security itself, but rather, given the risk-reducing effect of including it in a diversified portfolio of assets, the extent to which it contributes to maximizing return without altering the overarching risk preference.[19] Thus, recommending a "risky" investment may not only be entirely consistent with a "conservative" investment objective, it may, quite realistically, be compelled.[20]

The principle espoused by these two cases is, essentially, Modern Portfolio Theory (MPT). MPT focuses "on the risk characteristics of each asset not separately, but as it interacts in the portfolio."[21] When trying to determine whether a portfolio is suitable for a particular investor the courts

15. *Id.*
16. *Id.* at 236.
17. Leigh v. Engle, 858 F.2d 361, 368 (7th Cir. 1988).
18. 912 F.2d 897 (7th Cir. 1990).
19. *Id.* at 901-02.
20. *Id.*
21. Deborah M. Weiss & Marc A. Sgaraglino, *Prudent Risks for Anxious Workers*, 1996 WIS. L. REV. 1175, 1187 (1996). *See Erlich*, 505 A.2d at 236-37.

often use MPT.[22]

B. MODERN PORTFOLIO THEORY

MPT is used to determine two things: the level of risk of a particular portfolio, and that the portfolio's level of risk reflecting the level of risk that the particular investor wanted to undertake.[23] What is unique about MPT is that it does not look at the investment risk of a single security in a portfolio; rather it looks at the "risk" in the entire portfolio based on the investment objectives of the investor.[24]

MPT distinguishes between individual stock risk and overall portfolio risk. The fundamental difference between the two is that individual stock risk is measured in the varying terms of one stock's price over a given time, while portfolio risk is measured by the correlation between the totality of stocks in the portfolio and the stock market as a whole.[25] The correlation of a stock with the stock market as a whole is called the beta of the stock.[26]

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22. In ERISA actions the use of MPT is required. *See* 29 C.F.R. § 2550.404a-1 (2004); Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc., 173 F.3d 313 (5th Cir. 1999); Chao v. Moore, 26 Employee Benefits Cas. (BNA) 2033 (S.D. Md. 2001). For other cases that recognize MPT explicitly *see Leigh*, 858 F.2d at 368; Johnston v. CIGNA Corp., 916 P.2d 643 (Colo. 1996).

23. *See* Rapp, *supra* note 9, at 249-54.

24. *See id.* at 192-93.

> Under traditional analysis, a stockbroker's recommendation of a "risky" stock to the mythical little old lady whose investment objective is neatly categorized as "safety and income" would be a predictably easy case . . . . But, guided by principles of Modern Portfolio Theory (MPT), the offending recommendation may take on a markedly different character. Indeed, instead of being an "unsuitable" investment, the risky security may be seen as a wise investment that is consistent with, if not in fact compelled by, a responsible portfolio investment objective that is well-suited to the customer. The conduct of the broker who is oriented to such an objective should be assessed against a meaningful standard of care.

*Id.*

25. MPT proffers that the best way to minimize risk is to invest in a diversified portfolio of stocks, rather than in a single stock or a collection of positively correlated stocks. MPT also distinguishes between individual stock risk, which can and should be diversified by a prudent investor, and the overall market risk that an investor cannot control.

26. The magnitude of any given stock's decline is a function of its beta value: the higher the beta, the greater the decline in the stock's price over a specific period of time. MPT says that the investor should diversify away as much of the individual stock risk, or unsystematic risk, by investing in less than perfect positively correlated stocks. According to MPT, the prudent investor should be compensated only for taking on market risk, as measured by beta: the higher the market risk of the stock or portfolio, the higher the deserved level of compensation. This principle is captured by the Capital Asset Pricing Model (CAPM) equation, which states that:

$$K_i = k_{rf} + b_i{*}(k_m - k_{rf})$$

Where, $k_i$: required return on stock i; $k_{rf}$: risk-free interest rate; $k_m$: return on the entire stock market; $b_i$: beta on stock i.

According to the CAPM equation, the higher the beta of a stock, the higher its exposure to overall

The beta of each stock in the portfolio is then used to determine the overall risk of the portfolio. The level of risk produced is supposed to correspond to the level of risk the customer stated he or she wanted in the investment portfolio. This is the factor that makes the portfolio "suitable" or not "suitable" for a particular investor. In suitability claims, the basis of the lawsuit is that the portfolio was not suitable for the investor's stated objective(s).

## II. POTENTIAL "SUITABILITY" CAUSES OF ACTION

### A. FEDERAL SECURITIES LAW

As previously discussed, the Suitability Rules begat the Suitability Doctrine. Even though the Suitability Rules are technically ethical rules, their evolution has been clear: "Over the years, the Suitability Doctrine has undergone a subtle shift from ethics to substantive law."[27] A primary example of this evolution is Rule 10b-5 of the Securities Exchange Act of

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market risk, and hence the higher the required compensation for owning such a stock. If, on the other hand, the beta of a stock is zero, i.e. it does not fluctuate at all in sympathy with the rest of the stock market, the required return for such a stock will be exactly equal to the risk-free interest rate and no more. Given that MPT recommends diversification of individual stock risk, it is very likely that a prudent investor will invest in a portfolio of non-correlated stocks rather than in a single stock. To do this, the investor will have to calculate the overall beta of the portfolio using the weighted average of the individual stock betas. If the overall portfolio beta is much higher than 1, the portfolio carries a risk level higher than that of the stock market as a whole and is not suitable for an investor who is unable or unwilling to assume above average risk. Conversely, if the overall portfolio beta is much less than 1, the portfolio has relatively low risk and is unsuitable for an investor who is able and willing to assume above average risk.

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

27. *Policy Review*, *supra* note 2, at 73; *See* Poser, *supra* note 8, at 1495; Stuart D. Root, *Suitability – The Sophisticated Investor – and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287 (1991) [hereinafter Root] (discussing the Federal Securities laws and related rules that create an expectation that the broker will engage in practices that are fair and equitable to the investor and to the public). The article further states that "[even though] Congress has not addressed directly the circumstances under which broker-dealers should be obliged to provide suitable investments for customers, it has provided the statutory context within which the obligation has developed." *Id.* at 290.

1934.[28]

Rule 10b-5 makes it

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[29]

Rule 10b-5 is frequently utilized as a cause of action because

> [the] majority of "cases have denied the existence of a private remedy by an injured investor solely on the basis of violation of the applicable rule." But if the broker's actions in failing to recommend suitable securities can also be found to violate rule 10b-5, the general securities antifraud rule promulgated under section 10(b) of the Securities Exchange Act of 1934 . . . that might result in an award of damages against the broker.[30]

The end result is that Rule 10b-5 has is to make unsuitability claims on the basis that the broker made an untrue statement of a material fact or omitted to state a material fact necessary so that the information would not be misleading.[31]

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28. 15 U.S.C. § 78j(b) (2004).

29. 17 C.F.R. § 240.10b-5 (2004).

30. Donald Arthur Winslow & Seth C. Anderson, *Defining Suitability*, 81 KY. L.J. 105, 107-8 (1993) (citations omitted).

31. Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). For a more complete discussion of the use of Rule 10b-5 *see* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971); United States v. Russo, 74 F.3d 1383 (2d Cir. 1996); Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1993); Laird v. Integrated Res., Inc., 897 F.2d 826 (5th Cir. 1990); Bruschi v. Brown, 876 F.2d 1526 (11th Cir. 1989); Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983); Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977); Boettcher & Co., Inc. v. Munson, 854 P.2d 199 (Colo. 1993) (stating that the state statute is counterpart of Rule 10b-5); Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176 (Minn. 1994) (noting that the state statute is the counterpart of Rule 10b-5); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081 (1988) [hereinafter Fletcher].
There are related issues as well:

> Later federal cases, however, have adopted two alternative theories of liability in suitability cases. The first theory is that the broker misrepresented to his customer that the recommended security was suitable or (owing a duty to disclose) failed to disclose to the customer that the recommendation was unsuitable. The second theory is that the broker engaged in fraud by his conduct, because recommending a security to a customer with the knowledge that it is unsuitable, or with reckless disregard for its suitability, is an inherently deceptive act and constitutes a "device, scheme, or artifice

B. COMMON LAW CAUSES OF ACTION

Even though Rule 10b-5 is the most common basis for a suitability claim, common law causes of action are also frequently included in unsuitability suits.[32] This subsection will discuss some of the more commonly used causes of action, including breach of fiduciary duty, shingle theory, negligence, and common law fraud.

Breach of fiduciary duty is perhaps the most common and best developed common law basis for suitability claims.[33] Although the law differs from state to state in how it characterizes the relationship between a broker and a customer, the prevailing view is that where the customer places her trust and confidence in the broker, the broker owes the customer a fiduciary duty and that an unsuitable recommendation may be a breach of this duty.[34]

*Twomey v. Mitchum*[35] is the leading case on this issue. The *Twomey* court reasoned that "[t]he relationship between broker and principal is fiduciary in nature and imposes on the broker the duty of acting in the highest good faith toward the principal. . . . The duties of the broker, being fiduciary in character, must be exercised with the utmost good faith and integrity."[36] As one author states, "[t]he correct reading of the opinion in *Twomey* is that there is in all cases a fiduciary duty owed by a stockbroker to his or her customers; the scope of this duty depends on the specific facts and circumstances presented in a given case."[37] "At base, the existence of a fiduciary relationship is a factual question. It 'cannot be determined by

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> to defraud" the customer, or an "act, practice, or course of business which operates or would operate as a fraud or deceit" on the customer.

Poser, *supra* note 8, at 1538-39. *See also* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992) (discussing fraud by conduct); Katara v. D.E. Jones Commodities, Inc., 835 F.2d 966 (2d Cir. 1987) (discussing common law fraud).

32. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963)

33. *See, e.g., id.*; Laborers Nat'l Pension Fund v. N. Trust Quantitive Advisors, Inc., 173 F.3d 313, 315 (5th Cir. 1999); MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249 (10th Cir. 1989); Marchese v. Shearson Hayden Stone, Inc., 734 F.2d 414 (9th Cir. 1984); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2nd Cir. 1943); Rupert v. Clayton Brokerage Co., 737 P.2d 1106 (Colo. 1987); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508 (Colo. 1986); Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 396 S.W.2d 570, (Mo. 1965); Tschudy v. Amos C. Sudler & Co., 407 P.2d 877 (Colo. 1965).

34. Poser, *supra* note 8, at 1496.

35. 69 Cal. Rptr. 222 (Cal. Dist. Ct. App. 1968).

36. *Id.* at 236 (quoting Abrams v. Bendat, 331 P.2d 657, 661 (Cal. Dist. Ct. App. 1958); CHARLES H. MEYER, THE LAW OF STOCKBROKERS AND STOCK EXCHANGES AND OF COMMODITY BROKERS AND COMMODITY EXCHANGES 253 (Baker, Voorhis & Co. 1931).

37. Root, *supra* note 27, at 335.

recourse to rigid formulas.'"[38]

Breach of fiduciary duty has created a related cause of action, the shingle theory. The shingle theory is based on the logic that there are implied standards that a securities broker must meet as a professional when he or she hangs the proverbial "shingle" claiming to be a professional.[39] The shingle theory's professional standard of care is "shaped by assessments of broker conduct in relation to a baseline standard of fair dealing [for a professional]."[40] Simply put, the broker is held to the standard of a professional in that field.

The shingle theory's origin is in an early disciplinary case where the SEC ruled:

> the relation of a securities [broker] to his clients is not that of an ordinary merchant to his customers. Even apart from the relationship of agency [that] may exist, the status of a [broker] in relation to an uninformed client is one of special trust and confidence, approaching and perhaps even equaling that of a fiduciary.[41]

The essence of the shingle theory is a prohibition against a broker overreaching or taking unfair advantage through superior knowledge.[42] The shingle theory is not a standalone cause of action. Rather, the cases have raised it in conjunction with various other causes of action, such as the anti-fraud provisions of the Securities Laws and breach of fiduciary duty[43] and "[the] courts have variously identified the fiduciary duty of broker-dealers as arising out of the factual nature of the relationship, out of the strength of the agency created, or out of the implication that arises from the broker's hanging out a 'shingle.'"[44]

38. Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 118, 151 (S.D.N.Y. 2000) (quoting Scott v. Dime Sav. Bank of N.Y., 886 F. Supp. 1073, 1078 (S.D.N.Y. 1995)). *See also* Poser, *supra* note 8, at 1566 (discussing the factual issues relating to the existence of a fiduciary duty).

39. *See* Renee Barnett, Comment, *Online Trading and the National Association of Securities Dealers' Suitability Rules: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1101 (2000) ("The shingle theory is a common law principle stating that brokers make an implied representation to customers when they 'hang out a shingle' that they will deal with the customer fairly."). *See also* Poser, *supra* note 8, at 1550 ("The [shingle theory cause of action] arises from an implied representation made to the customer by the broker that he will act in the customer's interest, and that making an unsuitable recommendation violates that implied representation.").

40. Rapp, *supra* note 9, at 191.

41. William J. Stelmack Corp., 11 S.E.C. 601, 623 (1942).

42. *See* Duker & Duker, 6 S.E.C. 386, 389-90 (1939).

43. *See generally* Grandon v. Merrill Lynch & Co., 147 F.3d 184 (2d Cir. 1998); Banca Cremi, S.A. v. Alex, Brown & Sons, Inc., 132 F.3d 1017 (4th Cir. 1997); Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961).

44. Root, *supra* note 27, at 336 (citations omitted). *See* Merrill Lynch, Pierce, Fenner &

In addition to breach of fiduciary duty and its progeny, it seems logical that a common law cause of action for negligence[45] may exist when a stockbroker has failed to provide professionally responsible advice. However, negligence, like shingle theory, has not evolved into a separate federal cause of action "out of concern for flooding the courts with 'garden variety' actions against broker-dealers."[46] It has been raised in a few cases, but it is usually considered in the context of other legal rights.[47] However, some courts have considered the possibility that it may be a separate cause of action in a state claim.[48]

The claim of common law fraud may be raised as well. When using this cause of action every element of fraud must be proven,[49] including reasonable reliance, which is often the most difficult to prove.[50] Common law fraud may be included in unsuitability claims, but this area of the law has not yet been separately developed. As a result, common law fraud claims are often addressed as part of the totality of issues raised under Rule 10b-5.[51]

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Smith, Inc. v. Cheng, 697 F. Supp. 1224 (D.D.C. 1988); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2nd Cir. 1943); Duffy v. Cavalier, 264 Cal. Rptr. 740 (Cal. Ct. App. 1989); Twomey v. Mitchum, Jones & Templeton, Inc., 69 Cal. Rptr. 222 (Cal. Ct. App. 1968). *See also* Erlich v. First Nat'l Bank, 505 A.2d 220, 234-35 (N.J. Super. Ct. Law Div. 1984).

> A professional must exercise that degree of care, knowledge and skill ordinarily possessed and exercised in similar situations by the average member of the profession practicing in his field. . . . The Bank offered plaintiff professional investment advisory services. This was not merely a brokerage account. It is therefore the degree of care, knowledge and skill expected of professional investment advisers to which we must look for the standard of care. (citations omitted).

*Id.*

45. The commonly known elements of negligence are duty, breach, proximate causation, and injury. In this context, the source for duty is the claim that the broker is a professional and must meet professional standards, breach is based on the fact that the recommendations were not suitable for the investor profile of that particular portfolio, proximate cause is present because it is reasonably foreseeable that by making unsuitable recommendations for that investor's portfolio damages (injury) could occur.

46. Root, *supra* note 27, at 331; *see also* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir. 1966).

47. *See id.; see also* Grandon v. Merrill Lynch & Co., 147 F.3d 184 (2d Cir. 1998); *Banca Cremi, S.A.*, 132 F.3d at 1017; *Hanly*, 415 F.2d at 589; *Kahn*, 297 F.2d at 112; Piper, Jaffray & Hopwood Inc. v. Ladin, 399 F. Supp. 292 (S.D. Iowa 1975).

48. *See* Kwiatkowski v. Bear Stearns & Co., 126 F. Supp. 2d 672, 677 (S.D.N.Y. 2000).

49. "The elements of common law fraud are a material, false representation, an intent to defraud thereby, and reasonable reliance on the representation, causing damage to the plaintiff." Katara v. D.E. Jones Commodities, Inc., 835 F.2d 966, 970-71 (2d Cir. 1987). Each element must be established by clear and convincing evidence.

50. *See* Poser, *supra* note 8, at 1540-42.

51. For an example of a case that does not clearly distinguish between common law fraud and the requirements of Rule 10b-5 *see* Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978). For a discussion of common law fraud and the fact that it has not been clearly and

In addition to the primary causes of action discussed above, stockbrokers may trigger related causes of action when providing professional advice. The most readily available, assuming there was a written agreement between the broker and investor, is a claim for breach of contract.[52] While all contracts differ, some content may be uniform within the industry because "[w]ritten customer agreements governing account relationships are common, and most incorporate the constitutions, by-laws, rules and regulations of SROs in regard to all transactions, thus providing for compliance with the various suitability rules."[53]

If the broker's actions affect interstate commerce, he may be subject to civil liability under the Racketeer Influenced Corrupt Organization Act (RICO).[54] In *Laird v. Integrated Resources, Inc.*,[55] the plaintiffs alleged four predicate acts including misrepresentation and/or failure to disclose under rule 10b-5[56] to support a RICO claim.[57] The court ruled that "Rule 10b-5 violations are predicate acts under RICO."[58] The court remanded the case to the district court and directed that the RICO claim must be reassessed by considering evidence of the broker's alleged misrepresentations, evidence of his disclosures and his status as a fiduciary and measure the adequacy of his disclosures against these and any other relevant factors.[59]

### C. THE SUITABILITY CAUSES OF ACTION MAY BE DIFFICULT TO PROVE

The above are some of the various causes of action that may be

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separately established *see* Root, *supra* note 27, at 336-37. *See also* Matthew J. Benson, *Online Investing and the Suitability Obligations of Brokers and Broker-Dealers*, 34 SUFFOLK U. L. REV. 395 (2001).

52. Of course, any claim for breach assumes that there was an existing contract provision and that the broker breached it in a material manner.

53. Rapp, *supra* note 9, at 227.

54. 18 U.S.C.S. § 1961 (2004). *See* 18 U.S.C.S. § 1964(b) (2004), for the civil liability provision. *See also* 18 U.S.C.S. § 1962(a)-(c) (2004), for the interstate commerce provision.

55. 897 F.2d 826 (5th Cir. 1990).

56. *Id.* at 838 (the predicate acts included: "(1) misrepresentation and/or failure to disclose under rule 10(b)-5; (2) churning; (3) mail fraud; and (4) wire fraud"). *See also* Smith v. Ayres, 845 F.2d 1360, 1366 (5th Cir. 1988); James v. Meinke, 778 F.2d 200, 204 (5th Cir. 1985); Youmans v. Simon, 791 F.2d 341, 347 (5th Cir. 1986).

57. In order to fall within RICO the plaintiff must show the commission of two or more acts constituting a pattern of racketeering activity, directly or indirectly invested in, maintained an interest in, or participated in, an enterprise, the activities of which affected interstate or foreign commerce. *See* § 1962(a)-(c).

58. Laird v. Integrated Res., Inc., 897 F.2d 826, 838 (5th Cir. 1990). *See also* Harner v. Prudential-Bache Sec., 35 F.3d 565 (6th Cir. 1994); Montesano v. Seafirst Commercial Corp., 818 F.2d 423 (5th Cir. 1987).

59. *Id.*

brought in a suitability claim. The authors would be remiss if we did not also address at least two primary difficulties inherent in these causes of action, scienter,[60] and reasonable reliance.

1. The Issue of Scienter

The initial consideration with using Rule 10b-5 as a cause of action is that the person (stockbroker) failing to make the material statement, or omitting it, must act with "scienter"[61] or, as some other cases have stated, with reckless disregard for the truth.[62] Even though the "scienter" requirement has been relaxed to "recklessness" in many jurisdictions, it remains a difficult hurdle to overcome.[63] To have an opportunity to recover in a private cause of action under Rule 10b-5, a plaintiff must initially show two things: that "there was a material misrepresentation or omission and that this misrepresentation or omission was made with scienter," defined as "with intent to deceive, manipulate or defraud."[64] Phrased differently, a Rule 10b-5 cause of action must first address whether the broker failed to recommend suitable securities based on the investor profile due to a material misrepresentation or omission. If that element is met, then the trier of fact must determine whether the broker acted either knowingly or with reckless disregard for the fact that they were not suitable for that

60. "Scienter" is "[a] mental state consisting in an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 1373 (8th ed. 2004).

61. The basis for this requirement originated in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See also* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020 (2d Cir. 1993); O'Connor v. R.F. Lafferty & Co., 965 F.2d 893 (10th Cir. 1992); Backman v. Polaroid, 910 F.2d 10 (1st Cir. 1990); Bruschi v. Brown, 876 F.2d 1526 (11th Cir. 1989); Zobrist v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983); Clark v. John Lamula Investors, Inc., 583 F.2d 594 (2d Cir. 1978); Dupuy v. Dupuy, 551 F.2d 1005 (5th Cir. 1977).

62. *See, e.g.*, Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir. 1977); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2nd Cir. 1973); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971); Profilet v. Cambridge Fin. Corp., 231 B.R. 373, 380 (Bankr. S.D. Fla. 1999); First Union Disc. Brokerage Serv., Inc., v. Milos, 744 F. Supp. 1145 (S.D. Fla. 1990); Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg, 660 F. Supp. 1362 (D. Conn. 1987) (defining "reckless conduct" as an extreme departure from the standards of ordinary care).

63. However, there are a few cases that have used section 12(2) of the Federal Securities Act of 1933 as a basis for an unsuitability claim. The benefit of using section 12(2) is that scienter is not required to violate this section. *See, e.g.*, *O'Connor*, 965 F.2d at 899; MidAmerica Fed. Sav. & Loan Ass'n v. Shearson, 886 F.2d 1249, 1256 (10th Cir. 1989) ("[I]t is a firmly entrenched principle of § 12(2) that the 'availability elsewhere of truthful information cannot excuse untruths or misleading omissions' by the seller."); Sanders v. John Nuveen & Co., Inc., 619 F.2d 1222, 1229 (7th Cir. 1980). Without scienter, all that is needed to prevail is a showing that unsuitable recommendation/purchases were made by the broker.

64. *Clark*, 583 F.2d at 600 (citing *Ernst & Ernst*, 425 U.S. 185 for the proposition that scienter is required); *see Brown*, 991 F.2d 1020 (2d Cir. 1993); Poser *supra* note 8, at 1537.

investor's portfolio.[65] Scienter is essential to a Rule 10b-5 cause of action.

A common law fraud action is analogous because one of the elements is that the material misrepresentation or omission be made "knowingly." As already defined, "scienter" means "knowingly." Therefore, under both Rule 10b-5 and common law fraud, a plaintiff must prove that the broker acted with knowledge or reckless disregard for the truth. Thus, a plaintiff may have difficulty establishing scienter and even more difficulty proving that he or she reasonably relied on the broker's actions.

2. Reasonable Reliance

Reasonable reliance by the investor is at issue when the basis for the lawsuit is Rule 10b-5 or common law fraud. In those situations, the question of whether the investor's reliance on the broker's advice was reasonable depends upon several factors. This subsection examines four of those factors: The sophistication of the investor, discretionary[66] versus non-discretionary[67] account status, the existence of relationships between the broker and the investor, and the investor's access to relevant information when making purchase decisions.

The investor's sophistication is a factor both in deciding the question concerning the degree of trust that he or she placed in the broker's advice[68] and the degree of duty owed by the broker to the investor.[69] To fully

65. Suitability is then determined by using MPT.

66. A discretionary account is "[a]n account that allows a broker access to a customer's funds to purchase and sell securities or commodities for the customer based on the broker's judgment and without first having to obtain the customer's consent to the purchase or sale." BLACK'S LAW DICTIONARY 479 (7th ed. 1999).

67. A non-discretionary account is "[a]n account over which the broker was not formally granted by the customer sole authority to make trading decisions." Bowley v. Stotler & Co., 751 F.2d 641, 644 (3d Cir. 1985).

68. *See* Dennis J. Block & Jonathan M. Hoff, *Suitability Standards for Sophisticated Investors*, N.Y. L.J. 5 (Feb. 19, 1998) [hereinafter Block & Hoff] (stating, "[w]hile the courts have made clear that the securities laws afford all investors protection against fraudulent conduct, the suitability analysis inherently requires consideration of the relative sophistication and experience of the customer.").

69. *See, e.g.*, Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978). Of course the precise manner in which a broker performs these duties will depend to some degree upon the intelligence and personality of his customer. For example, where the customer is uneducated or generally unsophisticated with regard to financial matters, the broker will have to define the potential risks of a particular transaction carefully and cautiously. Conversely, where a customer fully understands the dynamics of the stock market or is personally familiar with a security, the broker's explanation of such risks may be merely perfunctory. *Id. See* Duffy v. Cavalier, 264 Cal. Rptr. 740, 742 (Cal. Ct. App. 1989) (holding that a fiduciary duty exists in every broker-customer relationship, but that the scope of this duty will depend on the facts of the case); Rupert v. Clayton Brokerage Co., 737 P.2d 1106 (Colo.

understand investor sophistication, we must understand that there are "sophisticated investors" and "investors with sophistication." There is a fundamental and enormous difference between the two. For purposes of this article, "sophisticated investors" are investors who have sufficient expertise in investing to understand and appreciate the risk posed by a single security within the context of their entire portfolio. The term "investors with sophistication" means investors who are, simply, well educated, wealthy and have an investment record. The former may truly be "sophisticated" for purposes of investing and may not need to trust or rely on the actions of their broker, where the latter may largely be at the mercy of their brokers.[70]

Investor sophistication is a central issue in all of the discussed suitability causes of action, although it arises in different ways. As an example, in a Rule 10b-5 claim "[s]ophistication . . . often reduces an investor's ability to show reasonable reliance. As a result, a sophisticated investor often faces a more difficult task of establishing causation under Rule 10b-5 than an unsophisticated one faces."[71] In a common law fraud claim the plaintiff must specifically prove that his or her reliance was reasonable.[72] There, the issue of sophistication goes to the element of reasonable reliance because what reliance is "reasonable" depends upon the level of sophistication of the investor.[73]

While sophistication is clearly an important factor in determining

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1987). *See also* Shorrock v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 72-24, 1977 U.S. Dist. LEXIS 12872 (D. Or. 1977); Weiser v. Shwartz, 286 F. Supp. 389 (E.D. La. 1968); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968); Root, supra note 27; Poser, *supra* note 8. *But see Duffy*, 264 Cal. Rptr. at 751 (discussing the law in California and concluding that "Twomey remains the controlling statement of the law applicable to this case. Contrary to appellants' position, the relationship between a stockbroker and his or her customer is fiduciary in nature; the distinction between a 'sophisticated' investor and an 'unsophisticated' one is not controlling in this regard.").

70. Of course, some types of securities are very difficult to understand, and even the otherwise sophisticated investor may not fully understand the risks involved. *See* Poser, *supra* note 8, at 1508 ("During recent years a plethora of novel and highly complex securities have come to the market."). Further, "'[s]ophistication,' as that term is used in the investment law, should never be confused with intelligence, prudence or good luck.'" West Virginia v. Morgan Stanley & Co., 459 S.E.2d 906, 913 (W. Va. 1995). Therefore, ultimately, there must be evidence as to exactly what the investor was "sophisticated" about.

71. Fletcher, *supra* note 31, at 1090. The article also provides a comprehensive discussion of the problems that sophisticated investors have demonstrating reasonable reliance. *See id.* at 1086-95. *See also* Hirsch v. Du Pont, 553 F.2d 750, 762-63 (2d Cir. 1977).

72. *See, e.g.*, Renner v. Chase Manhattan Bank, N.A., No. 03-7319, 2004 U.S. App. LEXIS 144 (2d Cir. 2004); Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc., 343 F.3d 189 (2d Cir. 2003).

73. *See generally id. See also* Rissman v. Rissman, 213 F.3d 381 (7th Cir. 2000).

whether an investor's reliance was reasonable, it is sometimes difficult to determine precisely how important it will be.[74] For an investor to purchase or agree to a recommendation that investor must know the "true state of affairs [concerning investment risks]."[75] So, evidence that the investor does not, or cannot, fully understand the principles of MPT may be very helpful to rebut a simple argument that the investor is knowledgeable about investments (i.e. a "sophisticated investor").[76]

Even when sophistication exists, it is not an absolute bar to recovery. The Third Circuit has held that

> [A] sophisticated investor is not barred (from) reliance upon the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced. Integrity is still the mainstay of commerce and makes it possible for an almost limitless number of transactions to take place without resort to the courts."[77]

The Second Circuit has been equally clear stating

> even sophisticated investors deserve the protection of the securities laws, including protection from intentionally or recklessly fraudulent conduct by securities salesmen: [A] salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. . . . The fact that his customers

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74. *See, e.g.*, Banca Cremi, S.A. v. Alex, Brown & Sons, Inc., 132 F.3d 1017, 1028-29 (4th Cir. 1997) (holding that "[no] single factor is dispositive of whether reliance is justified. [However] the sophistication of the investor has long been a critical element in determining whether an investor was entitled to section 10(b) relief."); Nye v. Blyth Eastman Dillon & Co., 588 F.2d. 1189, 1197 (8th Cir. 1978) (holding that "[t]he sophistication of the appellees is not sufficient, in and of itself, to preclude recovery. It is only one factor to be considered in determining the overall reasonableness of their reliance on the information in making an investment decision."). *See also* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 516 (10th Cir. 1983) (listing several "relevant factors" to use in determining whether reliance was reasonable):

> (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality of specificity of the misrepresentations (citations omitted).

*Id.*

75. *Nye*, 588 F.2d at 1197.

76. As simplistic as this may seem, one of the things that the plaintiff's counsel should focus on when their client could be considered sophisticated is that the professional (the broker) was hired precisely because the client thought that person was a professional and, accordingly, had insight and/or information that the client did or could not. For example, professionals frequently hire lawyers and physicians for advice and help in specialized areas, even though those consumers are also arguably "sophisticated" in their respective fields. Sophistication is not a generic principle, it is specific. The difference is one of being able to see the trees versus the forest; did this investor know about the risk characteristic of the portfolio instead of just the risk characteristics of that particular investment?

77. AES Corp. v. Dow Chem. Co., 325 F.3d 174, 182 (3d Cir. 2003).

may be sophisticated and knowledgeable does not warrant a less stringent standard.[78]

Sophisticated investors are not *per se* excluded from being successful in an unsuitability claim. They must just be able to overcome hurdles in their causes of action,[79] including the element of "reasonable reliance." The fact is that both sophisticated and unsophisticated investors enjoy protection from fraudulent conduct by brokers.[80]

When investors establish accounts with their brokers the accounts are classified as "non-discretionary" or "discretionary." Account classification is a major factor when assessing reasonable reliance under Rule 10b-5 claims or common law fraud claims and in determining the degree of trust in a breach of fiduciary duty or a negligence claim.

A non-discretionary account exists when the broker lacks the authority to buy and sell for the account of the investor.[81] In a non-discretionary account, the broker is an advisor and the investor makes his

78. Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); Lehigh Valley Trust Co. v. Central National Bank, 409 F.2d 989, 992 (5th Cir. 1969); *see generally* Poser, *supra* note 8, at 1523; Fletcher, *supra* note 31, at 1088 (discussing sophisticated investors and the standard of protection they deserve). However, Fletcher also identifies a study of cases involving investor sophistication, the federal courts' treatment of investor sophistication reflects a doctrine in disarray. "[I]nconsistency in approach necessarily leads to inconsistent judicial treatment of sophisticated investors under Rule 10b-5." *Id.*

79. *See, e.g.*, *Hanly*, 415 F.2d at 596 (the investors prevailed); *Nye*, 588 F.2d, at 1189 (the investors prevailed); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 520 (Colo. 1986) (the investor prevailed); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976) (the plaintiff, even though sophisticated, prevailed due to the close relationship between him and the defendant, which made his reliance reasonable); Duffy v. Cavalier, 264 Cal. Rptr. 740, 756 (Cal. Ct. App. 1989) (the investors prevailed). *See also AES*, 325 F.3d at 184 (court overruled a grant of a motion for summary judgment on some other issue, but quoted, with approval that a sophisticated investor deserves protection); West Virginia v. Morgan Stanley & Co., 459 S.E.2d 906, 921 (W. Va. 1995) (reversing the granting of a motion for summary judgment, but did state that sophistication is not a bar, by itself, for recovery). *But see* Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1520 (10th Cir. 1983) (the investors did not prevail because there was a prominent notice of the risk on the prospectus and they where sophisticated investors); Westcap Enter. v. City Colleges, 230 F.3d 717, 733 (5th Cir. 2000) (the investor did not prevail on appeal because they were sophisticated enough to fully understand the risks); *Banca Cremi*, 132 F.3d at 1028-29 (the investors did not prevail, but the court did recognize that sophistication is only one factor); McAnally v. Gildersleeve, 16 F.3d 1493, 1501 (8th Cir. 1994) (the investors did not prevail, they were sophisticated and continued to trade after they were made aware of the risks, however, the court said that a person's sophistication in stock and bonds does not mean that the person has sophistication in commodities futures options).

80. *See generally* Duker & Duker, 6 S.E.C. 386, 389-90 (1939). *See also* Block & Hoff, *supra* note 68, at 5 (stating that courts have generally held that sophisticated institutional investors and money managers are entitled to the same protection under the federal securities laws as unsophisticated retail customers and that a customer's knowledge and experience should not be employed as a shield against fraudulent conduct).

81. BLACK'S LAW DICTIONARY 205 (8th ed. 2004).

or her own decision as to whether or not to buy or sell.[82] In a discretionary account, the broker has the authority to buy and sell for the investor's account and may give advice or make recommendations.[83] There are two ways for a broker to have discretionary authority: Express and implied. The broker has express authority when the client has clearly given the broker the authority to buy and sell for the account without consulting with the client. Implied authority exists when the "customer is unable to evaluate his recommendations and to exercise an independent judgment"[84] as to whether to buy or sell for the account. This is also known as *de facto* control.[85]

Account status and investor sophistication can easily become intertwined. Reasonable reliance is easier to establish when the broker has clearly expressed discretionary authority because the broker is advising, buying and selling, as opposed to merely advising. When the issue is whether or not a broker had implied discretionary authority, issues of client sophistication can become complex because a sophisticated client presumably has more ability to evaluate the recommendations by the broker and then exercise independent judgment about the investment potential. When a sophisticated investor is involved, it is not enough to show that the client virtually always followed the broker's recommendation. It is most important to look at whether the client had the capacity to independently evaluate the recommendation and to genuinely make a decision of "yes" or "no."[86] When there is an implied discretionary account, the court must look at the entire relationship of the client and the broker, not just one aspect.[87] Courts have established a few non-exclusive factors to examine in regard to whether there is an implied discretionary account:

> In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, old, or naive with regard to financial matters, the courts are likely to find that the broker assumed control over the account. Second, if the broker is

82. *Id.*

83. *Id.* at 499.

84. Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677 (9th Cir. 1982) ("The touchstone [of whether the broker controls the account] is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable.").

85. *See* Poser *supra* note 8, at 1552.

86. *See Follansbee*, 681 F.2d at 677.

87. *See, e.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, 906 F.2d 1206 (8th Cir. 1990); Baker v. Wheat First Sec., 643 F. Supp. 1420 (S.D. W.Va. 1986).

socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence.[88]

Account status may be an important factor in any cause of action brought against a broker because the broker may assert "ratification"[89] as a defense and argue that the client retained control of decisions and action. However, when the client ratified a purchase but did not understand how that purchase fit into the portfolio, that client had given up control to the broker. Even in a non-discretionary account when the broker makes a recommendation, the broker should have a continuing responsibility to provide additional information to the client as to how that security will fit into the profile for that investor.

The investor in a discretionary account may be sophisticated enough to understand and research a particular security, but the fundamental question is: Was the client sophisticated enough to genuinely understand how that new security fits into her investor profile? If the broker does not provide sufficient information to the client to answer that question, it could still be argued that there was implied discretion because the information was not provided; therefore the client could not fully ratify the investment. Ratification requires full knowledge, not partial knowledge, of the situation.[90] If the issue in a non-discretionary account is whether the client ratified the recommendation of the broker, facts must be developed to show that there could not have been ratification. This is because the broker did not provide complete information as to how this new security would fit into the portfolio and how that inclusion would meet the client's investor profile. Absent such evidence, the client could not ratify the purchase even if the client was sophisticated about gathering and using information about each individual security.

In addition to sophistication and account status, another important factor to consider when determining reasonable reliance is the existence of

88. Fletcher, *supra* note 31, at 1103.

89. "Ratification is the affirmation by a person of a prior act which did not bind him but which was done or professedly done on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him." RESTATEMENT (SECOND) OF AGENCY § 82 (1957).

90. This is a long established tenet of law. *See, e.g.*, United States v. Beebe, 180 U.S. 343, 354 (1901) ("Knowledge of the facts is the essential element of ratification, and must be shown or such facts proved that its existence is a necessary inference from them."); Harbert/Lummus Agrifuels Projects v. United States, 142 F.3d 1429 (Fed. Cir. 1998); Hager v. Gibson, 108 F.3d 35 (4th Cir. 1997); Warner v. Central Trust Co., 865 F.2d 262 (6th Cir. 1988); Parkerson v. Borst, 264 F. 761 (5th Cir. 1920); Chicago, R. I. & P. R. Co. v. Chickasha Nat'l Bank, 174 F. 923 (8th Cir. 1909).

a longstanding business or personal relationship between the investor and broker. Such a relationship may create a sense of trust that causes the investor to be less vigilant than he or she would be otherwise.[91] At least one court has held that reasonable reliance may be triggered by the existence of a personal relationship when the investor is not exercising independent judgment because of the trust and confidence he or she has in the relationship with the advisor.[92]

A final factor in determining reasonable reliance is access to relevant information.[93] Again, this factor is considered but it is not determinative.[94] At least one author has argued that brokerage firms have a distinct advantage "over their customers with respect to access to information"[95] perhaps because some information is not as readily available to the public as it is to brokers.[96]

There are a variety of suitability causes of action that a plaintiff may bring. However, even the best developed causes will pose difficulties due to scienter and the multitude of separate concerns within reasonable reliance. Judges and juries are unlikely to have sufficient substantive knowledge to understand the legality or illegality of a broker's actions.

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91. *See, e.g.*, Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976). The plaintiff was an attorney and accountant who had access to the relevant corporate books and records. On the basis of misrepresentations by a close business and personal friend, the plaintiff sold his stock in the corporation without first examining the books and records. The divided court concluded that plaintiff's reliance was justified, despite his sophistication and failure to investigate, because the defendant had carefully cultivated the plaintiff's trust and confidence over a long period of time and then used that trust to encourage the sale. However, it must also be noted that the court found that review of the books and records would not have reveled defendant's deception.

92. *See generally* AES Corp. v. Dow Chem. Co., 325 F.3d 174 (3d Cir. 2002).

93. *See* Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993), which states:

> (1) The sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of longstanding business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

*Id.*

94. *See, e.g.*, *Nye*, 588 F.2d at 1197 ("[T]he information provided . . . is only an additional factor to be weighed in making a finding of reasonable reliance.").

95. Poser, *supra* note 8, at 1527.

96. *Id.* The author also lists some factors such as "the concealment of the fraud" or "the opportunity to detect the fraud" may also be at issue in suitability claims. *Id.* at 1541. The investor's inability to detect fraud may be due to the skill, knowledge and training of the broker. Brokers' income comes from sales and they may learn sales techniques that help overcome reluctance and other factors. *Id.* at 1523. Additionally, an investor may not be able to detect the misrepresentation because the transactions involve unique securities. "Take, for example, a well-prepared broker who pitches an exotic, customized interest rate swap to a corporate treasurer . . . it is unlikely that her knowledge or understanding extends to such a unique product." *Id.* at 1512.

The role of the expert witness in clarifying these issues is very important.

## III. THE ROLE OF THE EXPERT WITNESS

Several recent cases[97] and the Federal Rules of Evidence have expanded the role of the expert witness significantly. A person may become an "expert" through "knowledge, skill, experience, training, or education . . . ."[98] An expert witness may testify to "scientific, technical, or other specialized knowledge that will assist the trier of fact to understand the evidence or to determine a fact in issue . . . ."[99] An expert in a suitability case may be used to testify on a variety of issues. In this section, we will discuss expert testimony regarding the responsibility of the broker to make sure that a client investment profile has been created, the suitability of the securities in the investment portfolio based on the investor profile and MPT, and the level of sophistication of the investor (including the content and timing of such sophistication).

### A. EXPERT TESTIMONY AND MODERN PORTFOLIO THEORY

The level of risk that each investor is willing to take is determined by an "investor profile." Every broker must complete such a profile pursuant to Rule 2310[100] or similar suitability rules. The purpose is simple, yet vital:

> The construction of an investment portfolio is dictated by investor goals or, more precisely, a return objective. The process of identifying a return objective is independent of that which produces the most efficient asset mix designed to achieve it. . . . [T]he former is central to understanding and assessing the stockbroker's suitability obligation in making investment recommendations.[101]

This step is very important and an expert can testify to what the investor's profile should have been in situations where the broker did not create one. Questions for the expert witness in this area may focus on whether the broker has adequately identified an investment objective by obtaining all relevant information from the customer so that the broker is

97. *See, e.g.*, Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999); Gen. Elec. Co. v. Joiner, 522 U.S. 136 (1997); Daubert v. Merrell Dow, 509 U.S. 579 (1993).

98. FED. R. EVID. 702.

99. *Id.*

100. NASD Conduct Rules, 2310: Recommendations to Customers (Suitability), (Amended May 2, 1990 eff, for accounts opened and recommendation made after Jan. 1, 1991; amended by SR-NASD-95-39 eff, Aug. 20, 1996), *available at* http://www.cchwallstreet.com/nasd/nasd.asp?print=1&printnode=3.35&SelectedNode=3&FileName=/nasd/nasd_rules/RulesoftheAssociation_mg.xml (last visited Oct. 15, 2004).

101. Rapp, *supra* note 9, at 252.

able to ascertain risk and return parameters that are consistent with the customer's financial profile/investment profile.[102]

It may also be the case that a profile was initially created but the broker has not kept it current as the client's needs changed. When that occurs, the expert witness would be used to testify as to how the client's investment profile should have been updated based on the changed conditions. The expert will do that by reviewing all of the information about the client that is available[103] and drawing a conclusion as to what the profile should have been had the broker exercised due diligence.

If an investor profile does exist and is kept current, or after the profile is "created" by the testimony of the expert witness; the next role of the expert is to testify in regard to the suitability of a stock recommended or purchased for that profile. The professional, under MPT, must diversify an investor's account across non-correlated investments so as not to expose the portfolio to individual stock risk. The broker must ensure that the investor's risk profile is given due consideration in terms of the beta of the portfolio. The most common violations by a broker are recommendations or purchases of securities that are not suitable for an investor's stated risk level because the broker is required to create and maintain a suitable portfolio for each particular investor. The broker could violate this requirement in a discretionary account by not purchasing the appropriate securities. In a non-discretionary account the broker could violate this requirement by not recommending the appropriate securities when the client is not sophisticated enough to understand all aspects of securities and MPT. In a case where the account is non-discretionary and the client is arguably sophisticated, the broker can violate this requirement by not explaining the impact of each recommendation, in light of the portfolio and MPT, when the client is not truly sophisticated enough to understand the

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102. *See id.* at 272.

103. *See* FED. R. EVID. 703:

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert's opinion substantially outweighs their prejudicial effect.

*Id.* Pursuant to FED. R. EVID. 703, the expert, prior to testifying, may be provided with a copy of what the broker prepared, materials demonstrating how the broker maintained the profile, and other pertinent information to the broker's duty to maintain a suitable portfolio. *See also* United States v. Avants, 367 F.3d 433 (5th Cir. 2004) (holding that experts are allowed to review information from a large variety of sources).

ramifications of each transaction.[104]

The expert witness' testimony regarding diversification will focus on the above facets because "[w]ith MPT, suitability of a broker's recommendation is defined entirely in the context of a portfolio."[105] Some lines of questioning for the expert witness in this area could be:

> 'In your opinion, were the broker's recommendations made with the purpose of the creation of, or the contribution to, the performance of the investment portfolio, so that it is balanced as to the risk and the return parameters to reasonably enhance the efficiency of this particular portfolio based on the investor's profile?'[106] At this point the expert needs to demonstrate his/her belief based on the statistical analysis that the expert used to reach that conclusion.
>
> Is there a reasonable basis for the broker believing that this recommendation would enhance the efficiency of this portfolio, or should the broker have been aware of any information that would give the broker reasonable grounds to believe that the risk/return characteristics of this particular recommendation would not have a reasonable likelihood of enhancing the efficiency of this portfolio?[107]

The expert would then demonstrate what facts the broker should have been aware of at the time of the recommendation and that the broker either was not aware of or did not use those facts when making the recommendation.[108]

Under MPT, a broker must take care to diversify a portfolio and to minimize individual stock risk based on the entire investor profile. This means that regardless of whether the investor profile is high risk or very conservative, the broker must diversify the portfolio so that the risk of losing everything is reduced as much as possible. Even if the investor's risk tolerance is high, there is no justification under MPT to assume

104. *See, e.g.*, Follansbee v. Davis, Skaggs & Co., 681 F.2d 673 (9th Cir. 1982); *Nye*, 588 F.2d at 1189; Poser, *supra* note 8, at 1508.

105. Rapp, *supra* note 9, at 261.

106. *See id.* at 272.

107. *See id.* at 272-73.

108. Counsel needs to establish the degree of certainty for every expert opinion. An example would be: "Do you have an opinion to a reasonable degree of certainty that the portfolio for this investor was not appropriate based on the investor's investment profile?" *See* Richard Collin Mangrum, *Interpreting Nebraska Rule of Evidence 702 After the Nebraska Supreme Court Adopted the Federal Daubert Standard for the Admissibility of Expert Testimony in Schafersman v. Agland Corp.*, 35 CREIGHTON L. REV. 31, 39 (2001) [hereinafter Mangrum]. Even though the courts don't require "magic words" the statement that the expert is reasonably certain is important information to the fact finder. In addition, while the specific prefatory words to an expert's opinion are not magical, neither are they insignificant. "An expert opinion couched in terms of mere possibility, as compared with probability or certainty, provides an insufficient basis for admitting expert testimony." *Id.*

unnecessary risk by over-concentrating in one stock or a set of stocks that seem to move in unison or are otherwise highly positively correlated to the market as a whole. Diversification of risk is a pre-requisite for all prudent investors regardless of their risk profiles. If the investor's risk tolerance is high, he or she can be expected to assume higher non-diversifiable systematic risk[109] given by higher beta[110] stocks. On this issue, the general role of the expert will be to testify as to whether diversification was proper based on a statistical analysis.[111] Using MPT, the expert will testify in regard to the following:

> Whatever the general risk preferences of the investor, within a diversified portfolio there should be both risky and risk-free investments. Through diversification, the portfolio eliminates the non-systematic risks of component securities and leaves only an identifiable, but accepted, level of systematic risk associated with the expected return of the portfolio. . . . Conversely, such a portfolio will have the minimum risk at the desired level of expected return.[112]

"In selecting the risky and risk-free investments, the trick is not matching particular asset types (whatever their risk class) to an investor,

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109. Systematic risk is the risk associated with the stock market as a whole. Systematic risk affects the entire stock market, so it cannot be diversified away. Systematic risk does not consider the risk associated with a single stock, that risk is unsystematic risk.

110. As previously discussed, the beta of a stock measures the correlation of a given stock with the stock market as a whole. A stock with a beta of 1 would indicate that a 10% move in the overall stock market is accompanied by a 10% move in the price of the stock. A beta of -1 would imply that a 10% move in the overall stock market is accompanied by a -10% move in the price of the stock in question.

111. The broker's suitability obligation does not rest on intuition, it rests on a formal statistical process. The first task for the expert is to undertake a correlation analysis between stocks in the portfolio to determine the extent to which diversifiable, or unsystematic risk, has been diversified away. If the correlation between any two stocks in the portfolio is close to +1, the portfolio has not satisfied the basic pre-requisite of diversification and represents high unsystematic risk. The next step for the expert is to decompose the total investment loss suffered by the investor into: (a) loss resulting from unsystematic risk, or loss resulting from a lack of diversification, and (b) loss resulting from taking on above average market risk, given by a portfolio beta in excess of 1. If the portfolio beta is equal to 1, the loss suffered by the investor should equal that suffered by the stock market as a whole, typically represented by the Standard and Poor's (S&P) index of 500 stocks. If the portfolio beta exceeds 1, the overall systematic risk of the portfolio is greater than that of the stock market as a whole and the magnitude of the permissible loss due to adverse market conditions depends on the extent to which the portfolio beta exceeds 1. For example, if the portfolio beta is 1.50, this represents a 50 percent higher exposure to systematic market risk resulting in a 50 percent higher investment loss as compared to that suffered by the stock market as a whole. Hence, if the market has suffered a 10% loss, the investor with a portfolio beta of 1.50 should have suffered a 15% loss. Any loss exceeding 15% is due to the failure to diversify and is clearly a violation of the first pre-requisite of the guidelines of modern portfolio theory.

112. Rapp, *supra* note 9, at 249-50 (citing JACK CLARK FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT 236 (5th ed. 1991).

but rather identifying the appropriate level of risk and return for that investor."[113] "What has the greatest practical significance in suitability analysis is the fact that 'risky' securities may be absolutely 'suitable' investment recommendations . . . for stereotypically 'conservative' investors."[114] "[A] broker's suitability responsibility may actually compel recommendations that conventional, transaction-oriented thinking would abhor."[115]

> An important task for the investment professional is measuring the risk associated with the asset and its effect on the risk level of the portfolio. This is a two-part inquiry: (1) estimate the beta of the security, and (2) estimate the correlation between such security and the rest of the portfolio (which is referred to as the 'correlation coefficient'). Generally speaking, the relationship between risk and return is linear and 'investors are rewarded for bearing systematic risk.[116]

An accurate determination of beta is the most important single element in predicting the future behavior of a portfolio.[117]

Although [beta] is the product of arcane analysis of historic data, beta information for large numbers of traded securities is easily accessed by investors and investment professionals alike."[118] Reducing risk, while maintaining return, is the obvious goal of investing. "Retail stockbrokers have the resources to make, or at least fairly estimate, the needed determinations in regard to particular recommendations."[119]

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113. *Id.* at 250 (citing Seth C. Anderson & Donald Arthur Winslow, *Defining Suitability*, 81 KY. L.J. 105, 108-9 (1992-93)).

114. *Id.* (citing Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 103 (1990)).

115. *Id.*

116. *Id.* at 251 (citing ROBERT L. HAGIN, THE DOW JONES-IRWIN GUIDE TO MODERN PORTFOLIO THEORY 179 (1979)).

117. One method of estimating beta is through the use of "relative response coefficients." Essentially, this estimates the effects that certain macroeconomic events have on the security's price, as compared to the effect on the market as a whole. Note, however, that relative response coefficients fluctuate over time; likewise, a security's beta is ever-changing. *See* M. E. Blume, *Betas and Their Regression Tendencies*, J. FIN. 30 (June, 1975).

118. Rapp, *supra* note 9, at 251-52. Once a security's beta is known, its correlation coefficient needs to be considered. While the expected return of a portfolio is just the average of the weighted sums of the expected returns of individual investments, a portfolio's risk is not necessarily the average of the weighted sums of the investments' risks. In other words, suppose an investor has two securities with high betas but the securities are negatively correlated, meaning that when one goes up the other one generally goes down. The risk of the entire two-security portfolio, disregarding nonsystematic risk for the moment, would be substantially less than the sum of the two securities. *See* J. ELTON ET. AL., MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS (1981).

119. *Id.* at 251-52.

The final area an expert can testify to is investor sophistication. As previously discussed, sophistication is a fundamental issue in many suitability claims. Under Rule 10b-5 or a common law cause of action, sophistication is related to the investor's reasonable reliance. When a claim is based upon breach of fiduciary duty, the investor's level of sophistication has a direct bearing on both whether a fiduciary duty existed and the extent of any fiduciary duty that might exist. In a non-discretionary account where the argument is that the client ratified the security, a primary issue is whether the client was sophisticated enough to understand the suitability of each security for his or her portfolio.

The role of the expert when discussing investor sophistication is to explain why being wealthy, educated, and experienced in investments does not mean that one is sophisticated regarding MPT. The expert must begin explaining how each security fits into the overall picture of the portfolio to produce the degree of suitability appropriate for that investor's profile. The expert must draw an initial and general distinction between a "sophisticated investor" and an "investor with sophistication." The expert must then go beyond the general and analyze what this particular investor was sophisticated about and how they gained such sophistication. Since this testimony will involve suitability of the investment portfolio based on MPT, the expert will testify as to whether in his or her opinion the investor was sophisticated enough to understand how each security purchased, or recommended, by the broker fit into the investor's profile. Expert testimony as to the ultimate issue is admissible under the Federal Rules of Evidence,[120] assuming the expert is competent to give such an opinion.

### B. STANDARDS FOR ADMISSIBILITY OF EXPERT TESTIMONY

This part of the article uses relevant federal cases and Federal Rules of Evidence as the basis for examining standards for admitting expert testimony. As already discussed, the bulk of the suitability cases are in federal courts, others in state courts, and many may be in arbitration. We will discuss the Federal Rules of Evidence as they apply in federal court and because most states have adopted the same or substantially similar

120. *See* FED. R. EVID. 704:

> Rule 704. Opinion on Ultimate Issue
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> Except as provided in subdivision (b), testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact.

*Id.* Investor sophistication is one of the hurdles that counsel must overcome in some cases and an expert witness could be used, and would be very helpful, in explaining whether or not a particular investor was sophisticated.

rules. Additionally, to the extent that standards for expert testimony may exist in arbitrations, the standards may also mirror those of the Federal Rules of Evidence.

There are three recent cases that set the current standard for expert testimony:[121] *Daubert v. Merrell Dow*,[122] *General Electric Company v. Joiner*,[123] and *Kumho Tire Co. v. Carmichael*.[124] These three cases have helped clarify the Federal Rules of Evidence by allowing expert scientific and nonscientific testimony as long as the testimony meets a certain level of reliability and relevance.[125] Additionally, these cases create a "gatekeeping" function regarding expert witnesses. Anyone may now qualify as an expert by education, training or experience and the court will determine who has met the "expert" standard."[126] Because of the

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121. For further discussion of the history and recent developments regarding expert testimony *see* Leslie Morsek, *Get on Board for the Ride of Your Life! The Ups, the Downs, the Twists, and the Turns of the Applicability of the "Gatekeeper" Function to Scientific and Non-Scientific Expert Evidence: Kumho's Expansion of Daubert*, 34 AKRON L. REV. 689 (2001) [hereinafter Morsek]; Major Victor Hansen, *Rule of Evidence 702: The Supreme Court Provides a Framework for Reliability Determinations*, 162 MIL. L. REV. 1 (1999); Mangrum, *supra* note 109, at 39.

122. 509 U.S. 579 (1993).

123. 522 U.S. 136 (1997).

124. 526 U.S. 137 (1999).

125. *See* Morsek, *supra* note 121, at 693.

126. *See* FED. R. EVID. 702:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert . . . by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

*Id.*

Four levels of foundation are relevant to the admissibility of evidence by expert testimony: competency, theory, technique, and application. *See* Mangrum, *supra* note 108, at 34. *See also* Mark McCormick, *Scientific Evidence: Defining a New Approach to Admissibility*, 67 IOWA L. REV. 879, 911-12 (1982). The first level, competency, establishes the expertise of the witness and the "competency" of that person's testimony based on. The second level of inquiry in the "gatekeeping" function is to inquire whether the theory is reliable. If the theory is new, this may be shown by the expertise of the witness. The reliability of the MPT theory could be demonstrated by facts such as that MPT's creator, Harry Markowitz, received a Nobel Prize for creating the theory and formula (*Harry M. Markowitz - Autobiography*, *available at* http://www.nobel.se/economics/laureates/1990/ markowitz-autobio.html (last visited Aug. 9, 2004)) and the fact that the United States Department of Labor has a rule that MPT will be the basis of determining the suitability of portfolios in ERISA cases. *See* Laborers Nat'l Pension Fund v. N. Trust Quantitative Advisors, Inc., 173 F.3d 313, 317 (5th Cir. 1999). The third level of inquiry that the "gatekeeper" must determine is whether the technique or procedure was properly used (in MPT this would be the use of the formula itself). The expert may testify that he or she is qualified to use the technique or procedure properly based on knowledge, skill, experience, training, or education. In addition, the technique or procedure used is reliable because it has been reliably tested, has been subject to peer review and/or publication, has an complexities and intricacies of suitability actions, it will be virtually impossible for a claimant to succeed without competent expert testimony.

## CONCLUSION

Boom or bust, people will invest. Most investors use a broker, the gray area surrounds the term "use." There are "sophisticated investors" and "investors with sophistication." Either may rely on his or her broker for advice, recommendations, or purchases. Many will not realize their investment dreams. Several of those will bring suitability claims against their brokers.

Disillusioned prospectors may take a variety of causes of action. Each poses significant hurdles that cannot be cleared without expert testimony. This paper discussed the Modern Portfolio Theory (MPT) as an objective means of determining the risk of a portfolio and its suitability for an individual investor. It also discussed the unique role of the expert in interpreting, explaining, and applying that theory to determine what portfolio decisions are suitable for investors. The old adage is that "you get what you pay for" and, occasionally — though some may lament, rarely — the law mirrors common-sense. When it comes to suitability claims, the ultimate legal question is: did the investor get what he paid his broker for?

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established rate of error, and is generally accepted in that profession, whether there are safeguards in the characteristics of the technique, whether there are existing standards governing the use of MPT, whether there is some continuing maintenance or an updating of the standards governing MPT, whether there are other experts available to test and evaluate MPT, and questions to establish the degree of care taken by the expert to prepare the information.
Following is a brief list of questions which may elicit such information:

During the period under review, were the standards and controls as prescribed by modern portfolio theory properly maintained?

"Are the opinions based on reliable supporting data or other bases of the type normally relied upon by an expert in the field?" Sofia Adrogue, *The Independent Expert Evolution: From the Path of Least Resistance to the Road Less Traveled*, 34 TEX. TECH. L. REV. 843, 874 (2003).

"Are (any) assumptions reasonable and specific to the facts of the case, as well as consistent with the undisputed facts and at least one party's view of the disputed facts?" *Id.*

In addition to testifying that the formula was properly used, the expert must also explain the technique or procedure itself to the fact finder, and explain how the information developed by the use of the formula relates to his/her testimony regarding MPT. This last step is the application function – the fourth level of inquiry by the gatekeeper. The expert must be qualified based on knowledge, skill, experience, training, or education to be able to apply the principle and to be able to interpret the results. The expert must testify to the proper use of the statistical methods employed to arrive at the results that he/she is testifying to. The expert must also testify why he or she is capable of interpreting or explaining the application of the method to the case, and is able to explain the application of the result to the opinion that arises there from. *See* Mangrum, *supra* note 108, at 34-36.