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Cover Page Footnote

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ARTICLES

SECURITIES ARBITRATIONS INVOLVING MORTGAGE-BACKED SECURITIES AND COLLATERALIZED MORTGAGE OBLIGATIONS: SUITABLE FOR UNSUITABILITY CLAIMS?

Bradley J. Bondi[*]

I. INTRODUCTION AND BACKGROUND

Over the past two years, the world has witnessed the unfolding of the "subprime mortgage crisis". A steep rise in home foreclosures beginning in late 2006 caused a ripple effect throughout the economy, resulting in a dearth of liquidity across the lending sector. The largest rise in defaults occurred on so-called "subprime"[1] and other adjustable rate mortgages (ARMs).[2] These types of mortgages were offered initial-

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1. A subprime mortgage is a loan having a higher interest rate and suboptimal terms than a traditional loan. A subprime mortgage is obtained usually by persons who do not qualify for a traditional loan due to poor credit scores, a history of default, or other negative factors. *See* Danielle DiMartino & John V. Duca, The Fed. Reserve Bank of Dallas, *The Rise and Fall of Subprime Mortgages,* ECON. LETTER, Vol. 2, No. 11, at 2 (Nov. 2007), *available at* http://dallasfed.org/research/eclett/2007/el0711.pdf.

2. An adjustable rate mortgage is a type of mortgage where the interest rate varies according to a specific benchmark. *See* Investopedia.com, Adjustable-Rate Mortgage (ARM), http://www.investopedia.com/terms/a/arm.asp (last visited Nov. 5, 2008). The

ly during a time of rising housing prices, often to unqualified borrowers,[3] who thought that they would later have the opportunity to refinance at more favorable terms. As housing prices declined, however, refinancing became more difficult; defaults increased sharply as interest rates reset at higher rates on many of the mortgages.[4] These events contributed to approximately 1.3 million foreclosures in 2007, an increase of approximately 75% from 2006.[5] Foreclosures increased to 2.3 million in 2008, an increase of approximately 80% from 2007.[6] Some experts have estimated that subprime defaults ultimately will reach between $200 billion and $300 billion before the crisis ends.[7]

Mortgage lenders and banks – which maintained the mortgages on their balance sheets, and thereby retained the credit risk – suffered the first losses. Other financial institutions avoided large losses, however, by passing along the credit risk to investors through securitization of the mortgages into mortgage-backed securities (MBSs) and collateralized mortgage obligations (CMOs). These investment products, in turn, were purchased by retail and institutional investors, often following a recommendation by a broker-dealer.

MBSs are asset-backed securities having cash flows backed by the

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mortgage industry (primarily thrift institutions) developed adjustable rate mortgages to control against the risk to lenders associated with interest rates. *See* Thomas P. Vartanian, *Counseling Participants in the Development of New Financial Products, Services, and Techniques*, Practising Law Inst., PLI Order No. A4-4134 73, 169 (1985). ARMs gained popularity in the United States around 1980. *See id.* at 170.

3. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007) (describing predatory lending practices where lenders make loans to borrowers who they know cannot afford the monthly payments).

4. *See* Ben S. Bernanke, Chairman, Fed. Reserve Bd. of Governors, Speech at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition: The Subprime Mortgage Market (May 17, 2007) (transcript available at http://www.federalreserve.gov/newsevents/speech/Bernanke20070517a.htm) (discussing the multiple causes of subprime adjustable-rate mortgage delinquencies); *see also* DiMartino & Duca *supra* note 1, at 1, 5.

5. Press Release, RealtyTrac Inc., U.S. Foreclosure Activity Increases 75 Percent in 2007 (Jan. 29, 2008), *available at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=3988&accnt=64847.

6. Press Release, RealtyTrac Inc., U.S. Foreclosure Activity Increases 81 Percent in 2008 (Jan. 15, 2009), *available at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=5681&accnt=64847.

7. *See Postcards from the Ledge*, ECONOMIST, Dec. 19, 2007, at 10.

principal and interest payments of a pool of mortgage loans.[8] Payments are made periodically over the lifetime of the underlying loans.[9] CMOs are more complex mortgage-backed securities, comprised of pools of home mortgages backed by government-insured agencies such as Freddie Mac and Fannie Mae.[10] There are two streams of income from each pool: one from the aggregate interest payments and the other from the aggregate principal payments made on the mortgages.[11] These income streams are then divided into tranches based on credit quality and sold as separate securities to investors.[12] Losses are applied in reverse order of seniority and, therefore, junior tranches offer higher coupons (interest rates) to compensate investors for the added default risk.[13] Due to the risk associated with junior tranches, they have been called "toxic waste" by some commentators.[14] Because CMOs are backed by government-sponsored agencies, each tranche usually retains a surprisingly high rating, although each has a completely different risk profile.[15]

CMO derivatives, such as "inverse floaters"[16] and "interest-only strips,"[17] have become popular among investors in recent years. These derivatives have considerably more risks than normal CMOs. One of the risks associated with CMO derivatives is that their value fluctuates significantly with slight changes in interest rates.[18] These products are

8. *See* SEC, Mortgage-Backed Securities, http://www.sec.gov/answers/mortgagesecurities.htm (last visited Nov. 17, 2008).

9. *Id.*

10. *See* SEC, Collateralized Mortgage Obligations (CMOs), http://www.sec.gov/answers/tcmos.htm (last visited Nov. 17, 2008).

11. *Id.*

12. *Id.*

13. For a detailed discussion of the conflicts between the various tranches, see Michael Mackenzie, *'Super-Senior' CDO Investors Flex Their Muscles*, FINANCIAL TIMES, Apr. 14, 2008, *available at* http://www.ft.com/cms/s/0/b2bcd0ee-0a5b-11dd-b5b1-0000779fd2ac.html?nclick_check=1.

14. *See* Investopedia.com, Toxic Waste, http://www.investopedia.com/terms/t/toxicwaste.asp (last visited Nov. 7, 2008).

15. *See* John Churchill, *The Death of a Brokerage,* REGISTERED REP., Aug. 1, 2007, *available at* http://www.registeredrep.com/advisorland/regulatory/finance_death_brokerage/index.html.

16. *See* Investopedia.com, Inverse Floater, http://www.investopedia.com/terms/i/inversefloater.asp (last visited Nov. 7, 2008).

17. *See* Investopedia.com, Interest Only (IO) Strips, http://www.investopedia.com/terms/i/iostrips.asp (last visited Nov. 7, 2008).

18. Churchill, *supra* note 15 ("One of the risks associated with CMO derivatives

also illiquid, meaning that investors are often stuck holding the securities even as their value spirals downward.[19] A related risk of CMO derivatives is pricing risk. Often CMO derivatives are priced only once a month, using methodologies that may not be readily transparent. As a result, when the time comes to sell the CMO derivatives, investors may find it difficult to arrive at a price.[20]

MBSs and CMOs gained tremendous popularity with investors in the late 1990s and in the early part of this decade when broker-dealers began recommending them to retail and institutional customers as suitable investment alternatives to treasury securities to hedge against inflation risk while earning a presumably safe return. In *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, the Fourth Circuit summarized the turbulent CMO market of the late-1980s to the mid-1990s: "From 1987 to 1993, U.S. government-sponsored CMO issuances grew dramatically, from $900 million to $311 billion per year. The market in CMOs collapsed in 1994; new issuances fell to $25.4 billion in 1995."[21]

In the late 1990s, the country witnessed a resurgence in the mortgage-backed securities market as mortgage rates dropped and home sales increased.[22] In 2000, the MBS market overtook the market for U.S. treasury securities.[23] At its height, the total market value of all outstanding U.S. MBSs was approximately $6.1 trillion.[24] "[A]lmost $2 trillion [of that amount consisted of] riskier nonagency securities that are not insured by the federal government or by Fannie Mae or Freddie Mac."[25]

When the subprime mortgage crisis hit the U.S. economy in late 2006, many investors holding MBSs or CMOs that were purchased before 2006 suffered significant losses because the values of the under-

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like inverse floaters and interest-only strips . . . is that their value fluctuates wildly with small moves in interest rates.").

19. *Id.*

20. *Id.*

21. Banca Cremi, S.A. v. Alex. Brown & Sons, Inc., 132 F.3d 1017, 1022 (4th Cir. 1997).

22. *See* Richard W. Stevenson, *The Outlook for Recovery: Three Factors to Watch*, N.Y. TIMES, Oct. 7, 2001, § 3, at 4.

23. *See* Sec. Indus. & Fin. Mkts. Ass'n (SIFMA), U.S. Treasury Securities Outstanding, http://www.sifma.org/research/pdf/Treasury_Securities_Outstanding.pdf (last visited Nov. 17, 2008).

24. *See* Edmund L. Andrews, *Fed Hopes To Ease Strain on Economy Activity*, N.Y. TIMES, Mar. 12, 2008, at A1.

25. *Id.*

lying assets sharply declined. These investors included retail customers, corporations, and institutions such as pension funds, university endowments, municipalities, and even the investment banks themselves. The fact that so many investment banks purchased MBSs and CMOs is a significant difference from the crash in 1994.[26] As one commentator described, "Wall Street drank its own Kool-Aid. Big investment banks like Bear Stearns Cos., Citigroup and others not only sold the CDOs – they also bought them."[27]

The losses have been enormous. As of May 2008, Citigroup had suffered a staggering \$40.7 billion in subprime losses – the most of any bank – and had been forced to cut 9,000 jobs.[28] Other subprime losses as of that date include: \$38 billion at UBS,[29] \$31.7 billion at Merrill Lynch,[30] \$14.9 billion at Bank of America, \$12.6 billion at Morgan Stanley, \$12.4 billion at HSBC, \$12 billion at Royal Bank of Scotland, \$9.7 billion at JP Morgan Chase, \$8.3 billion at Washington Mutual, \$7.5 billion at Deutsche Bank, \$7.3 billion at Wachovia, and \$6.3 billion at Credit Suisse.[31]

Several financial services firms have been forced out of business due to their dealings in MBSs and CMOs, leaving investors with significant losses. Most commentators blame the demise of Bear Stearns, Wall Street's fifth largest investment bank, on the subprime crisis.[32] Available credit virtually dried up as banks became less willing to lend to

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26. *See* Christopher Thornberg, *Wall Street Bailout?*, L.A. TIMES, Mar. 28, 2008, *available at* http://www.latimes.com/news/opinion/la-op-leonard-thornberg28mar28,0,3127741, full story.

27. *Id.*

28. *See* BBC News, Timeline: Sub-prime Losses, http://news.bbc.co.uk/1/hi/business/7096845.stm (last visited Nov.17, 2008). All the figures reported in the text include losses from *all* subprime instruments, not only MBSs and CMOs. Any reference to "subprime" in the Article is not limited to MBSs and CMOs.

29. *Id*.

30. *Id.* In November 2007, Merrill Lynch experienced its largest write-down in history of \$8.4 billion, which at the time represented the biggest known loss in Wall Street history. *See* Graham Bowley & Jenny Anderson, *Where Did the Buck Stop at Merrill?*, N.Y. TIMES, Nov. 4, 2007, § 3.

31. Timeline: Sub-prime Losses, *supra* note 28.

32. *See* Koelle Boyce, *Bear Stearns: Latest Victim of the Sub-prime Crisis*, BANKING BUS. REV., Mar. 17, 2008, http://www.banking-business-review.com/article_feature.asp?guid=198FE768-A593-460B-AFFD-285301705565.

each other after they suffered large losses on subprime mortgages and related financial products.[33]

Even smaller firms have suffered as a result of their activity in subprime mortgage products. Brookstreet Securities of Irvine, California, one of the top 25 independent broker-dealer firms, went out of business in June 2007 when a large number of institutional and retail customer accounts received margin calls from Brookstreet's clearing firm, National Financial Services, a division of Fidelity Investments.[34] The margin calls were sparked by a sudden decline in value of investments in CMOs, including CMO derivatives.[35] By June 22, 2007, Brookstreet had exhausted its entire net capital of $12 million to meet a margin call and yet still had a margin balance of $70 million against securities worth $85 million, and that value was declining.[36] Ultimately, Brookstreet became insolvent.[37]

As losses continue to stack up for investors of MBSs and CMOs, it is inevitable that investors will seek legal recourse against the broker-dealers from which they purchased the securities. One claim that undoubtedly will be advanced by investors is that the MBSs and CMOs were "unsuitable" investments. A broker-dealer has an obligation under the governing rules of self-regulatory organizations (SROs), as well as federal and state securities laws, to recommend only "suitable" investments and trading strategies.[38] A claim for unsuitability typically arises when a representative of a broker-dealer recommends to a customer an investment that he knows, or should have known, is inappropriate for that customer based on the customer's investment objectives.[39] An allegation of unsuitability is among the most common claims brought in

33. *See* BBC News, *Rescue for Troubled Wall Street Bank*, Mar. 17, 2008, http://news.bbc.co.uk/1/hi/business/7299938.stm.

34. Churchill, *supra* note 15.

35. *Id.*

36. *Id.*

37. *Id.*

38. *See generally* DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 5-5 (5th ed. 2008) (describing the legal obligations of a broker-dealer under the various laws and rules).

39. *See id*. In the typical unsuitability claim, the customer alleges that the broker recommended investments that were not appropriate for his investment goals, or even his age and investment objectives. Unless otherwise indicated, this Article uses the terms "customer," "investor," and "client" interchangeably to mean generally an individual or institution that has a business relationship with a particular broker.

securities arbitration.[40] In 1998, unsuitability claims accounted for 95% of filings under the errors and omissions insurance policies of the National Association of Securities Dealers (the NASD) members.[41] Unsuitability claims currently account for a large portion of the claims asserted by customers during FINRA arbitration proceedings.[42]

Mandatory arbitration clauses in the customer agreements at virtually every broker-dealer firm mean that claims asserted by investors will be heard in arbitration unless both parties elect to have the case heard in court.[43] Supreme Court precedent has made it nearly impossible for investors unilaterally to challenge a mandatory arbitration clause.[44]

The shift in forum from courts to arbitration panels has had a significant effect on jurisprudence of unsuitability claims. In federal courts, unsuitability claims are brought under the antifraud provisions of the federal securities laws, primarily Section 10(b) of the Exchange Act and Rule 10b-5, which together require a showing of intent to defraud or recklessness.[45]

By contrast, unsuitability claims in arbitration are brought under the more amorphous rules of the self-regulatory organizations, which do not necessarily require proof of fraud but instead are rooted in notions of

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40. *Id.* In an Avoidance and Prevention Advisory (Advisory) distributed to its member firms in May 1998, the National Association of Securities Dealers, Inc. (NASD) disclosed that unsuitability claims account for ninety-five percent of filings under NASD members' errors and omissions insurance policies. *See Zarb Urges Broker Dealers to 'Be on Guard' About Suitability,* 30 SEC. REG. & L. REP. (BNA) 810 (May 29, 1998).

41. *See* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999).

42. *See* Dispute Resolution Statistics, *available at* http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm (last visited Feb. 1, 2009). This Article describes the existing doctrine of suitability and its application in certain circumstances, rather than analyzing the justification of the doctrine of suitability. In other words, this Article does not undertake a normative analysis of suitability.

43. *See generally* SIFMA, White Paper on Arbitration in the Securities Industry 3 (Oct. 2007), *available at* http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf [hereinafter White Paper on Arbitration]. An interesting issue to consider, which is beyond the scope of this Article, is whether mandatory arbitration is an appropriate scheme for the adjudication of disputes between a customer and broker.

44. *See, e.g.*, Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989); Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987).

45. Securities Exchange Act of 1934 Rule 10(b), 15 U.S.C. § 78j(b) (2008); Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008).

fairness and equity.[46] Although the vast majority of courts hold that there is no private right of action for violations of SRO rules,[47] certain rules, such as the FINRA suitability rules, set forth the standard of care to which registered representatives and broker-dealers are judged in arbitration.[48] A violation of FINRA rules may arise from intent, recklessness, or negligence.[49] To recover in arbitration, a customer asserting a claim must prove, at a minimum, that the SRO rule (e.g., suitability) sets forth the standard of care and that there was a breach of that standard of care that proximately caused damages.

This short Article explores the unsuitability claim from its inception to its modern application. It then discusses unsuitability claims in the context of MBSs and CMOs and in the forum of arbitration. Finally, this Article briefly highlights some of the basic considerations of whether a safe harbor for recommendations of brokers to certain institutional customers would be appropriate to consider.

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46. *See* White Paper on Arbitration, *supra* note 43. There are some instances where an action in court based on fraud and a claim in arbitration based on fairness and equity will reach the same result, although the starting positions may be different.

47. *See, e.g.*, Hoxworth v. Blinder, Robinson & Co., Inc., 903 F.2d 186, 200 (3d Cir. 1990) ("NASD regulations do not give rise to a private right of action."); Salzmann v. Prudential Securities Inc., No. 91 Civ. 4253 (KTD), 1994 WL 191855, at *8 (S.D.N.Y. May 16, 1994) (agreeing with "the large body of case law holding that no private cause of action exists for violation of the rules of self-regulatory organizations" (quoting Bloch v. Prudential-Bache Sec., 707 F. Supp. 189, 195-96 (W.D. Pa.1989)).

48. *See* NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL, RULES OF THE ASSOCIATION, Rule 2310, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=3638&record_id=4315 (last visited Oct. 12, 2008) [hereinafter FINRA Conduct Rule 2310]. As of the date of publication of this Article, FINRA has been in the process of transferring rules from the NASD rulebook to the Consolidated FINRA Rulebook. *See* FINRA's Rulebook Consolidation Process, *available at* http://www.finra.org/Industry/Regulation/FINRARules/P038095. Although technically it currently is "NASD" Conduct Rule 2310, this Article refers to all of the rules as "FINRA" in anticipation of the transfer to the Consolidated FINRA Rulebook. It also should be noted that some of the rules may be re-numbered following the transfer. *See* Rulebook Consolidation Process, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117155.pdf.

49. *Id.*

II. EVOLUTION OF THE LAW OF UNSUITABILITY CLAIMS

A. The Requirement To Recommend Only Suitable Investments

The notion that financial services professionals are required to recommend only suitable investments to customers has existed since the beginning of the securities laws in the United States.[50] Shortly after its establishment in 1938, the NASD, the SRO then responsible for the regulation of the broker-dealers, adopted Article III, section 2 of its Rules of Fair Practice,[51] which mandated that members recommend only suitable investments.[52] The New York Stock Exchange (NYSE),[53] the American Stock Exchange,[54] and several regional exchanges followed with their own rules pertaining to the suitability of investments.

Beginning in July 2007, the NASD was phased out with the creation of the Financial Industry Regulatory Authority (FINRA).[55]

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50. *See generally* JOHN RAYMOND BOATRIGHT, ETHICS IN FINANCE 15-17 (1999); Financial Product Fundamentals, § 10:2.2, at 10-6 (Clifford E. Kirsch ed., 1999) (explaining how an adviser recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes (citing Westmark Fin. Servs. Corp., Investment Advisors Act Rel. No. 1117 (May 16, 1998))).

51. This rule since has been renamed Conduct Rule 2310. *See* Self-Regulatory Organizations: Order Approving Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Rearranging of Rules and a New Rule Numbering System for The NASD Manual, File No. SR-NASD-95-51, Exchange Act Release No. 34-36698 (Jan. 11, 1996).

52. The rule sets out principles for fair dealing with customers and the broad parameters for suitability of securities transactions:

> 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.

FINRA Conduct Rule 2310(a), *supra* note 48.

53. NYSE Rule 405, first enacted in 1969, currently states as follows: "use due diligence to learn the essential facts relative to every customer and every cash or margin account, including accounts in Non-Managed Fee-Based Account programs, accepted or carried by such member organization." NYSE Rule 405(6), N.Y.S.E. Guide (CCH) P 2405, at 3696 (2001) *available at* http://rules.nyse.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_3&manual =/nyse/nyse_rules/nyse-rules/.

54. American Stock Exchange Guide (CCH) P 9431, 2647 (1995).

55. FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the NYSE. FINRA "is the largest non-governmental regulator for all securities firms doing business in the United States." FINRA.org, About FINRA, http://www.finra.org/AboutFINRA/CorporateInformation/index.htm (last visited Jan. 1, 2009).

Although the NASD suitability rule had undergone several amendments over the years, the rule currently exists as FINRA Conduct Rule 2310.[56] Because FINRA "oversees nearly 5,000 brokerage firms, about 173,000 branch offices and approximately 677,000 registered securities representatives,"[57] FINRA Conduct Rule 2310 is the most often-cited rule in disputes concerning suitability. Rule 2310 does not require a showing of intent, or even recklessness, on the part of the financial services representative. Instead, the rule relies upon quasi-equitable principles of due care and fair dealing.[58] In its current form, FINRA Conduct Rule 2310 provides:

> (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.[59]

For non-institutional investors, FINRA members (e.g., brokers) must make "reasonable efforts" to obtain information concerning such areas as the customer's financial status, tax status, investment objectives, and any other information considered in making a recommendation.[60]

By its terms, FINRA Conduct Rule 2310 is limited to recommendations.[61] While the meaning of the term "recommendation" has been the subject of much debate, it generally means "when the [FINRA] member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages."[62] On the other hand,

56. *See* FINRA Conduct Rule 2310(a), *supra* note 48.

57. *Id.*

58. *See, e.g.*, Nelson v. Pac. Life Ins. Co., No. Civ.A. CV203-131, 2004 WL 1592617, at *3 (S.D. Ga. July 12, 2004) ("Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing." (quoting FINRA Conduct Rule 2310) (internal quotations omitted)).

59. FINRA Conduct Rule 2310(a), *supra* note 48.

60. FINRA Conduct Rule 2310(b), *supra* note 48.

61. FINRA Rule 2310(a), *supra* note 48; *see also* Parsons v. Hornblower & Weeks-Hemphill Noyes, 447 F. Supp. 482, 495 (M.D.N.C. 1977) (explaining that Rule 2310(a) requires an evaluation of suitability only with respect to recommendations); George A. Schieren et al., *Suitability and Institutions*, *in* SECURITIES LITIGATION 1995, at 699, 752-61 (PLI Corp. Law & Practice Course Handbook Series No. B4-7112 1995).

62. NASD, Notice to Members 96-60, Clarification of Members' Suitability

FINRA Conduct Rule 2310 "would not apply . . . to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member."[63] Still, as far back as 1997, the NASD clarified: "[w]hether a particular transaction is in fact recommended depends on an analysis of all the relevant facts and circumstances . . . ."[64]

Lawyers, academics, and commentators have struggled to determine when the delivery of promotional materials would constitute a "recommendation". Today, this debate is particularly important in the context of complex financial products such as MBSs and CMOs because clients periodically receive reports on these products from brokers. A suitability claim may turn on whether a client received an unsolicited report from a broker concerning the product or whether the client requested the material.

Several provisions of "Interpretative Material" by FINRA help to define the scope of the suitability rule. Interpretative Material is generally considered to be part of the rules it interprets and has the same importance as the actual rules.[65] Three provisions of Interpretative Material

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Responsibilities Under NASD Rules With Special Emphasis On Member Activities In Speculative And Low-Priced Securities (Sep. 1996), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p016905.pdf.

63. *Id.* (citing Sales Practice Requirements for Certain Low Priced Securities, Exchange Act Release No. 34-27160, 54 Fed. Reg. 35468 (Aug. 28, 1989)). In Release No. 34-27160, the SEC explained the term "recommendation" in the context of the new penny stock rules. The Commission explained: "[T]he NASD and other suitability rules have long applied only to "recommended" transactions. . . . [T]he [Penny Stock Suitability] Rule would not apply to situations in which a broker-dealer functioned solely as an order taker and executed transactions for person who on their own initiative decided to purchase a [penny stock] without a recommendation from the broker-dealer. Nor would the Rule apply to general advertisements not involving a direct recommendation to the individual. The Rule would apply, however, to situations where the broker-dealer recommends to an investor the purchase of a specific [penny stock], whether through direct telephone communication with the customer or through sending promotional material through the mail." Sales Practice Requirements for Certain Low-Priced Securities, Exchange Act Release No. 34-27160, 54 Fed. Reg. 35468, 35476-77 (Aug. 28, 1989), 1989 SEC LEXIS 1603, at 52 (Aug. 22, 1989).

64. NASD, For Your Information, Clarification of Notice to Members 96-90 (Mar. 1997), *available at* http://www.finra.org/web/groups/Industry/@ip/@reg/@notice/documents/Notices/P004933.pdf.

65. *See* 15 U.S.C. § 78(c)(a)(27) (2006). *But see* NASD, Notice to Members 96-25, SEC Approves NASD Manual Revisions, Publication Scheduled for May, NTM 96-25 (Apr. 1996), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/

are particularly relevant to the suitability doctrine in general, and specifically as applied to complex financial products: (i) IM-2310-1, "Possible Application of SEC Rules 15g-1 through 15g-9";[66] (ii) IM-2310-2, "Fair Dealing with Customers";[67] and (iii) IM-2310-3, "Suitability Obligations to Institutional Customers."[68]

IM-2310-1 provides that non-exchange-listed equity trading for less than $5 per share may be subject to the SEC's penny-stock rules 15g-1 through 15g-9.[69] In essence, these SEC penny-stock rules provide for enhanced disclosures and a two-day "cooling off period" during which the broker must furnish the investor with a disclosure document that must be signed and returned by the investor.[70]

IM-2310-2 interjects the equitable concept of "fair dealing" into the suitability doctrine. It states that "sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers".[71] IM-2310-2 sets forth a non-exhaustive list of examples where fair dealing was not observed.[72] It also contains a provision addressing "new financial products," which may have a bearing on certain MBSs and CMOs. That subsection states in part:

@notice/documents/notices/p005008.pdf ("IM stands for Interpretive Material of the Rules of the Associate *that has not been converted to Rule form*, including interpretations, resolutions, explanations, policies and guidelines. The IM number includes the number of the Rule or Rules Series which the material interprets." (emphasis added)).

66. NASD, Possible Application of SEC Rules 15g-1 through 15g-9, NASD Manual (CCH), IM-2310-1, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4316&element_id=3639&highlight=Possible+Application+of+SEC+Rules+15g-1#r4316 [hereinafter IM-2310-1].

67. NASD, Rules of Fair Practice, NASD Manual (CCH), IM-2310-2, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4317&element_id=3640&highlight=IM-2310-2#r4317 [hereinafter IM-2310-2].

68. NASD, Considerations Regarding the Scope of Members' Obligations to Institutional Customers, NASD Manual (CCH), IM-2310-3, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3641 [hereinafter IM-2310-3]. As of the date of publication of this Article, FINRA has been in the process of renumbering these provisions. *See supra* note 48.

69. IM-2310-1, *supra* note 66.

70. 17 C.F.R. § 240.15g-1-9 (2008).

71. IM-2310-2, *supra* note 67.

72. *Id.*

> As new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products.[73]

B. Suitability Obligations Owed to Institutional Investors

A separate provision of Interpretive Material, IM-2310-3, explains the suitability obligations owed to "institutional investors", particularly those "with at least $10 million invested in securities in the aggregate in its portfolio and/or under management".[74] It addresses both debt and equity securities.[75] Although IM-2310-3, by its title, is directed towards institutional clients, it reiterates the general, two-part test for suitability. That is, the broker must have (1) a reasonable basis for recommending a particular security or strategy to an institutional client, and (2) reasonable grounds for believing the recommendation is suitable for the customer to whom it is made.[76] In other words, a recommendation must be suitable for at least some institutional customer (an objective test) and suitable for the specific customer (a subjective test). IM-2310-3 concedes that "[t]he manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction,"[77] and it provides a non-exhaustive list of the factors that should be considered by the broker in making a recommendation. Regarding this list, the provision states that:

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73. *See id.* at (e). FINRA reiterated these requirements in September 2007 in Regulatory Notice 07-43, which stated: "Firms do not have an obligation to shield their customers from risks that customers want to take, but they are required to fully understand the products recommended by their registered representatives, to give their customers a fair and balanced picture of the risks, costs and benefits associated with the products or transactions they recommend and recommend only those products that are suitable in light of the customer's financial goals and needs." FINRA, Regulatory Notice, Senior Investors 07-43 (Sept. 2007), at 3, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p036816.pdf.

74. IM-2310-3, *supra* note 68. Institutional investors may include corporations, trusts, investment banks, municipalities, pension funds, hedge funds, mutual funds, and other registered entities. *See* FINRA Rule 3110(c).

75. *Id.*

76. *Id.*

77. *Id.*

> [t]he two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a member's recommendation.[78]

IM-2310-3 also attempts to explain the point at which the broker-dealer has satisfied its obligation with respect to suitability for a sophisticated institutional investor. "Where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled."[79] A footnote following that statement warns, however: "This interpretation does not address the obligation related to suitability that requires that a member have '. . . a reasonable basis to believe that the recommendation could be suitable for at least some customers'".[80]

It is unclear whether this footnote has any independent significance. A broker that has reasonable grounds for concluding that the institutional customer has the requisite capability to evaluate the risks arguably would meet the duty of having a reasonable basis for believing that the investment is suitable for at least one customer. In other words, the fact that an institutional investor with the requisite capability to evaluate the risk is purchasing the investment provides a reasonable basis for the broker to believe that the investment could be suitable for at least some customers.

C. *Special Considerations of Suitability Regarding MBSs and CMOs*

With the rise in mortgage-backed securities at the turn of the twenty-first century, the NASD in November 2003 adopted IM-2210-8, "Communications with the Public about Collateralized Mortgage Obligations (CMOs)".[81] IM-2210-8 sets forth the types of disclosures

78. *Id.*
79. *Id.*
80. *Id.* n.2.
81. NASD, Communications with the Public About Collateralized Mortgage Obligations (CMOs), NASD Manual (CCH) IM-2210-8, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4301&element_id=3625&highlight=im-2210-8#r4301 [hereinafter IM-2210-8].

that must be provided to investors. The level of disclosures required differs depending on whether the customer is an institutional investor or non-institutional investor. All advertisements, sales literature, and correspondence provided to *any* investor concerning CMOs must include, among other disclosures, that the instrument is a "Collateralized Mortgage Obligation"[82] and that "a CMO's yield and average life will fluctuate depending on the actual rate at which mortgage holders prepay the mortgages underlying the CMO and changes in current interest rates".[83] Comparisons with other investment vehicles, including a bank certificate of deposit, are permitted but not required.[84] IM 2310-8 also requires a broker to provide customers with "questions an investor should ask before investing", but it does not provide any guidance on what those questions should be.[85]

For non-institutional investors, a broker must offer educational materials that include:

> [C]haracteristics and risks of CMOs including credit quality, prepayment rates and average lives, interest rates (including their effect on value and prepayment rates), tax considerations, minimum investments, transaction costs and liquidity;[86]
>
> [T]he structure of a CMO, including the various types of tranches that may be issued and the rights and risks pertaining to each (including the fact that two CMOs with the same underlying collateral may be prepaid at different rates and may have different price volatility); and[87]
>
> [T]he relationship between mortgage loans and mortgage securities.[88]

D. Suitability Claims in the Courts

Unlike the suitability doctrine that has developed under the rules of the NASD and later FINRA, the suitability doctrine under the case law is based on rigid legal principals relating to fraud rather than equity and

82. *Id.* § (b)(1)(A).
83. *Id.* § (b)(1)(D).
84. *Id.* § (b)(1)(B).
85. *Id.* § (b)(2)(B).
86. *Id.* § (b)(2)(A)(i).
87. *Id.* § (b)(2)(A)(ii).
88. *Id.* § (b)(2)(A)(iii).

fairness. Specifically, the suitability doctrine in case law is rooted primarily in the antifraud provisions of Section 10(b) of the Securities Exchange Act and Rule 10b-5.[89] The basic elements of an unsuitability claim are:

1. that the securities purchased were unsuited to the buyer's needs;
2. that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs;
3. that the defendant recommended or purchased the unsuitable securities for the buyer anyway;
4. that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and
5. that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.[90]

Unlike an unsuitability claim brought under the rules of FINRA, an unsuitability claim under Section 10(b) requires the plaintiff-investor to establish that there was a material misstatement or omission by the broker and that the plaintiff-investor relied upon that statement or omission.[91] The level of an investor's sophistication is the primary factor that courts weigh to determine whether the investor's reliance on representations by a broker was justified.[92]

89. Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1031 (2d Cir. 1993) (explaining that a claim for unsuitability "is a subset of the ordinary §10(b) fraud claim"); *see also* O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 897 (10th Cir. 1992) (The court explained that a suitability claim could be analyzed "simply as a misrepresentation or failure to disclose a material fact. In such a case, the broker has omitted telling the investor the recommendation is unsuitable for the investor's interests. The court may then use traditional laws concerning omission to examine the claim.").

90. *Brown*, 991 F.2d at 1031 (setting forth the elements of a Rule 10b-5 claim based on unsuitability).

91. Robert N. Clemens Trust v. Morgan Stanley DW, Inc., 485 F.3d 840, 846 (6th Cir. 2007) ("A valid claim under Section 10(b) of the Act and Rule 10b-5 'must allege, in connection with the purchase or sale of securities, the misstatement or omission of a material fact, made with scienter, upon which the plaintiff justifiably relied and which proximately caused the plaintiff's injury.'") (quoting *In re* Comshare Inc., 183 F.3d 542, 548 (6th Cir. 1999)).

92. *See, e.g.*, Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277, 1299 (W.D. Mich. 1986) (holding that the sophistication of the customer is dispositive).

Historically, courts have been reluctant to hold that sophisticated investors relied on recommendations made by their brokers.[93] For example, in *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, the Fourth Circuit held that a brokerage firm, Alex. Brown & Sons, Inc., did not fraudulently sell unsuitable investments when it sold CMOs to Banca Cremi, S.A., a Mexican bank, because Banca Cremi was a sophisticated investor with knowledge of the risks.[94] When the market in CMOs collapsed in 1994, Banca Cremi suffered substantial losses on six CMOs it had purchased through Alex. Brown. The Fourth Circuit found that Banca Cremi had chosen its own investment strategy by balancing the risks and benefits of the CMOs against its goals.[95] The court concluded that Banca Cremi had sufficient sophistication and had been provided with adequate information to appreciate the risks of CMOs "to render unjustified any reliance on a recommendation that the securities were suitable investments".[96]

93. *See, e.g.*, *Banca Cremi*, 132 F.3d 1017; Kennedy v. Josephthal & Co., 814 F.2d 798, 804-06 (1st Cir. 1987) (holding that investors, who were wealthy and sophisticated attorneys, were not justified in relying on misrepresentation of broker's employee concerning limited partnership units); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677-78 (9th Cir. 1982) (holding that an investor, who had a college degree in economics, had taken a course in accounting, had read corporate financial reports with understanding, and who was a regular reader of investment advisory literature failed to assert a claim for unsuitability); Hirsch v. du Pont, 553 F.2d 750, 763 (2d Cir. 1977) ("The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information.").

94. *Banca Cremi*, 132 F.3d at 1032.

95. *Id.* at 1029.

96. *Id.* at 1032; *see also supra* note 93.

III. ARBITRATION OF UNSUITABILITY CLAIMS OF MORTGAGE-BACKED SECURITIES AND COLLATERALIZED MORTGAGE OBLIGATIONS

As a result of mandatory arbitration clauses in most customer agreements, arbitration tribunals have become the principal forum for private actions for damages based on violation of the suitability doctrine. Arbitrators have greater flexibility than federal judges in fashioning an outcome based on principles of fairness and equity.[97] Indeed, *The Arbitrator's Manual* states:

> Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.[98]

A review of arbitration decisions illustrates the flexible standards that arbitrators apply to reach a result. For example, in *Peterzell v. Charles Schwab & Co.*, a retail customer brought a claim against his broker for damages, alleging that the broker induced him to purchase options that were unsuitable for his investment objectives.[99] The brokerage firm argued that the broker never asserted that he was an expert in options trades, that the customer indicated that he was experienced in options trades, and that the broker provided the customer with an accurate prospectus.[100] The arbitration panel nevertheless awarded the customer a portion of his claim.[101] The panel explained:

> Claimant, Joel Peterzell, contributed to his losses by providing false information, devising a questionable strategy and continuing to trade

97. *See* Kenneth R. Davis, *When Ignorance of the Law is No Excuse: Judicial Review of Arbitration Awards*, 45 BUFF. L. REV. 49, 120 (1997) ("Unlike judges who are bound by rigid legal principles, arbitrators tend to be flexible, considering business ethics, the relation of the parties and other nonlegal factors in reaching innovative decisions." (internal citations omitted)).

98. Sec. Indust. Conf. On Arbitration, The Arbitrator's Manual, Preface (2007), *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p009668.pdf (last visited Nov. 19, 2008) (quoting Domke on Aristotle).

99. Peterzell v. Charles Schwab & Co., Inc., No. 88-02868, 1991 WL 202358 (N.A.S.D. June 17, 1991).

100. *Id.*

101. *Id.*

> as losses mounted. Suitability, however, is an ongoing obligation and, although Charles Schwab initially met its suitability obligations, it failed to maintain any ongoing supervision of the Claimant's suitability.
>
> At some point in time, Claimant became unsuitable, even with his false representations. Charles Schwab's Compliance Department should have, at that time, realized his losses were disproportionate to his claimed net worth and annual income.[102]

In other words, arbitration panels have awarded damages to customers even where the same claims may not have survived a motion to dismiss in federal court.[103] That is because absolute defenses in law are generally viewed by arbitrators as merely mitigating factors to weigh in determining the overall fairness of the result.[104] The statistics seem to prove this point: 20% of all arbitration claims are ultimately decided by arbitrators, while only about 1.5% of civil claims filed in court are decided by a judge or jury.[105]

Moreover, judicial review of arbitration awards is severely limited. Arbitration decisions are rarely published, so arbitrators can fashion equitable remedies without facing public scrutiny. In addition, under the Federal Arbitration Act, a court generally may not vacate an arbitration award because the arbitrator made erroneous findings of fact or misapplied the law.[106] Instead, the appellant must establish, *inter alia*, that the arbitrator acted in manifest disregard of the law, which is nearly impossible to show, particularly when the decision of the arbitration panel is not published.[107]

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102. *Id.*

103. *See* White Paper on Arbitration, *supra* note 43, at 26 ("Whereas motion practice is standard in courts, SRO arbitration generally discourages dispositive motions.").

104. *See id.* at 26-28.

105. *Id.* at 3.

106. 9 U.S.C. § 10 (2008); *see also* Miller v. Prudential Bach Securities, Inc., 884 F.2d 128, 130 (4th Cir. 1989) ("[S]uch misinterpretation or misapplication simply does not constitute grounds for vacating an arbitrator's decision.").

107. *See, e.g.*, Stolt-Nielsen SA v. AnimalFeeds Intern. Corp., 548 F.3d 85, 91-92 (2d Cir. 2008) (holding that the arbitral panel did not manifestly disregard the law; "'The manifest disregard' doctrine allows a reviewing court to vacate an arbitral award only in those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent" (quotation omitted)); Chase Bank USA, N.A. v. Hale, 19 Misc.3d 975, 985, 2008 N.Y. Slip Op. 28141, 9 (N.Y. Sup. Mar 31, 2008) (holding that arbitrator's ruling satisfies the threshold "barely colorable" interpretive standard of review for manifest disregard of law to be applied under 9 U.S.C. § 10(a)(4)). *But see*

A. Claims Brought by Retail Customers

With these concepts in mind, customers who have suffered losses from MBSs and CMOs likely will assert unsuitability claims that are focused on the general unfairness associated with their losses. Investors who purchased low tranche CMOs (which had the greatest risk) and CMO derivatives based on the advice of their brokers have suffered the largest losses. Some have argued that the low tranches and CMO derivatives are *per se* unsuitable for retail customers given the tremendous risk associated.[108] This is not the first time such an argument has been advanced. When the CMO market crashed in 1994, commentators questioned whether low tranche CMOs and CMO derivatives were appropriate for retail customers, and successful legal actions were brought under the premise that they were not.[109] This argument, however, fails to account for the fact that some retail investors are sophisticated and may have a preference for high-risk investments.

In the recent subprime mortgage crisis, some initial signs indicate that brokers may have pushed retail customers into these risky products. In a June 2007 "ComplianceAlert",[110] the Office of Compliance Inspections and Examinations (OCIE)[111] of the Securities and Exchange Commission identified a number of deficiencies in the sales practices at some broker-dealers that sold CMOs to retail customers. OCIE ob-

Halligan v. Piper Jaffray, Inc., 148 F.3d 197, 204 (2d Cir. 1998) (holding that the arbitrators acted with manifest disregard for the law).

108. *See* Churchill, *supra* note 15.

109. Susan Antilla, *Wall Street; Salomon's Hong Kong Hangover*, N.Y. TIMES, Sept. 18, 1994, at F13; *see also* Ted Sickinger*, Broker Hit with Big Fine: Piper Jaffray Cited for Improper Marketing of High-Risk Derivatives,* KAN. CITY STAR, Mar. 7, 1996, at B1 (describing how NASD disciplined Piper Jaffray for improperly marketing and selling a mutual fund that contained high-risk, mortgage-backed derivatives); *Merrill Lynch Is Told To Pay Two Clients*, N.Y. TIMES, Sept. 2, 1996, at 45 (describing how NASD arbitration panel awarded $1 million to elderly sisters after Merrill Lynch sold to them CMOs on margin).

110. SEC, ComplianceAlert (June 2007), *available at* http://www.sec.gov/about/offices/ocie/complialert.htm [hereinafter ComplianceAlert].

111. "The Office of Compliance Inspections and Examinations ("OCIE") protects investors through administering the SEC's nationwide examination and inspection program. Examiners in Washington D.C. and in the Commission's 11 regional offices conduct examinations of the nation's registered entities, including self-regulatory organizations, broker-dealers, transfer agents, investment companies and investment advisers." SEC, OCIE http://www.sec.gov/about/offices/ocie.shtml (last visited Nov. 7, 2008).

served that the broker-dealers it had examined "had sold some of the most complex and riskiest classes of [CMO] securities to their retail customers".[112] If a broker recommended these higher-risk products and the retail customer suffered a loss, arbitrators might feel compelled under equitable principles to award damages without fully evaluating whether the customer appreciated the risks.[113] On the flip side, the suitability evaluation creates the potential for gamesmanship as retail investors might argue in hindsight that they lacked the requisite sophistication to appreciate the risks of the investment.

The disclosures provided by some brokers to investors may have been insufficient. In its 2007 examination, OCIE stated that "[i]n some cases, the firms did not provide investors with NASD-required educational materials"[114], which are required by IM-2210-8.[115] "At other times, firms presented investors with sales literature that appeared to be unbalanced and misleading in the way that it portrayed the risks and yields of the securities, and that generally minimized the risks of the securities."[116] OCIE also observed that some firms either failed to submit the advertisements and sales literature concerning CMOs to the NASD for approval, or did not "respond adequately to NASD's comments prior to using sales material. These firms disseminated information which did not appear to provide balanced and complete disclosure of the risks inherent in the CMOs that were sold".[117] Undoubtedly, both retail and institutional investors that lost money on MBSs and CMOs as a result of a broker's failure to provide proper literature will highlight that failure in their arbitration complaints.

Further compounding customer harm, some brokers recommended

112. ComplianceAlert, *supra* note 110.

113. *See* Michael Hudson & Justin Lahart, *Suits Fly over Mortgage Risks to Investors*, CHI. TRIB., Jul. 22, 2007, at 41. Awarding recovery to a retail customer, who knowingly assumed the risks of the investment, potentially creates a moral hazard. If recovery is possible under the suitability doctrine irrespective of the investor's sophistication, then the investor would have less incentive to undertake his own independent analysis of the risks.

114. ComplianceAlert, *supra* note 110.

115. *See supra* notes 81-88 and accompanying text.

116. ComplianceAlert, *supra* note 110.

117. *See id.* In September 2008, FINRA brought an enforcement action against three brokers who engaged in abuses in their marketing and sales of mortgage-backed securities to retail customers. *See* FINRA Sanctions Three Brokers for Sales of CMOs to Retail Investors, *available at* http://www.finra.org/Newsroom/NewsReleases/2008/P039153 (last visited Feb. 1, 2009).

that retail customers invest in MBSs and CMOs on margin.[118] Investing on margin is essentially borrowing money from a broker to purchase securities.[119] A broker's recommendation to purchase on margin may be considered unsuitable, even aside from the underlying investment, if the customer, such as an elderly or retired customer, cannot absorb losses or has a low risk tolerance.[120] Some securities are simply not appropriate for margin accounts due to the risks involved. For instance, brokers generally do not permit customers to purchase penny stocks, over-the-counter bulletin board securities or initial public offerings on margin.[121] Given the risks associated with certain MBSs and CMOs (particularly CMO derivatives), allowing certain customers to purchase these instruments on margin may be viewed as presumptive evidence of unsuitability.

B. Claims Bought by Institutional Investors

For institutional investors, the outcome of an unsuitability claim in arbitration may turn, as a practical matter, less on fairness and more on whether the institutional investor was able to appreciate and comprehend the risks.[122] Of course, if the broker provided false or misleading disclosures to an institutional customer, then the arbitrator may not reach the question of the customer's sophistication except to ascertain whether the customer *knew* the information was false or misleading.[123] If, on the

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118. *See, e.g.*, Sonn & Erez, More About Misconduct, http://www.sonnerez.com/PracticeAreas/More-About-Misconduct.asp (last visited Nov. 19, 2008).

119. Investopedia.com, Margin Trading: What Is Buying on Margin?, http://www.investopedia.com/university/margin/margin1.asp (last visited Nov. 7, 2008).

120. *See Merrill Lynch Is Told To Pay Two Clients*, *supra* note 109 (describing how NASD arbitration panel awarded $1 million to two elderly sisters after Merrill Lynch sold them CMOs on margin).

121. Margin Trading: What Is Buying on Margin?, *supra* note 119.

122. *See, e.g.*, *Banca Cremi*, 132 F.3d at 1029 (rejecting plaintiff bank's argument that it was not a sophisticated investor based on records reflecting that it did not blindly follow broker's advice); *Kennedy* 814 F.2d at 804-06 (1st Cir. 1987) (holding that investors, who were wealthy and sophisticated attorneys, were not justified in relying on misrepresentation of broker's employee concerning limited partnership units); *Follansbee,* 681 F.2d at 677-78 (holding that an investor, who had a college degree in economics, who had taken a course in accounting, who had read corporate financial reports with understanding, and who was a regular reader of investment advisory literature failed to assert a claim for unsuitability); *Hirsh*, 553 F.2d 3 at 763.

123. *Cf. Banca Cremi*, 132 F.3d at 1029 (holding that bank's reliance on broker's false misrepresentation was not justified because knowledge can be imputed when investor's conduct amounts to recklessness).

other hand, the broker provided complete and accurate disclosures to the institutional customer as required under IM-2210-8, the outcome of the arbitration likely will depend on the level of sophistication of the institutional customer.[124] The arbitration proceeding therefore will focus on the level of review conducted by the institutional customer, as well as the sophistication of the persons at the institution who conducted the review.

Certain MBSs and CMOs may be so complex that some institutional investors cannot appreciate the risk. FINRA explained this concern in a Regulatory Notice in September 2007:

> FINRA is concerned about the suitability of recommendations to some pension plans, particularly recommendations involving relatively new, complicated or high-risk asset classes such as . . . the equity tranches of some collateralized mortgage obligations (CMOs). As NASD IM-2310-3 points out, even institutional investors that have the general capability to assess risk may not be able to understand a particular instrument, particularly a product that is new or that has significantly different risk and volatility characteristics than other investments made by the institution. Therefore, in making recommendations to institutional customers, including pension funds, firms should consider both the general ability of the institution to independently assess investment risk, and whether the customer understands the particular product well enough to exercise that ability with respect to the recommendation.[125]

The difficulty lies in the fact that all institutional investors are not equivalent. FINRA defines "institutional customer" in general terms as "any entity other than a natural person".[126] Some institutional investors – such as commercial banks, large municipalities, and public companies – usually employ persons with financial expertise to oversee the investments of the institution. The size of the institution generally affects its financial ability to hire investment officers with the requisite knowledge and skills to understand complex financial products.[127]

Even with the expertise of investment officers, however, some institutional investors have lost substantial amounts of money as a result

124. *Cf.* Proctor & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1279 (S.D. Ohio 1996).

125. FINRA, Regulatory Notice, Senior Investors, *supra* note 73, at 4.

126. IM-2310-3, *supra* note 68.

127. *See* Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U. L. REV. 1493, 1505 (2001).

of brokers recommending unsuitable investments.[128] For example, in the 1990s, the large conglomerate Proctor & Gamble brought an unsuitability claim after suffering substantial losses on unsuitable investments recommended by its broker.[129] Similarly, one academic institution in the mid-1990s, City Colleges of Chicago, lost $50 million, which comprised half of its portfolio, as a result of its investments in CMOs.[130] Orange County, California, with $7.4 billion in assets, has been one of the largest institutions to bring an unsuitability claim against a broker.[131]

Obviously, an institutional investor, which is not a natural person, cannot be "sophisticated" or "unsophisticated"; rather, the level of the institution's sophistication depends entirely on the individual or individuals tasked with evaluating the investment decision. Even some institutional investors benefit from the added input of a broker. As one municipal official testified in the aftermath of the 1994 CMO crash:

> Regardless of the size of their portfolio or their level of sophistication, state and local government investors are unlikely to have access to either the quantity or quality of information relating to specific investment instruments that a broker-dealer has. Broker dealers have real-time, virtually unlimited access to information, such as pricing, structure, and risk factors of an instrument.[132]

Another focus in any arbitration involving an institutional customer will be on the stated investment objectives of the institution, which may

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128. *See, e.g.*, State v. Morgan Stanley & Co., Inc., 459 S.E.2d 906 (W. Va. 1995) (unsuitability claims on behalf of the state of West Virginia); City of San Jose v. Paine, Webber, Jackson & Curtis Inc., No. C 84-20601 RFP, 1991 WL 352485 (N.D. Cal. June 6, 1991) (unsuitability claim on behalf of City of San Jose, California); Pension Fund-Mid Jersey Trucking Indus.–Local 701 v. Omni Funding Group, 731 F. Supp. 161 (D.N.J. 1990) (unsuitability claim on behalf of pension fund); MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/Am. Express, Inc., 886 F.2d 1249 (10th Cir. 1989) (unsuitability claim on behalf of savings and loan institution); Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208 (7th Cir. 1993) (unsuitability claim on behalf of a bank).

129. *Proctor & Gamble*, 925 F. Supp. 1270.

130. Westcap Enters. v. City Colleges of Chicago, 230 F.3d 717 (5th Cir. 2000).

131. County of Orange v. Merrill Lynch & Co. (*In re* County of Orange), 191 B.R. 1005, 1017 (Bankr. C.D. Cal. 1996); Andrew Pollack & Leslie Wayne, *Ending Suit, Merrill Lynch to Pay California County $400 million*, N.Y. TIMES, June 3, 1998, at A1.

132. Testimony Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce, 104th Cong. (1995) (statement of Mark J. Saladino, Principal Deputy County Counsel, Los Angeles County, California).

be reflected in the municipality's governing law or in the institution's articles of organization, charter, or bylaws. If a broker recommended an investment that conflicts with the stated investment objectives of the institution, then the institution may be able to recover on an unsuitability claim even where the institution's investment officers fully comprehended the risks.[133]

IV. CONSIDERATION OF A NEW APPROACH FOR INSTITUTIONAL AND SOPHISTICATED INVESTORS

The anticipated influx of unsuitability claims relating to MBSs and CDOs may spark calls for new regulatory guidance in the area of institutional investors. Such guidance may be long overdue. The number of institutional investors and their influence has increased significantly in the second half of the last century. In 1950, only seven percent of the total outstanding corporate stock was owned by institutional investors.[134] By 2000, fifty-one percent of all stock was owned by institutional investors.[135]

Any regulatory response should consider the potential moral hazard created by the existing suitability rules for institutional customers. By having the recourse of an unsuitability claim, institutional investors are insulated from some investment risk, which may result in that investor undertaking less due diligence than if it had borne more risk. As discussed above, IM-2310-3 attempts to address this concern regarding the moral hazard with respect to sophisticated institutional investors by stating that a broker's obligations are discharged after determining that the institutional customer has made an "independent investment decision[]" and is "capable of independently evaluating investment risk."[136]

Unfortunately, IM-2310-3 provides little certainty to investors or broker-dealers. The scheme under IM-2310-3 is open to manipulation by some investors who might claim *post hoc* in arbitration that they lacked the ability to appreciate the risk at the time of their investment decision. On the other hand, the scheme also allows for brokers to argue that their institutional customers appreciated the risk and made an inde-

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133. FINRA, Regulatory Notice, Senior Investors, *supra* note 73, at 4.
134. Poser, *supra* note 127, at 1501.
135. *Id.*
136. IM-2310-3, *supra* notes 78-80 and accompanying text.

pendent investment decision. Coupled with the uncertainty associated with IM-2310-3 is the inherent uncertainty of arbitration proceedings that rely on principles of fairness and equity and turn on whether a broker made a "recommendation". All of these uncertainties presumably are priced into the transactions between a broker and an institutional customer, resulting in higher transaction costs.

In order to address the potential moral hazard and the uncertainties under the current scheme, one proposal that might be considered is the implementation of a safe harbor for brokers that provide recommendations to certain institutional investors and sophisticated individuals.[137] Under this proposal, if the broker has not provided any materially false or misleading information or omitted material information, then that broker's recommendation of a financial product – coupled with complete and truthful disclosure of all the risks – to an institutional or sophisticated customer should not be subjected to subsequent scrutiny in arbitration. Indeed, in some situations, an institutional investor and sophisticated individual may understand the financial product as well, if not better than, the broker making the recommendation.[138]

A safe harbor for broker recommendations to institutional investors and sophisticated individual investors would be analogous in some respects to the private offering exemptions under the Securities Act of 1933.[139] An institutional investor and high net-worth individual (exceeding a certain income or asset threshold) could be precluded from bringing an unsuitability claim based on a recommendation of an investment, provided the broker did not make any material misstatements or omit material facts concerning the investment. An additional requirement based on the number of years of investment experience could be added to the safe harbor for individual investors in order to address concerns that income and net worth do not necessarily correlate with investment sophistication.

Moreover, to meet the safe harbor, brokers could be required to provide a uniform disclosure document with detailed warnings that, in

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137. The author takes no position on whether such proposal ultimately should be adopted. Rather, this proposal should be carefully evaluated and studied, along with other potential alternatives.

138. *See, e.g.*, *Banca Cremi*, 132 F.3d at 1029 (rejecting plaintiff-bank's argument that it is not a sophisticated investor).

139. 17 C.F.R. § 230.501, *et seq.*; *see also* SEC, Accredited Investors, http://www.sec.gov/answers/accred.htm; SEC, Rule 506 of Regulation D, http://www.sec.gov/answers/rule506.htm.

effect, instruct the investors on the safe harbor and strongly encourage the investor to seek independent counsel and advice. Finally, the safe harbor for institutional customers could be limited to recommendations to a subset of institutional investors that are particularly well-equipped to assess the risk of their investment such as large financial institutions and corporations. The safe harbor would not apply to a broker's recommendations to institutional investors that have specific legal constraints regarding their types of investments.

There are potential benefits of a safe harbor that should be evaluated. First, a safe harbor likely would decrease the number of claims brought in litigation and arbitration by customers that presumably can fend for themselves regarding their investment decisions. Second, a safe harbor might encourage institutional investors to hire personnel with the requisite skills and expertise to evaluate complex investment products. In effect, it would incentivize institutional investors to conduct thorough due diligence to "self-police" their own investment decisions.[140] Conversely, it would create a disincentive for institutional investors to invest in high-risk instruments that could result in significant losses. Third, by creating an incentive to self-police, a safe harbor likely would reduce reliance on third-party ratings. Some commentators have pointed to third-party ratings as a culprit in the current subprime crisis, arguing that MBSs and CDOs are so complex that investors relied blindly on credit ratings.[141] By placing greater emphasis on firm due diligence, the safe harbor may have a secondary effect of reducing reliance on third-party ratings.

A safe harbor does not come without costs. Some commentators have criticized similar safe-harbor approaches tied to investor wealth or sophistication as creating an unfair shift in responsibility.[142] They argue that sophisticated investors deserve protection under the federal securities laws from intentionally or recklessly fraudulent conduct by a broker. As the Second Circuit explained forty years ago, "a salesman cannot deliberately ignore that which he has a duty to know and recklessly state

140. Self-policing is not a substitute for vigorous enforcement of the securities laws by regulators.

141. *See, e.g.*, Opening Statement of Chairman Henry A. Waxman, Hearing of the Comm. on Oversight and Government Reform, U.S. H. of Reps. (Oct. 22, 2008), *available at* http://oversight.house.gov/story.asp?ID=2255; John Birger, *The woman who called Wall Street's meltdown*, FORTUNE, Aug. 6, 2008, *available at* http://money.cnn.com/2008/08/04/magazines/fortune/whitney_feature.fortune/index.htm.

142. *See* Poser, *supra* note 127.

facts about matters of which he is ignorant. . . . The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard".[143]

The concerns of those commentators, however, may be addressed in part by fashioning a safe harbor that is limited to recommendations not involving material misstatements or omissions. By limiting the safe harbor to merely the *recommendations* by brokers (and not any misstatements or omissions), the safe harbor might serve to prevent brokers from becoming insurers for the choices of their institutional customers, thereby reducing the moral hazard observed under the current system. The anticipated result would be that institutional clients would make more careful investment decisions, hopefully avoiding another reoccurrence of the types of losses that occurred in the 1994 CMO crash and the recent subprime mortgage crisis.[144]

A safe harbor for certain institutional customers does not foreclose the possibility that institutional customers and broker-dealers will "opt in" to an arrangement of added protection. Presumably, sophisticated parties are able to fend for themselves.

Institutional customers and broker-dealers can agree to contract terms that are mutually beneficial and that allocate the risks in a transparent and predictable fashion. In some instances, institutional customers may contract for additional protection and incur additional transaction costs. In other instances, institutional customers may contract for less protection and incur less cost. The ultimate level of protection would be determined on the front end, which in turn would help guide the level of diligence required by the institutional customer.

V. CONCLUSION

As the subprime mortgage crisis continues to unfold, there will be a substantial increase in the number of claims brought by customers

143. Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) ("The speculators and chartists of Wall Street and Bay Street are also 'reasonable' investors entitled to the same legal protections afforded conservative traders.").

144. There are undoubtedly other costs and benefits associated with a safe harbor that cannot be contemplated without a thorough study. Therefore, a full analysis of all the costs and benefits would be required before any action is taken. This Article merely presents some of the issues to be debated, and it does not advocate for a particular outcome.

alleging that brokers recommended unsuitable investments in MBSs and CMOs. As with the 1994 CMO crash, there will be a significant number of claims brought by institutional investors. These claims should prompt regulators to reconsider the unsuitability doctrine as applied to certain institutional customers. Creating a safe harbor for the recommendations of broker-dealers to certain institutional investors may encourage more careful review of investments by the institutional customers and may provide greater certainty to both institutional customers and broker-dealers.