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The Unsuitability of the "Suitability Rule": Why FINRA's Current Interpretation of Conduct Rule 2310 Undermines Investor "Holding Claim" Entitlements in Contemporary Markets

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**THE UNSUITABILITY OF THE
“SUITABILITY RULE”: WHY FINRA’S
CURRENT INTERPRETATION OF
CONDUCT RULE 2310 UNDERMINES
INVESTOR “HOLDING CLAIM”
ENTITLEMENTS IN CONTEMPORARY
MARKETS**

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“You got to know when to hold’em, know when to fold’em, know when to walk away, and know when to run.”¹

I. INTRODUCTION

This article’s thesis is that FINRA Conduct Rule 2310,² FINRA’s “suitability rule,”³ should be interpreted to govern all broker-customer communications that constitute non-trivial investment advice regarding portfolio composition, not just buy, sell or exchange communications, per current interpretation (the “BSE Interpretation”).⁴ Because acting on advice to hold a security (a “Holding Claim”)⁵ can affect risk just as significantly as a recommendation to buy, sell or exchange one,⁶ the BSE Interpretation leaves a large body of investment advice affecting

¹ KENNY ROGERS, *The Gambler, on THE GAMBLER* (United Artists 1978). This article is a modified version of a considerably longer work of the same name published as Chapter 15 in 2008 SECURITIES ARBITRATION (P.L.I., N.Y. 2008).

² FINRA, Conduct Rule 2310, Recommendations to Customers (Suitability), available at http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159000499&element_id=1159000500&highlight=2310#r1159000499 (last visited Jan. 6, 2009). By order dated July 26, 2007, the Securities and Exchange Commission approved the National Association of Securities Dealers’ and New York Stock Exchange Regulation’s proposed consolidation of their respective member regulatory operations under a single organization: the Financial Industry Regulatory Authority (FINRA). Self Regulatory Organizations, Exchange Act Release No. 34-56145, 2007 WL 5185330 (July 26, 2007), refer to the conduct rules by “FINRA” rather than the “NASD” prefix contained in the FINRA Transitional Rulebook, which consists of two sets of rules: (1) NASD Rules and (2) the rules incorporated from NYSE (Incorporated NYSE Rules).

³ See Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 Bus. Law. 1599, 1599-1600 (1999) (“This simple sounding admonition, which has come to be known as the “suitability rule,” is one of the most ill-defined concepts in all of securities law Yet, suitability is one of the most common issues arising in disputes between brokers and customers. Indeed, there are several thousand cases filed each year in which aggrieved investors allege financial harm resulting from broker recommendations of unsuitable securities or investment strategies.”) (footnotes omitted).

⁴ See Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L. J. 535, 541-43 & nn.12-14 (2005) (discussing widespread agreement among courts, commentators and regulators that broker-dealers have no liability on suitability grounds absent a recommendation).

⁵ See John R. Bielema, Jr. and Michael P. Carey, *State Law Securities “Holding” Claims and SLUSA Preemption*, 15 A.B.A. Sec. Litig. J. 1 (Fall 2004) (defining “holding claims” as a “subset of securities fraud litigation that has long been disfavored under federal law and has until recently been largely ignored under state law”; noting California, New York and Texas have approved such claims); Amanda M. Rose, *Life After SLUSA: What is the Fate of Holding Claims?*, 69 Def. Couns. J. 455, 461-63 (2002) (arguing holding claims have no clear definition, “involve no transactional element,” and “concern the static relationship between a shareholder and corporation, a substantive relationship defined consistently. . . by state law.”); Andrew Edison, *Holding Claims: An Emerging Cause of Action for Securities Fraud*, ANDREWS LITIGATION REPORTER, Oct. 6, 2004, at 1, available at http://www.bracewells.com/files/tbl_s16Publications%5CFileUpload77%5C1169%5CEdisonComm.pdf.

⁶ Booth, *supra* note 3, at 1600 (“Most courts and commentators seem to agree that the most important factor to be considered in connection with suitability is risk. . . There are few cases, however, in which courts have attempted to quantify risk. In most cases, the courts do little more than attach impressionistic labels such as “growth,” “income,” or “speculative” to individual securities.”) (footnotes omitted); 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, 227-30 (1998).

customer portfolio risk unregulated by suitability standards.⁷ Such interpretation not only fails to reflect Rule 2310's well recognized customer-protective purposes, but effectively transmogrifies Rule 2310 into a shield for wrongdoing, neutralizing Rule 2310's ability to serve as a bulwark against the potential misconduct of inherently conflicted securities commission salespersons.⁸

Because FINRA's interpretation of the suitability rule is itself unsuited to the task of protecting securities customers, it should be rejected. Rather than governing only the purchase, sale or exchange of securities, the rule should be understood to encompass recommendations to hold securities. Part II describes FINRA's historical interpretation of Rule 2310, the meaning of the term "recommendation," relevant FINRA notices to members and a number of awards adopting a broad interpretation of "recommendation." Part III describes state "holding claim" cases and arguments supporting Holding Claims made under agency principles.⁹ Part IV discusses broker advertising, assessing the legitimacy of Holding Claims in light of the types of statements brokers have been making to induce potential customers to trade with their registered representatives.

II.

A. Rule 2310 and FINRA's BSE Interpretation

Rule 2310 provides, in relevant part: "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. . . ."¹⁰ FINRA has refused to define "recommendation,"¹¹ narrowly construing it, and taking the

⁷ See Howard M. Friedman, *On Being Rich, Accredited and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 315-16 (1994).

⁸ Commentators have discussed this conflict. See, e.g., Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U. L. REV. 1493, 1525 (2001) ("The motivation to sell risky securities (and not to disclose their risk adequately) that the compensation system creates applies to sales efforts aimed at institutional as well as individual investors. The selling-practice problems driven by the securities industry's compensation system have thus far resisted efforts for reform. . . Institutional finance officers, whether sophisticated or not, are often barraged by sales pitches from their self-styled financial counselors, who are in reality highly paid and thus highly motivated salesmen and saleswomen."). In the context of holding claims, brokers, without liability exposure, might carelessly advise customers to hold securities, to give the appearance that they are delivering services beyond the scope of their contractual obligations, leading customers to believe they are receiving valuable investment advice on the cheap.

⁹ See Stuart D. Root, *Suitability – the Sophisticated Investor – and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 330 n.131 ("A broker, informed of a customer's investment objectives and informed of the security's characteristics, has a duty to warn of any unsuitability of which it is aware. This flows either from the Rules of Fair Trade or principles of agency, or both." (citing Restatement (Second) of Agency, § 381)). See generally Rapp, *supra* note 6, at 195-202 (connecting the suitability rule's evolution to its doctrinal underpinnings in agency and fiduciary law).

¹⁰ FINRA, *supra* note 2.

¹¹ See Michael K. Wolensky, *Securities Law And The Internet Enforcement Issues: Application of Suitability Obligations*, in SECURITIES LAW & THE INTERNET 251, 257 (PLI Corp. L. & Practice, Course Handbook Series No. 00BS, 1999) (NASD has refused to define the term "recommendation" as used in Rule 2310); Nancy C. Libin and James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?*, 01 COLUM. BUS. L. REV. 601, 614 & nn.36-39 (2001) ("[T]he suitability rule applies only to securities that the broker-dealer 'recommends' to customers. . . [FINRA] has not expressly

position that recommendations must be buy, sell or exchange communications, but not communications by brokers which advise customers to retain securities.¹²

The BSE Interpretation is supported by the literal language of Rule 2310 and is consistent with federal cases requiring the purchase or sale of a security to permit Rule 10b-5 plaintiff standing.¹³ Although courts and commentators have recognized that suitability standards have historically applied only to buy, sell, or exchange recommendations,¹⁴ the BSE Interpretation has recently come under substantial criticism.¹⁵

It is important to determine what types of broker communications Rule 2310 covers not only because that determination is critical to the resolution of arbitral disputes involving Holding Claims but because it is likely to substantially influence how broker-dealers conduct themselves with respect to investment advice they already routinely provide.

B. FINRA General Guidance as to how to Identify "Recommendations"

FINRA has, on occasion, attempted to clarify the term "recommendation." In an April, 2001, Notice to Members, for example, FINRA provided guidance to members with respect to Rule 2310 and FINRA's "Recommendation Requirement."¹⁶ Although the Notice's "Policy Statement" directly concerned so-

defined what constitutes a 'recommendation,' and there is little case law on the issue. . . . The cases that have discussed the scope of the term 'recommendation' fail to provide clear guidance." (citing, *inter alia*, Rafael Pinches, Exchange Act Release No. 41816, 1999 SEC LEXIS 1754, at *20 n. 22 (Sept. 1, 1999) (securities purchased on customer's behalf, but not authorized by client deemed "implicitly recommended within the meaning of [FINRA] rules")). Libin and Wrona argue that because the term "recommendation" is not defined, the question whether a particular transaction is recommended depends on analysis of all relevant circumstances and facts. Such analysis will, per the commentators, depend on the communication's content, context, and presentation and, in particular whether the communication could reasonably be viewed as a 'call to action,' or suggestion that the customer engage in a particular transaction. The more individually tailored a communication to a customer is about a security or group of securities, the more likely the communication will be viewed as a recommendation that triggers suitability obligations. Some of FINRA's Notices to Members discussing how members can determine whether their communications with customers constitute "recommendations," within the meaning of Rule 2310, are discussed *infra*, at notes 21-26 and accompanying text.

¹² See Rapp, *supra* note 6, at 204 n.62, ("Under this narrow interpretation of [FINRA's] own suitability rule, salesmen might be encouraged to learn as little as possible about the customers to whom they recommend securities." (quoting House Comm. On Interstate & Foreign Commerce, Report of the Special Study of Securities Markets of the SEC & Exch. Comm'n, H.R. Doc. No. 95 (1963))).

¹³ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734-36 (1975).

¹⁴ See Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1560 (1999) ("Rule 2310(a) is limited by its express terms to recommendations. . . . the majority of the authorities are consistent in the position that the suitability obligation is imposed on a broker-dealer only in the context of a recommendation."). The authors note further that the "definition of a 'recommendation' within the context of Rule 2310(a) raises difficult questions of interpretation," and that "a broad range of circumstances may cause a transaction to be considered recommended." *Id.*

¹⁵ See, e.g., Gedicks, *supra* note 4, at 569-575 (characterizing brokers as mere "order clerks" to support recommendation requirement is contrary to broker-dealer advertising, particularly at full service firms; arguing that the common law of agency and shingle theory support a duty to warn customers of unsuitable transactions and, consequently, support a rejection of the "recommendation requirement"). *Id.*

¹⁶ NASD, NOTICE TO MEMBERS 01-23, 1, ONLINE SUITABILITY: SUITABILITY RULE AND ONLINE COMMUNICATIONS 1 (Apr. 2001), http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003887.pdf.

called “On-line Suitability,” FINRA’s views set forth in its Policy Statement are, per its own commentary, relevant to the interpretation of Rule 2310 more generally.¹⁷ The Policy Statement was intended to provide guidance to members trying to determine when a “recommendation,” within the meaning of FINRA rules, occurred. FINRA began by explaining what the Policy Statement was *not* intended to do:

[FINRA] Regulation emphasizes. . . that this current Policy Statement does not (1) alter member obligations under the suitability rule or (2) establish a “bright line” test for determining whether a communication does or does not constitute a “recommendation” for purposes of the suitability rule. No single factor discussed below, standing alone, necessarily dictates the outcome of that analysis.¹⁸

Part of FINRA’s affirmative guidance was detailed as follows:

As [FINRA] Regulation has often emphasized “[w]hether a particular transaction is in fact recommended depends on an analysis of *all the relevant facts and circumstances*” . . . the “facts and circumstances” determination of whether a communication is a “recommendation” requires an analysis of the content, context, and presentation of the particular communication or set of communications. . . . *An important factor in this regard is whether – given its content, context, and manner of presentation – a particular communication from a broker/dealer to a customer reasonably would be viewed as a “call to action,” or suggestion that the customer engage in a securities transaction.* . . . the more individually tailored the communication to a specific customer. . . the greater likelihood that the communication may be viewed as a recommendation.¹⁹ (emphasis added).

In its conclusion, FINRA cautioned members to remember that the customer’s best interests must continue to be of paramount importance in any setting, traditional or online.²⁰ In a subsequent clarification of the Policy Statement phrase “call to action,” FINRA wrote: “A customer could reasonably discern a ‘call to action’ by receiving an e-mail or reading a web posting that, objectively considered, suggests that the customer take concrete steps to bring his or her investment portfolio into line with one suggested by the broker-dealer.”²¹

In the context of Holding Claims, the phrase “call to action” is vague. Linguistically, advising a customer to maintain his or her portfolio composition can be described as advice to essentially “do nothing.” A “call to action” seems, on its face, to require advice to the customer that he or she “do something,” i.e., by acting to change the current state of affairs by some form of “affirmative” conduct. Commentators, however, have noted that there are forms of conduct, even if properly described for some purposes or perspectives as “doing nothing,” that may, nevertheless, be properly and simultaneously characterized as “legally” doing

¹⁷ *Id.* at 1 & n.3 (“Although the focus of this Policy Statement is on the application of the suitability rule to electronic communications, much of the discussion is also relevant to more traditional communications such as discussions made in-person over the telephone, or through postal mail.”). *Id.*

¹⁸ *Id.* at 1.

¹⁹ *Id.* at 2.

²⁰ *Id.* at 5.

²¹ FINRA Policy Statement: Online Suitability (May 10, 2001) available at <http://www.finra.org/Industry/Regulation/Notices/2001/p003886>.

something.²² Here, advice to hold securities may be viewed, economically, as effectively the same thing as recommending that the customer purchase them for his or her account, a subject discussed in detail below.²³ Thus, advice to hold securities may properly be viewed as a “call to action,” with respect to portfolio composition.

In the phrase “engage in a securities transaction,”²⁴ the terms “engage” and “transaction” are vague. The term “engage” suggests affirmative or active conduct – conduct in which a customer “engages.” Since the composition of a portfolio is altered by purchasing or selling of securities, it is normal to think of securities transactions in terms of the buying and selling of securities. Even if the customer’s decision to act on a broker’s advice by holding a security is not a “transaction,” it is, nevertheless, equivalent to a transaction, from the perspective of portfolio risk. The phrase “individually tailored”²⁵ seems applicable to advice from broker’s to hold securities because such advice reflects the broker’s understanding of the coincidence of the customer’s account objectives and the risk/reward attributes of the subject portfolio. The phrase “bring into line”²⁶ is more complex as it implicitly suggests that something, in the sense of affirmative conduct, is being advocated as a means to change what already exists.

C. Arbitration Awards, Administrative Decision and “Recommendations”

Notwithstanding FINRA’s BSE interpretation of the term “recommendation” and historical judicial recognition of the BSE Interpretation, some FINRA panels have reached results at odds with FINRA’s interpretation of Rule 2310.²⁷ In some cases, arbitral panels have broadly construed conduct that does not appear to directly fall within the buy/sell/exchange structure.²⁸ In other arbitrations, panels have permitted recovery in the apparent absence of any “recommendation.”²⁹

In *Peterzell v. Charles Schwab & Co.*, for example, claimant traded options, steadily increasing his financial exposure, incurring losses of \$133,000.³⁰ He sued discount broker Schwab, claiming it violated suitability obligations by allowing him to continue trading.³¹ A FINRA Panel concluded that Schwab should have stopped Peterzell, even though the firm had neither provided advice nor any

²² See, e.g., Laurence A. Steckman & Peter Daily, *Attorney Inaction as Trial Strategy: A Study of the Effects of Judicial Use of Non-action Neutral Language on the Analysis and Adjudication of Claims of Ineffective Assistance of Counsel Under the Sixth Amendment*, 6 J. SUFFOLK ACAD. L.89 (1989).

²³ See *infra* notes 122-34, and accompanying text.

²⁴ FINRA, *supra* note 16, at 2.

²⁵ FINRA, *supra* note 16, at 2.

²⁶ *Id.*

²⁷ See Gedicks, *supra* note 4, at 544 & n.25 (listing arbitration awards that appear not to have followed the recommendation condition precedent approach, notwithstanding general agreement of courts and commentators on the requirement).

²⁸ *Id.*

²⁹ *Id.*

³⁰ *In re Peterzell v. Charles Schwab & Co.*, No. 88-02868, 1991 WL 202358, at *1 (Nat’l Ass’n of Sec. Dealers, Inc. June 17, 1991).

³¹ *Id.*

recommendation – it concluded Schwab had an “ongoing obligation” to ensure claimant’s investments were suitable.³²

In *Quick & Reilly v. Barton*, a firm was ordered to pay damages to a self-described “compulsive trader” for letting him recklessly trade index options.³³ Although the firm rendered no investment advice or recommendations, a New York Stock Exchange Panel concluded that the firm had an ongoing responsibility to monitor the trading and to take steps to stop it.³⁴

PaineWebber was found to have breached a duty to monitor a customer’s trading and to warn of increased unhedged risk in *Trans National Group Services, Inc. v. PaineWebber, Inc.*³⁵ The duty to monitor, the panel concluded, arose out of “conversations” between claimant’s principal and the broker, and was breached when the firm failed to adequately supervise the accounts.³⁶ Commentators have identified many recent examples of arbitrations, which appear to have disregarded the BSE Interpretation, even in the context of on-line trading.³⁷ These arbitrations show that at least some Panels have concluded that ongoing suitability obligations exist, in some circumstances, despite the absence of a “recommendation” or even affirmative “investment advice.”³⁸ In the words of one commentator:

[T]he suitability rule . . . is a substantive requirement that imposes on a broker-dealer “an obligation not to recommend a *course of action* clearly contrary to the best interests of the customer, whether or not there was full disclosure.” . . . [T]here is no bright-line test as to what constitutes a recommendation for purposes of Rule 2310, but rather a spectrum of situations, from a broker acting merely as an order-taker, at the one extreme, and the urging by a broker of a customer to buy a particular security, at the other. In between are a variety of situations in which it may not be entirely clear whether or not the rule applies.³⁹

A number of SEC administrative decisions have similarly concluded that a broker-dealer could have “an obligation not to recommend a course of action clearly contrary to the best interests of the customer” in at least some circumstances.⁴⁰ The broker’s determination of what investment is in the “best interests of the customer” requires the broker to match customer’s objectives to an investment that will reasonably permit that objective to be reached; in other words, the investment is “suitable” given those objectives and information the broker has gleaned from his knowledge of the customer and his financial profile.⁴¹ One central purpose of the Suitability Rule has been to attempt to professionalize

³² *Id.* at 2.

³³ *In re Quick & Reilly, Inc. v. Barton*, 1990 WL 306396, at *1 (N.Y.S.E. Feb. 15, 1990).

³⁴ *Id.*

³⁵ *In re Trans Nat’l Group Servs., Inc. v. PaineWebber, Inc.*, No. 91-00770, 1992 WL 472902, at *6-7 (Nat’l Ass’n of Sec. Dealers, Inc. June 30, 1992).

³⁶ *Id.* at 6.

³⁷ *See, e.g.*, Gedicks, *supra* note 4, at 544 & n.25.

³⁸ *See, e.g., id.* at 555.

³⁹ Poser, *supra* note 8, at 1529-30 (emphasis added).

⁴⁰ *In re Powell & McGowan, Inc.*, Exchange Act Release No. 7302, 41 SEC 933 (Apr. 24, 1964).

⁴¹ *See id.* at 2.

investment advice.⁴² As set forth in *Lange v. H. Hentz & Co.*:

The purpose of the rules is found in the desire to professionalize the securities industry. To that end, the ethical has been emphasized over the legal and as a result the class of persons which has specially benefited from the adoption of [FINRA] Rules is the class of security dealers and not the public.⁴³

The district judge in *Lange* cited the Report of the Special Study of Securities Markets of the Securities and Exchange Commission which discussed the need to improve the conduct of securities professionals and which evidenced a “clear intent” to avoid “legalism” and concentrate on simple ethical guidelines:

[T]he [FINRA] rules themselves . . . for the most part, are affirmatively and rather vaguely phrased in terms of what shall be rather than in terms of concrete proscriptions. Thus for example, one is not directed not to recommend that which is unsuitable but is instead directed to recommend that which is suitable. That semantic difference is important, for in the former case the range of violations is narrowed by restricting the penalty to the unsuitable match between the investor and the security while in the latter case the suitable security is required to be matched with the proper shareholder, an admirable but difficult challenge.⁴⁴

In other words, FINRA Rules articulated broad goals and objectives for industry professionals and, by avoiding “legalisms” hoped that self-regulation would be sufficient to protect customers from unsuitable advice.⁴⁵ The debate continues as to whether sharply defined standards will more effectively meet the conflicting interests of commission securities sales personnel and retail customers.

III.

A. Small v. Fritz – California “Holding Claims”

In 2003, the California Supreme Court, in *Small v. Fritz Co.* addressed whether California law permitted plaintiffs to maintain Holding Claims.⁴⁶ The plaintiff held stock in the co-defendant corporation and claimed that the firm’s officers fraudulently issued financial earnings reports that overstated the firm’s earnings and profit.⁴⁷ The misleading reports allegedly induced the plaintiff to hold the corporation’s stock, and when the firm’s earnings and profits were adjusted down, the plaintiff sustained economic damages.⁴⁸ Citing the Restatement (Second) of Torts, the *Small* court set forth its rationale:

⁴² See *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1382 (D.Tex. 1976).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See *id.*

⁴⁶ *Small v. Fritz Co.*, 65 P.3d 1255 (Cal. 2003); see also Edward Gartenberg, *The California Supreme Court Recognizes Holding Claims for Securities Actions*, 1MEALY’S EMERGING SECURITIES . LITIG. 25 (Apr. 2003), available at <http://library.findlaw.com/2003/Dec/1/133178.html> (discussing the *Small* dissenting and concurring opinions).

⁴⁷ *Small*, 65 P.3d at 1257-58.

⁴⁸ *Id.* at 1258.

Section 525 of the Restatement Second of Torts states: “One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act *or to refrain from action* in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.” . . . And section 551, subdivision (1) states: “One who fails to disclose to another a fact that he knows may justifiably induce the other to act *or refrain from acting* in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose” California law has long recognized the principle that induced forbearance can be the basis for tort liability . . . *Gutman v. Howard Sav. Bank* (D.N.J. 1990) 748 F. Supp. 254, 264, upholding a holder’s action based on forbearance under New York and New Jersey law, said: “*Lies which deceive and injure do not become innocent merely because the deceived continue to do something rather than begin to do something else. Inducement is the substance of reliance; the form of reliance-action or inaction-is not critical to the actionability of fraud.*”⁴⁹

The situation in *Small* can be analogized to the situation that frequently arises in broker customer Holding Claim cases. A broker negligently advises a customer to hold securities that, given changed risk-reward features of the security and/or portfolio composition, should have been sold. Under *Small*, the customer has the same suitability protections as investors negligently induced to buy, sell or exchange securities.⁵⁰ Such brokers, under *Small*, would be viewed as affirmatively, not passively, negligent.⁵¹ They become responsible for all damages proximately flowing from such negligence.⁵²

The *Small* defendants argued that California should not recognize causes of action for fraudulent or negligent inducement to hold securities when the issuing firm trades on national markets and the subject representations are public disclosures rather than private communications to the firm’s shareholders.⁵³ The defendants argued that the recognition of holding claims would invite “nonmeritorious ‘strike’ suits designed to coerce settlements,”⁵⁴ and that such claims presented substantial proof problems regarding how a claimant would have acted but for defendants’ misrepresentations.⁵⁵

In rejecting defendants’ argument, the *Small* court explained that part of the justification for the rule that a purchase or sale of a security must occur to have standing under Rule 10b-5 was the express anticipation that claimants would have state law causes of action covering the same misconduct even if not actionable under the 1934 Act.⁵⁶ Moreover, by deterring fraudulent and negligent misrepresentations, the *Small* court reasoned that lawsuits for holding claims would promote investor confidence in California’s financial markets and thereby

⁴⁹ *Id.* at 1259 (third emphasis added).

⁵⁰ *Id.* at 1260.

⁵¹ *See id.*

⁵² *See Small*, 65 P.3d at 1260.

⁵³ *Id.*

⁵⁴ *Id.* at 1260.

⁵⁵ *Id.* at 1260-65.

⁵⁶ *Id.* at 1262.

counterbalance the deleterious effects of possible nuisance suits.⁵⁷

To reduce the threat of nuisance suits and to mitigate concomitant proof problems, the *Small* court announced that in claims for both fraudulent *and* negligent inducement claims, plaintiffs must plead with great specificity the “reliance” element.⁵⁸

In a holder’s action a plaintiff must allege specific reliance on the defendants’ representations: for example, that if the plaintiff had read a truthful account of the corporation’s financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place. The plaintiff must allege actions distinguished from the unspoken and unrecorded thoughts and decisions, that would indicate that the plaintiff actually relied on the misrepresentations.⁵⁹

B. State Law on Holding Claims Move up

Only a handful of states clearly allow for such claim.⁶⁰ California,⁶¹ Massachusetts,⁶² and New Jersey,⁶³ clearly do. Florida,⁶⁴ New York,⁶⁵ and Illinois,⁶⁶ and Wisconsin⁶⁷ have cases of varying degrees of precedential force that apparently permit holding claims.

In Texas, a state appellate court held that the state recognizes a cause of action for inducement to hold securities, where an issuing firm’s executives held face-to-face discussions with the plaintiff-investors and allegedly caused the

⁵⁷ *Small*, 65 P.3d at 1264.

⁵⁸ *Id.* at 1259.

⁵⁹ *Id.* at 1265.

⁶⁰ See David E. Robbins, *Securities Arbitration Procedure Manual*, (5th ed. 2001) § 5-5[d] (noting that many states do not recognize holding claims and trenchantly analyzing the authority in those states that apparently do).

⁶¹ *Small*, 65 P.3d at 1257.

⁶² *Fottler v. Moseley*, 60 N.E. 788 (Mass. 1901) (sustaining a claim against stock broker that induced his client to withdraw a sell order of stock that eventually declined in value); *David v. Belmont*, 197 N.E. 83 (Mass. 1935) (affirming jury charge that banker and securities dealer would be liable to customer for damages if it were found that customer relied on misrepresentations in deciding not to sell his devalued securities).

⁶³ *Duffy v. Smith*, 32 A. 371 (N.J. 1895) (holding that plaintiff had a cause of action against defendant who induced him to hold stock in a company that eventually failed); *Gutman v. Howard Savings Bank*, 748 F. Supp. 254, 262 (D.N.J. 1990). (predicting New Jersey would recognize holding claims under common law based on state courts’ reluctance to dismiss novel tort claims and on cases holding that inducing inaction furnishes a viable claim in other contexts).

⁶⁴ *Rogers v. Cisco Sys.*, 268 F. Supp.2d 1305, 1314 (N.D. Fla. 2003) (extrapolating from Florida state cases to predict that “Florida courts would recognize a cause of action in fraud or negligent misrepresentation for [a] holding claim[.]”).

⁶⁵ *Kaufmann v. Delafield*, 229 N.Y.S. 545, 546-47 (N.Y. App. Div. 1928) (recognizing plaintiff had a cause of action against the defendant that purportedly induced him to retain stock); *Gutman*, 748 F. Supp. at 263 (“The Court concludes that, under New York law, a plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused plaintiff to hold securities which plaintiff otherwise would have sold.”).

⁶⁶ *Gordon v. Buntrock*, No. 99 CH 18378 (C.C. Ill. July 19, 2004).

⁶⁷ *Seidman v. Sheboygan Loan & Trust Co.*, 223 N.W. 430, (Wisc. 1929) (recognizing a cause of action against defendant corporate officers that induced plaintiff to hold devalued notes.)

plaintiffs to hold the firm's securities to their financial detriment.⁶⁸ On unrelated grounds, however, the appellate court withdrew the opinion and, in a new decision, granted defendant's summary judgment and failed to address whether holding claims were actionable going forward.⁶⁹ Other states, for example, Connecticut⁷⁰ and probably Georgia,⁷¹ apparently do not recognize holding claims.

C. Agency Based Argument Regarding Holding Claims

Commentators have recognized that FINRA's suitability rule has been forged from agency and fiduciary law and that the doctrinal underpinnings supporting the suitability rule and legal cause of action for its breach may warrant additional investor protections.⁷² Agency law operates with "shingle theory," a variant of fiduciary law, to warrant holding brokers liable for failing to inform unsophisticated customers of their unsuitable investment decisions, even when brokers make no "recommendation."⁷³ In essence, a broker is his customer's agent by force of their agreement to enter into an ongoing relationship whereby the latter purchases and sells securities for the customer's account in accordance with the customer's instructions. As the customer's agent, the broker owes a duty to disclose material information relevant to the objectives for which the agent was retained:

Agents have long been held to owe a specific duty to give or to provide material information to the principal about the matter entrusted to the agent. This duty obligates the agent to communicate to the principal any relevant information in the agent's possession of which the agent knows or should know that the principal is not aware, but of which the principal would want to be informed. The provision of such information enables the principal to maintain the principal's rightful control of the agent and the purpose of the agency, by revising or rescinding earlier instructions, issuing additional instructions, changing the focus of the agency, or terminating it altogether (citations omitted).⁷⁴

With respect to those matters to which the customer has entrusted the broker to act on his behalf, the broker has an ongoing duty to provide the customer with relevant material information. Of course, this says nothing about the ends to which the agency relationship was entered in the first place. If, as the cases suggest, the customer enters into a contract with the broker that provides the broker will only execute transactions at the customer's behest, then at first blush it seems correct

⁶⁸ *Shrivanian v. Defrates*, 2004 WL 2610509, *withdrawn* 161 S.W.3d 102, 105 (Tex. App. 2005).

⁶⁹ *Shrivanian v. Defrates*, 161 S.W.3d 102.

⁷⁰ See *Chanoff v. United States Surgical Corp.*, 857 F. Supp 1011 (D. Conn.), *aff'd*, 31 F.3d 66 (2d Cir. 1994).

⁷¹ See *In re WorldCom Sec. Litig.*, 336 F. Supp. 2d 310, 323 (S.D.N.Y. 2004) (Cote, J.) (predicting that Georgia state law would not recognize holding claims).

⁷² Gedicks, *supra* note 4, at 546; See also Rapp, *supra* note 6, at 194-95.

⁷³ Gedicks, *supra* note 4, at 546. See also Rapp, *supra* note 6, at 196 ("The 'Shingle Theory' of liability simply holds that a broker's solicitation and acceptance of orders from customers constitutes an implied representation by the broker that she will deal fairly with those customers in the usual manner and in accordance with trade custom and practice.") (citation omitted).

⁷⁴ Gedicks, *supra* note 4, at 571.

that the only duties the broker owes are to faithfully and diligently execute transactions. Not surprisingly, in arbitrations and litigations, both discount and full-service brokers alike refer to language in the account contract that provides that the customer makes all final decisions regarding securities transactions.⁷⁵

D. Shingle Theory

Enter “shingle theory” and its underlying support in fiduciary law. By holding themselves out as professionals with expertise in financial markets, brokers implicitly represent and thereby instill in their customers the expectation that they will deal “equitably and fairly” with them.⁷⁶ This implied obligation to act equitably and fairly—rather than exploit the customer—is a general fiduciary duty that the Commission and FINRA rely upon in issuing rules and regulations to “mitigate [the] harsh consequences that otherwise would ensue when a person is made vulnerable by his or her reasonable reliance on the superior knowledge, skill, or position of” brokers.⁷⁷

The unsuitability of any security recommended by the broker-dealer is thus a fact that is material to the agency relationship and of which the broker-dealer should know that the customer would want to be informed. It is also clear that the just and equitable treatment of customers demanded by the shingle theory requires that the broker-dealer disclose the unsuitability of any recommended security.⁷⁸

Under shingle theory, in inducing customers to rely upon financial firms’ expertise, firms cloak themselves with general fiduciary duties to their customers to treat them fairly and equitably. On the strength of shingle theory’s legal and normative force, one commentator concludes:

A consideration of the equities counsels in favor of imposition of a duty to warn even on discount brokers. Advertising by discount firms frequently emphasizes easy profits, and rarely emphasizes risk. Discount advertising also typically targets middle- and lower-middle-class investors with little knowledge of or experience with direct securities investing, and who are often unable to sustain substantial losses in their portfolios. Additionally, bulk commission discounts and commission-free trading promotions to encourage the opening of discount accounts encourage unprofitable frequent trading. (citations omitted)⁷⁹

If agency law and “shingle theory” combined support holding brokers liable for failing to warn customers of the unsuitability of securities transactions even when the broker makes no recommendation whatsoever, it lends far more support to hold a broker liable for affirmatively recommending that a customer hold an unsuitable security.

When a broker affirmatively advises a customer to hold a security, that advice is plainly material to the agency relationship. The customer sought the

⁷⁵ *Id.* at 541-43.

⁷⁶ *Id.* at 557.

⁷⁷ *Id.* at 562.

⁷⁸ *Id.* at 574.

⁷⁹ Gedicks, *supra* note 4, at 572.

broker's counsel to further his investment objectives. Conversely, when the broker and his firm hold themselves out as offering state-of-the-art financial stratagems and theories in working to meet the customer's objectives, it is neither equitable or fair to limit those obligations to recommendations to buy, sell or exchange advice contrary to the advertising of brokerage firms. Shingle theory and its touchstone in fiduciary law favor deterring firms from instilling expectations in customers that said firms may then contract out of in opening account papers; a bait and switch which no average customer would suspect.

IV.

How many customers would be willing to pay full-boat commissions to purported "full service" brokers if these brokers told them they would function as nothing more than order-takers, that they were not obliged to review any of their customer's investments, and that, if they happened to offer a customer utterly incompetent advice, there would be no recourse against them because they signed form documents that say "broker" as opposed to "investment advisor?" How different are the services, so described, from those that a discount brokerage supplies at substantially reduced fees?

A. Broker Advertising

Many broker-dealer firms market their investment services by advertising their brokers as investment "advisors" ready to provide sophisticated investment guidance regarding the composition of portfolios:

To meet negative images and perceptions over the years, the "customers' man" of old, or the later vintage "account executive," is today a "Financial Adviser," "Financial Consultant," "Investment Consultant" or, more generally, an "investment professional." . . . such titles connote something different from "salesperson," and imply more than a marketing strategy. Diversified "asset gathering" approaches to servicing investment clientele, and the rise of fee-based business among stockbrokers through money-management consulting, or so-called "wrap" accounts. . . illustrate at least an evolving shift from salesperson to consultant. . . Brokerage firm marketing materials eschew the notion that investment professionals simply recommend investments and execute transactions.⁸⁰

Another commentator writes:

Brokerage firms seek to encourage customers to believe that their salespersons are professionals upon whom the customers can rely for expert investment advice. This is made patently clear by their advertising, which emphasizes that brokerage firms can be trusted to give investment advice, designating their salespersons as "financial consultants," "financial advisors," or "account executives"; and in other ways in their customer contacts.⁸¹

⁸⁰ Rapp, *supra* note 6, at 218-19.

⁸¹ Poser, *supra* note 8, at 1534.

The same commentator set-forth the following examples of industry advertising:

A review of the web sites of several brokerage firms shows that they encourage the public to depend on them for investment advice. Typical slogans are “Advising Investors for Over a Century” (Legg Mason), “Your Guide to the Financial World” (First Union Securities), “We Help You Invest Responsibly” (Fidelity Investments), “We want your business, we’ll earn your trust” (Ferris Baker Watts), and “We Measure Success One Investor at a Time” (Morgan Stanley). Titles such as “financial advisor” or “financial consultant” “are pregnant with important legal meaning,” since they invite the customer to enter into a relationship of “trust, confidence and dependence” with the broker. Rapp, *supra* note 3, at 190 n.3. Paine Webber, for example, provides consulting services to institutions and wealthy individuals. Among the services it offers are “asset allocation advice and the evaluation, recommendation and ongoing analysis of investment managers.” UBS/PaineWebber, Corporate & Institutional Services Homepage, at <http://www.ubsPaineWebber.com/index.html> (last visited Nov. 12, 2001).⁸²

Their websites show firms were still making the same sorts of statements until recently. On the home page of Ferris Baker Watts, “We want your business, we’ll earn your trust,” flickers across the screen.⁸³ The corporate philosophy, likewise displayed on the home page, states: “Since 1900, Ferris Baker Watts, Incorporated has maintained a very basic philosophy: focus on the needs of our individual and corporate clients by placing our experience and services at their disposal to help them reach their financial goals.”⁸⁴ The link to obtain basic information about Wachovia Securities provides:

Why Wachovia Securities? [. . .]

We prosper by helping you prosper. That simple fact is at the center of everything we do. Our Financial Advisors listen and respond to your financial needs. They have the knowledge and resources to help you take control of your financial future. When you select a Wachovia Securities Financial Advisor, we realize you have chosen us over scores of alternatives in a highly competitive industry. We will work hard to earn your trust each time we serve you.

Our Mission. To combine the strength and heritage of our firm with the insight, concern, and experience of our associates to give clients objective, individualized advice and service that will help them achieve their long-term financial goals.⁸⁵

The link on Merrill Lynch’s homepage that provides information on the firm’s “Individual Investors” programs currently states:

What a Merrill Lynch Financial Advisor Can Do for You

[Y]our Merrill Lynch Financial Advisor will work with you to develop strategies that can help you achieve your most important goals, whether you’re saving for your children’s education, buying a home, growing your business, or building a

⁸² *Id.*, at 1534-35 ns.157-58.

⁸³ Ferris, Baker Watts, Inc., <http://www.fbw.com>.

⁸⁴ *Id.*

⁸⁵ Wachovia Securities, <http://www.wachoviasec.com/wachoviasec/WachoviaSecCommand>.

legacy for your family. . . Merrill Lynch Financial Advisors are supported by the full breadth of the firm's vast resources, including its world-class investment research, which they apply to help their clients manage their portfolios effectively. Depending on your needs, your Financial Advisor also may arrange for you to access the services of institutional-level investment managers through the Merrill Lynch Consults program.⁸⁶

Brokers continue to hold themselves out as doing far more than just executing the buy-sell-exchange recommendations of their customers; they are regularly advertising that they are engaged in the same types of activities as investment advisors. Requiring broker-dealer firms to apply the most current and effective strategies of financial economics would do little more than hold them to do what their advertising suggests they are already doing. As the SEC has recently stated:

The terms "financial advisor" and "financial consultant," for example, are descriptive of such services provided by broker-dealers. As part of their ongoing business, full service broker-dealers consult with or advise customers as to their finances. Indeed, terms such as "financial advisor" and "financial consultant" are among the many generic terms that describe what various persons in the financial services industry do, including banks, trust companies, insurance companies, and commodity professionals. Moreover, we are concerned that any list of proscribed names we develop could lead to the development of new ones with similar connotations. We believe the better approach, which we are adopting today, is to

require broker-dealers to inform clients clearly that they are entering into a brokerage, and not an advisory, relationship. The customer disclosure requirements, which we discuss above, must be included in all customer documents for fee-based brokerage accounts. We encourage brokers to consider making similar disclosure in other communications.⁸⁷

In a recent article, one commentator observed that:

[I]t may be advisable to incorporate language in nondiscretionary customer agreements, or in an attached document, to the following effect:

You understand that we are under no obligation to provide you with information or advice affecting your trading decisions. However, we may from time to time provide you with such information or advice, at your request or as a courtesy to you. You expressly acknowledge that you are solely responsible for all trading decisions made in your account, regardless of any information or advice you may or may not receive from us. You understand and acknowledge that our providing such information or advice does not impose on us any obligation to provide any continuing information or advice, to update or modify previously provided information or advice, or to provide you with conflicting information or advice of which we may be

⁸⁶ Merrill Lynch, <http://www.totalmerrill.com/TotalMerrill/pages/WorkingWithMerrillLynch.aspx?referrer=mlcom>.

⁸⁷ Certain Broker-Dealers Deemed Not to be Investment Advisors, Exchange Act Release No. 51523, 2005 WL 991247, at *20 (Apr. 12, 2005).

aware.⁸⁸

The reason such language was being suggested by this commentator was because customers who are paying full commissions believe the types of statements being made in the advertising. They reasonably believe they are paying for the “special expertise” of their brokers with respect to portfolio construction and portfolio management and the suggested language would provide a basis, that currently does not exist, for denying customers any claim against brokers who are engaging in services that the customers would reasonably interpret as the type of services for which they are paying. This leads to a broader question. To what extent will the law enforce brokerage form agreements where legal obligations are being created in a manner that indisputably compromises the customer’s reasonable (advertisement-based) expectations and insulates brokers from liabilities that a customer would reasonably expect exist for incompetent service?⁸⁹

Some commentators have argued suitability obligations should be deemed triggered when advice to hold securities is given:

[T]he broker-dealer’s obligation to give suitable investment advice is not triggered solely when a recommendation to purchase or sell a security is involved As a practical matter, a customer is often in contact with his or her broker to discuss whether he or she should change any of the investments currently in his or her account. Advice to retain current holdings should be as much subject to the suitability requirement as advice to add new securities to, or eliminate securities from, one’s portfolio . . . not just a recommendation to purchase, sell or exchange a security. . . . So long as a customer maintains an inappropriate portfolio of securities in his account and the broker-dealer has reason to believe that the investor is still relying on the broker-dealer’s firm for advice, a continuing breach of fiduciary duty should be seen as occurring as to the entire portfolio Maintenance of the persisting inappropriate investment strategy constitutes a continuing wrong committed by the broker-dealer.⁹⁰

Such advice, in many cases, directly affects the integrity and risk characteristics of their portfolios and is often the reason a full service broker was sought in the first place.⁹¹ What is the basis for imposing such duties? Agency theory, discussed above, provides one such source.⁹² Public policy provides another source. Brokers, as commission sales personnel, have financial incentives to respond to customers and to provide more, rather than less investment advice to them. Doing so encourages customers to trust them and feel their financial

⁸⁸ Richard A. Rosen, *The Kwiatkowski Decision: Implications for the Nature and Scope of Duties of Brokers and FCM’s to Their Customers*, 22 No. 9 Futures and Derivatives Law Report (Dec. 2002).

⁸⁹ On the other hand, a number of commentators have urged that requiring firms to apply the insights of modern portfolio theory would impose substantial costs on firms. See, e.g., Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L. J. 527, 573 (1998) (imposing suitability obligations in financial derivatives transactions would impose on the dealer additional responsibility of determining if the counter-party understood the investment risks and whether the counter-party used its own independent judgment in entering into the derivatives transaction).

⁹⁰ Friedman, *supra* note 7, at 315-16.

⁹¹ *Id.*

⁹² Gedicks, *supra* note 4.

situation is in good hands.

It is highly unlikely that most customers distinguish technically “gratuitous” investment “advisory service” from investment advice provided by brokers in the context of a “full service” relationship. To the extent firms hold their brokers out as highly trained, full service investment professionals, not order-takers, and attempt to cultivate relations of trust and confidence with respect to the provision of investment services, customers paying full-boat commissions will continue to reasonably believe part of the “full boat” is the investment advice they are receiving. Providing brokers and firms with a get-out-of-jail-free card based on a distinction between the services brokers and investment advisors provide is effectively a bait-and-switch.

B. Assessment of Holding Claims as a Species of Suitability Claim

Firms’ advertising induces public customers to trust substantially all investment advice brokers provide; absent an ongoing disclaimer that the services are really gratuitous and that incompetent holding advice is not actionable, clients simply assume advice being given is advice they are paying for within the meaning of “full service.” It should not be the customer’s responsibility to figure out that no matter how sub-standard and injurious advice may be relative to customer objectives, the firm is insulated from liability. Where form agreements disclaim responsibilities in a manner inconsistent with firm advertising, the quality of duty a firm owes to its clients should be a function of what the firm stated to the public to induce the customer/firm relationship. Courts have cited common law sources and the Restatements in finding such duty.⁹³ The question whether to recognize “holding claims” in non-discretionary accounts turns on how competing policies are assessed.

1. Defense Counsel Arguments Against Holding Claims

At least five central arguments favor non-recognition of such a claim. Defense counsel should argue all of them.

First, the BSE Interpretation is consistent with the precise language of Rule 2310; if the rules drafters wished to include holding claims, they would have said buy, sell, exchange or hold, but they did not do so, presumably for a valid reason.

Second, the BSE Interpretation is consistent with federal law, which

⁹³ See, e.g., *Union Bank of Switzerland v. HS Equities*, 457 F. Supp. 515, 522 n.12 (S.D.N.Y. 1978) (broker was “under a duty to supervise plaintiff’s account with reasonable care, to keep plaintiff fully advised as to the condition of the account, not to mislead plaintiff as to its status, and not to act in its self-interest at the expense of the plaintiff. In sum [broker] was required to keep plaintiff fully informed as to material matters that could affect plaintiff’s judgment with respect to transactions which were the subject of its account.” *Id.* at 522. The court noted that “the duty to keep plaintiff fully informed flows from the broker-customer relationship whether characterized as fiduciary or agency.” *Id.* at 522 n.12 (citations omitted) “Similarly, the Restatement (Second) of Agency § 380 (1958) states that implied in an agency relationship is the duty of the agent to inform the principal of matters ‘relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have.’” (citing, *inter alia*, N.Y. Jurisprudence, Brokers 30 (1959) (“Generally, a broker is under a duty to disclose to his employer all the material information which he may possess or obtain concerning the transaction involved.”)). *Id.* at 522 n.12.

precludes holding claims under the purchaser/seller rule for reasons tracing to the ease with which such claims can be made, difficulty defending them and complexities of litigation.

Third, the BSE Interpretation is consistent with the Second Circuit's transaction-by-transaction approach in *De Kwiatkowski v. Bear Stearns & Co., Inc.*,⁹⁴ which relies on settled law that brokers servicing non-discretionary accounts have no duties between transactions and only have duties to provide honestly believed information and competent execution of customer directed transactions, with all such duties circumscribed by customer agreements.⁹⁵

Fourth, the BSE Interpretation is consistent with the notion that securities liability can only arise where there has been a purchase or sale security transactions – holder claims rely on the idea that there can be liability for inducing someone not to enter into a securities transaction, a proposition for which there is little historical authority.

Fifth, under the BSE Rule and transaction-by-transaction approach, costs are lessened because no continuous oversight of the portfolio is necessary and brokers need not make any effort to determine the risk characteristics of the portfolio. They just need to execute orders with no potential liability for their advice.

2. Claimants' Counsel Arguments Favoring Recognition of Holding Claims

At least five central arguments favor recognition of such a claim. Claimants' counsel should argue all of them.

First, a "recommendation," clarified by FINRA as a "call to action" should be interpreted in terms of whether the advice alters the risks of a customer

⁹⁴ *De Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293 (2d Cir. 2002).

⁹⁵ See generally *Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952-53 (E.D. Mich. 1978). In a non-discretionary account the broker's duties include becoming familiar with the stock being recommended, "inform[ing] the customer of the risks involved in purchasing or selling" the security at issue, "the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security," and "the duty not to misrepresent any fact material to the transaction"; in non-discretionary accounts. *Id.* at 953. The fiduciary duty is limited with each transaction being viewed separately -- the broker is bound to act in the customer's interest when transacting business for the account, but all duties to the customer cease "when the transaction is closed." *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 769 F.2d 561, 567 (9th Cir. 1985). Where an account is non-discretionary, the broker's fiduciary relationship to the client is limited to the making of specific purchase and sale recommendations and the effecting transactions selected by the customer -- the broker has no ongoing duty to provide the customer with information about a stock after purchase is complete and the giving of advice triggers no ongoing duty to do so. *Id.* However, *Lieb* also distinguishes circumstances in which extra-contractual duties are imposed upon a broker under the theory of de facto control. *Lieb*, 461 F.Supp. at 953-54. De facto control will be deemed to have occurred where, in reviewing the course of dealing between the parties, the circumstances are such as to effectively render the client dependent upon the broker. *De Kwiatkowski*, 306 F.3d at 1308. These special circumstances exist where, for example the client "has impaired faculties, or has a closer than arms-length relationship with the broker, or who is so lacking in sophistication that de facto control of the account is deemed to rest in the broker." *Id.* When de facto control is exercised by the financial advisor, the broker clearly owes the customer not only a fiduciary duty with regard to each individual transaction but also a fiduciary duty, on an ongoing basis, to the total account, which includes all of the broad fiduciary duties that are owed by brokers handling discretionary accounts. *Lieb*, 461 F. Supp at 954.

portfolio. Inaction, when action is appropriate, is really “doing something.”⁹⁶

Second, permitting holder claims to be heard in arbitration is consistent with the status of state law holding claims.

Third, because advice to hold securities affects portfolio risk just as much as advice to buy, sell or exchange securities, a duty to advise customers properly exists and can be justified under agency and shingle theories.

Fourth, as detailed in *Small v. Fritz Companies*, there is no critical distinction between fraudulent buy/sell advice and fraudulent advice that induces a claimant to hold securities to his detriment.⁹⁷ Inducing an investor to hold securities places him in the same economic position as if the broker advised him to buy the security.⁹⁸

Fifth, requiring brokers to live up to their own advertising makes good sense as a policy matter, particularly where such advertisements induce potential customers to sign on with full service firms, but the obligations the firms represent they have, in boiler-plate contracts, are inconsistent with their advertising.⁹⁹

Finally, the law generally finds that duties should be placed on the party who can avoid the risk of harm at the least cost, and that is, plainly, the broker-dealer.

Imposing these duties would not shift to the broker the responsibility for institutional investments that go wrong or make the broker a guarantor of the success of the institution’s investments. It would simply make a broker-dealer, as a trained professional in the securities industry, responsible for making affirmative recommendations that it knows, or ought to know, are unsuitable for its institutional customers. Placing the responsibility on the broker for the suitability of its recommendations would promote efficiency, fairness, and the honesty of the markets. The rule would be efficient because the broker-dealer is usually in a better position than the customer to learn the essential facts and degree of risk concerning a security that it is recommending, and can do so at a lower cost.¹⁰⁰

IV. CONCLUSION

Where an investor, upon his broker’s advice, decides to hold a position rather than sell it, the investor may be deemed to have made a “second investment decision” to accept the market risk of continued security ownership. His decision to “hold” is, economically, equivalent to a repurchase of his position at the

⁹⁶ The “call to action” theory may also be inconsistent with the so-called “second investment rule.” Assume a buyer purchases securities on the basis of fraud later learns of the fraud, but nevertheless decides to hold the position. If the securities then decline, the buyers “second investment decision” to hold the securities is thought to break the chain of causation between the initial misrepresentation and the buyer’s subsequent financial injury; the second investment decision “ratifies” the first even though it is a decision “to hold” the initially purchased securities.

⁹⁷ See *Small v. Fritz Companies*, 30 Cal. 4th 167, (Cal. 2003).

⁹⁸ *Id.*

⁹⁹ Poser, *supra* note 8, at 1519 (“Here, the question is whether it is cheaper and more efficient to place suitability obligations on broker-dealers [requiring] them to police their sales personnel effectively, on the one hand, or to require institutional investors to hire sophisticated investment officers or retain sophisticated independent investment advisers, on the other.”).

¹⁰⁰ *Id.* at 1570.

prevailing market price and can affect portfolio risk as much as if a new position were purchased. A “second investment decision” of this type represents “action” taken by an investor.

If one investor, accepting a broker recommendation, holds the security position he already had rather than selling it, he is in the same position, relative to risk, as a second investor, accepting a broker’s recommendation to purchase a new position in the same security. It makes no sense to deem only the investment purchase decision of the second investor in response to the recommendation to be governed by suitability standards.

Portfolios left untended will, over time, become unsuitable due to random market forces regardless of investment objective. Portfolio “management” is designed to bring portfolios “into line” with a steadily maintained investment risk profile. The portfolio adjustments necessary to maintain a desired risk profile will include buying, selling – in whole or in part – and holding security positions within the portfolio, which is why suitability rules have long required that the composition of existing security holdings be taken into account in determining the suitability of any incremental recommendation to alter portfolio investments.

If a customer accepts a broker’s “hold” recommendation and thus maintains a risk exposure that would otherwise have been terminated, it is an artifice that does disservice to securities industry principles of commercial honor and fair dealing to characterize such a customer decision as “doing nothing.”

Just as if one were to maintain cruise speed while approaching a controlled traffic intersection, rather than slow down by application of a brake, a heightened degree of risk would inherently be assumed that could be characterized as excessive, or even reckless. No driving instructor, having advised his student to maintain his speed, could expect to evade responsibility behind an artifice that he only recommended “doing nothing,” and that the ensuing collision was not a foreseeable consequence of the driver’s reliance on his non-trivial recommendation, and the driver’s resultant “action” to refrain from measures customarily taken to avoid perceived risk.

The BSE Interpretation leaves a large body of investment advice affecting customer portfolio risk unregulated by suitability standards. It is exactly this type of advice that customers, based on broker advertising, have reason to believe is a service being provided as part of a full service contract. Restating our thesis, FINRA’s “suitability rule” should be interpreted to govern all broker-customer communications that constitute non-trivial investment advice regarding portfolio composition, not just buy, sell or exchange communications; per current interpretation.