1992

Defining Suitability

Seth C. Anderson
Huntingdon College

Donald Arthur Winslow
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Securities Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation
Available at: https://uknowledge.uky.edu/klj/vol81/iss1/3
Defining Suitability*

BY SETH C. ANDERSON**
AND DONALD ARTHUR WINSLOW***

INTRODUCTION

The ordinary investor normally looks to a broker to give advice regarding suitable investments. For that reason, the issue of the suitability of such investments is a fundamental part of the investment process and is important to investors and brokers alike. Suitability concerns the type of investment vehicles that an investor will utilize to attain investment goals that may range from rampant speculation to simply maintaining the real value of a pool of funds.

Over the past two decades there have been substantial changes in the securities markets and in the type of financial products that investors may use in attaining their objectives. Trading volume in conventional options and futures has exploded, while at the same time newer investment vehicles such as index options and junk bonds made their debut. Furthermore, billions of dollars have been invested in new closed-end investment company shares.1 Together with the potential investor benefits made possible by these changes, there have also arisen greater opportunities for abuse of investors by unscrupulous or inept purveyors of financial instruments.

Many cases illustrate how unsuitable investments can result from investment advice that is inappropriate for the client in question. In one well-known case, the plaintiff, a widow, had her account churned together with unsuitable investments until the account had less than

---

* Copyright © 1992 by Seth C. Anderson and Donald Arthur Winslow.
** Frank A. Plummer Professor, Department of Business Administration, Huntingdon College. B.S. 1969, University of Alabama; M.B.A. 1980, Auburn University at Montgomery; Ph.D. 1984, University of North Carolina.
*** Associate Professor of Law, University of Kentucky College of Law. A.B. 1975, University of California at Los Angeles; M.B.A. 1979, Johnson Graduate School of Management; J.D. 1980, Cornell Law School.

1 A “closed-end investment company” offers a security similar to that of a traditional mutual fund. These companies may hold a very specialized portfolio of investments, or a highly diversified portfolio. See ROGER K. CHISHOLM & MARILU H. McCARTY, PRINCIPLES OF ECONOMICS 264 (1978).
half its original principal amount. This was accomplished in part by placing the plaintiff’s funds in “a trading account in securities and a speculative account in commodities.” As a result, the widow was left with far less money than she needed to maintain her lifestyle, thus illustrating the real problem with unsuitable investments: an investor can lose not only more money than anticipated, but often more money than the investor can in fact afford to lose.

In this Article we will delineate those types of instruments that are consistent with certain investment objectives. We cannot resolve all difficulties, but we can provide a framework for a spectrum definition of suitable investments in general. As we have previously demonstrated in connection with churning (excessive trading by brokers), a rough and ready attempt can be made to approximate the appropriate investment vehicle in light of the individual investor’s objectives and level of risk aversion. We will show that certain investment vehicles are more appropriate for given objectives than are others. We will also compare various investor goals to objectives pursued by different classes of mutual funds. These general notions of suitability will then be used as a partial basis for a proposal designed to help the industry resolve the difficulties in determining suitability in individual cases.

I. PRACTICAL SIGNIFICANCE OF SUITABILITY

A. Legal Consequences

The requirement that a broker recommend suitable investments has several sources, primarily in the rules of the Self-Regulatory Organizations (SROs). The National Association of Security Dealers

---

3 Id. at 424, 430. The plaintiff was held estopped on the suitability question, but the facts illustrate the problem of unsuitable investments for investors who simply cannot afford to lose principal.
5 Mutual funds allow investors to purchase shares of an investment company which in turn holds shares of other companies. This arrangement allows the small investor to realize the benefits of a highly diversified portfolio as the value of the mutual fund share is driven by the market performance of the shares held by the mutual fund. There is a wide variety of mutual funds available, with objectives ranging from more speculative growth funds to more stable blue chip funds. For a general discussion of mutual funds, see Louis Engel & Peter Wyckoff, How To Buy Stocks 269-86 (1976).
SurrABiLIlY (NASD) has among its Rules of Fair Practices a rule (Recommendations to Customers) that requires that a broker have "reasonable grounds" for believing that an investment is "suitable" and that he make "reasonable efforts to obtain information concerning ... the customer's financial status ... [and] investment objectives" and other reasonable information before recommending a particular investment.7 The New York Stock Exchange (NYSE) requires that each member "know [his or her] customer" with respect to recommendations, sales or offers;8 this directive contains an "[o]bviously implicit" duty on the part of the broker to insure that the recommendations reasonably relate to the needs revealed by the customer's particular situation.9 A former Securities Exchange Commission (SEC) rule, applicable in addition to the rules promulgated by the SROs, required that a reasonable inquiry into the suitability of an investment be made prior to the making of a recommendation.10

If a broker violates one of the suitability rules, a variety of consequences may follow. For example, the SRO may institute a disciplinary action, although these have been infrequent.11 There is also the possibility of a private suit based on the violation of a particular rule, but the great majority of "cases have denied the existence of a private remedy by an injured investor solely on the basis of violation of the applicable rule."12 But if the broker's actions in failing to recommend suitable securities can also be found to violate rule 10b-5,13 the general securities antifraud rule promulgated under section 10(b) of the Securities Exchange Act of 1934,14 or common law fiduciary duties,15 the client has a potential private

---

9 JENNINGS & MARSH, supra note 6, at 643.
10 17 C.F.R. § 240.15b10-3 (1982).
11 HAZEN, supra note 6, at 426.
12 Id., see also COX ET AL., supra note 6, at 1222-23 ("Courts have split on this question," with early cases showing a willingness to imply such a right and later cases showing a reluctance, but not a complete unwillingness, to do so. Cox compares Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980), which holds that it is highly improbable that Congress forgot to mention but nonetheless intended a private action, with Cook v. Goldman, 726 F. Supp. 151 (S.D. Tex. 1989), in which the court recognized a private right of action.;) Woods v. Piedmonte, 676 F. Supp. 143 (E.D. Mich. 1987) (holding that allegations involving churning in two accounts can support a claim under RICO).
15 It has long been held that stockbrokers owe a fiduciary duty to their clients. See, e.g., Birch v. Arnold & Sears, Inc., 192 N.E. 591 (Mass. 1934). See also Brokers Had Duty
right of action that might result in an award of damages against the broker.  

B. Some Problems with Reaching a Conclusion Regarding Suitability in a Private Action

It is often difficult to determine whether a broker has violated suitability requirements. Such difficulty arises in part from the existence of other broker action often present where there are suitability problems, as well as the generality with which the issue of suitability itself is usually approached.

First, it is sometimes difficult to separate suitability problems from churning violations. Leading commentators have observed that the two types of broker misbehavior often occur in the same case, perhaps because it is easier to churn an account with investments that are more speculative than the client needed, i.e., investments that are unsuitable.  

Suitability issues, though obviously present, are sometimes not even raised by courts in considering a churning case. The suitability issues thus tend to lurk in cases rather than playing a dominant role.

Second, even when suitability issues do come to the forefront, further difficulties present themselves. Leading scholars have suggested that little "guides the matching [of a particular client's needs] to "Sophisticated" Client, Calif. Appeals Court Affirms, Sec. Reg. & L. Rep., June 16, 1989, at 892 (criticizing court's failure to recognize broker's common law fiduciary duty to client).

See Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. Feb. 1981); Clark v. John Lamula Investors Inc., 583 F.2d 594 (2d Cir. 1978); Hazen, supra note 6, at 427-28; see also Cox et al., supra note 6, at 1223 (suggesting that uncertainty regarding the right of action from the breach of SRO rules results in pressure to characterize the conduct as a breach of rule 10b-5).

See JENNINGS & MARSH, supra note 6, at 639-41. According to those commentators, the Seventh Circuit views suitability violations as an essential part of the churning case. The Ninth Circuit, however, holds that suitability and churning represent distinct offenses. See, e.g., Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 424, 430 (N.D. Cal. 1968) (holding that the plaintiff was estopped on the suitability question as she was found to have been put on notice of the churning), aff'd, 430 F.2d 1202 (9th Cir. 1970); see also Nesbit v. McNeil, 896 F.2d 380, 386 (9th Cir. 1990) (holding that one should not "conflate" the two concepts and that recovery may be separate for each with an offset of trading gains to cover churning damages); Mihara v. Dean Witter & Co., 619 F.2d 814, 826 (9th Cir. 1980) ("[W]hile damages for churning are limited to commissions and interest, plaintiff's claim as to the suitability of the securities purchased would also encompass trading losses.").

See, e.g., Nesbit v. McNeil, 896 F.2d at 381 ("[T]he investments chosen by defendants were not the kind of investments that one would purchase if one sought a stable, income-producing portfolio."). This account generated a profit, although less than the amount of the commissions realized by brokers.
to [the appropriate level of] risk and return."  The bottom line in a given case may be the culpability of the broker's behavior and the degree of sympathy compelled by a particular plaintiff, as demonstrated in one case where a teletype operator supporting her father was put into commodities futures, options, and tax shelters. Additionally, the customer may be overly aggressive in light of his or her circumstances, which may cause the court to look for solid evidence that the broker led the investor astray.

This generality problem is exacerbated by practices that confound a precise determination of suitability. The broker's inquiry can result in the client's instructions, or needs, being communicated in a manner too general, ambiguous or inconsistent to reliably indicate which investments might be suitable for that client's needs. One such example may occur if the client is permitted to ask simultaneously for growth, income and stability of principal. In addition, the broker may misunderstand the goals communicated by the client, and the client may not be aware of the failure of communication.

Despite these difficulties, some inroads may be made on the suitability issue. By the presentation and analysis of some readily available data, we can work toward a better definition of suitability. Further suggestions may facilitate more certain and reliable communication between client and broker.

II. DATA FROM SOURCES TIED TO MODERN FINANCE THEORY

Risk aversion is a concept that is fundamental to modern finance theory. It holds that a rational investor will assume incremental risks only if incremental returns can be expected. This basic idea is the foundation of utility theory, which describes the investor's likely utility from various combinations of risk and return. From these concepts more sophisticated theories such as the Capital Asset Pricing Model (CAPM) have also grown. We will use the risk-return

---

19 Cox et al., supra note 6, at 1223.
20 Id. (citing Leone v. Advest, Inc., 624 F. Supp. 297, 304 (S.D.N.Y. 1986)).
21 Id. at 1224 (citing Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154 (1st Cir. 1986)).
22 For an explanation of why these characteristics are often mutually exclusive, see infra notes 23-36 and accompanying text.
24 Id.
25 Id. at 75, 92-101.
comparison in a simple manner in order to show that certain investor goals are consistent with particular types of investments.

Figure 1 illustrates a risk-return trade-off line for an investor.

![Figure 1](image)

The complete development of this capital market line can be found in THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY 175 (2d ed. 1983).

28 The FINANCIAL DESK BOOK 3.9 (Richard G. Wollack ed., 1985) [hereinafter DESK BOOK].
course may be compared to the tactics of an investor seeking moderate income and moderate growth who purchases a highly diversified portfolio of assets (market portfolio) that closely tracks the asset markets' overall return ($E(R_m)$) and risk ($\sigma_m$). Theoretically, all investors should hold some combination of the risk-free asset and the market portfolio. We are using the capital market line paradigm as a convenient depiction of the basic risk-return relationship.

In Figure 2 we present the relative positions in risk-return space of a variety of investment vehicles.

---

29 *Id.* at 4.17.
30 Theoretically, all investors should hold some combination of the risk-free asset and the market portfolio. We are using the capital market line paradigm as a convenient depiction of the basic risk-return relationship.
31 The representation in Figure 2 is adapted from a graph by Lawrence J. Gitman and Michael D. Joehnk. See GITMAN & JOEHNK, supra note 26, at 202.
As mentioned above, government securities are the least risky. Savings accounts are considered less risky than corporate bonds, which in turn are less risky than preferred stock, etc. Futures and options can be viewed as the riskiest of financial assets.\(^2\)

The relative positions of the vehicles in Figure 2 are approximate. For example, mutual funds may be stock- or bond-oriented, and may be specialized or general. A fund's particular characteristics will determine specifically where it lies in risk-return space. The particular use of a financial vehicle may also determine where it lies. For example, put options\(^3\) may be used for pure speculation, or they may be used more conservatively for protection against price declines. Such issues will be developed in a later section.\(^4\)

In Figure 3\(^5\) we present a stereotypical view of where particular classes of investors should lie in risk-return space.

---

\(^2\) *Id.*

\(^3\) A "put option" is a contract which permits the holder to sell a predetermined number of equity shares at a predetermined price prior to a specified date in the contract. See Glenn G. Munn, Jr. & F.L. Garcia, *Encyclopedia of Banking and Finance* 767 (7th ed. 1973).

\(^4\) See *infra* notes 45-49 and accompanying text.

\(^5\) Figure 3 is based upon a number of assumptions. First, it is assumed that retirees are likely to be more risk averse than the general public. Next, it is assumed that pension funds and business people have objectives and a sufficient level of sophistication to justify an increased exposure to risk. Finally, sophisticated investors and high risk takers are assumed to take more risks. Sophisticated investors may seek such risk as a result of their experience and ability to more accurately predict future outcomes even when speculative securities are involved. High risk takers, while not necessarily financially sophisticated, may enjoy the excitement of the potential riches that come with the assumption of greater risk. For a discussion of the considerations driving the placement of these classes of investors along the capital market line, see Gitman & Joehnk, *supra* note 26, at 200-04.
High risk investing as a rule should be reserved for sophisticated investors who are willing and able to lose money in anticipation of gaining large returns. At the other end of the spectrum lie those investors whose objective is preservation of capital.\textsuperscript{36}

Of course, as discussed above, this brings up one of the great dilemmas confronting suitability cases: it is hard to say which investor belongs at which point on this line. Because of their situation, which may not be fully communicated to or understood by the broker, investors may belong at different points on the line. Determining where is often difficult.

III. THE BASIS FOR DETERMINING SUITABILITY

A. Stocks and Bonds

Ultimately, the risk-return characteristic of an investment vehicle determines the suitability of that vehicle for an investor with a given objective. Fortunately, there are data available which show the historical risk-return relationship for the broad classes of financial instruments comprising the vast majority of investment vehicles. Stocks, corporate bonds, and government securities are by far the largest groups of vehicles. Other vehicles include derivative securities, such as various options and futures.

The arithmetic mean return for six groups of investment vehicles for the 1926-1987 period is shown in Figure 4.\textsuperscript{37}

\textsuperscript{36} Gambling, such as card-playing or betting on horses, is not a rational activity for risk-averse individuals and is beyond the scope of this Article.

\textsuperscript{37} The representation in Figure 4 is a partial representation of an exhibit in IBBOTSON ASSOCIATES, STOCKS, BONDS, BILLS AND INFLATION YEARBOOK 25 (1988) [hereinafter STOCKS, BONDS, etc.]. This source states:

The arithmetic mean of a series is the simple average of the elements of the series. Stated mathematically, the arithmetic mean from \( T_1 \) to \( T_2 \) is given by:

\[
R_A(T_1, T_2) = \frac{1}{n} \sum_{t=T_1}^{T_2} R_t
\]

where \( n \) is the number of periods from \( T_1 \) to \( T_2 \); that is \( (T_2 - T_1 + 1) \).

\textit{Id.} at 72.
The standard deviation of each series is listed and plotted for comparison of the relative riskiness of each vehicle group. From this it can be seen that common stocks have exhibited greater

---

38 According to Stocks, Bonds, Etc., supra note 37, at 72-73:

The standard deviation of a series is a measure of the extent to which observations in the series differ from the arithmetic mean of the series. For a series of asset returns, the standard deviation is a measure of the volatility, or risk, of the asset.

In a normally distributed series, about two-thirds of the observations lie within plus or minus one standard deviation of the arithmetic mean; about 95% of the observations, within two standard deviations; and more than 99%, within three standard deviations.

Mathematically, the standard deviation is given by:
riskiness as measured by the standard deviation of returns. Small company stocks have returned more than common stocks, in the aggregate, and their standard deviation of returns has been greater.\textsuperscript{39} Corporate bonds have returned more than government bonds.\textsuperscript{40} Intermediate-term bonds have returned less than long-term government bonds. As expected, Treasury bills returned less than bonds, due to their relatively small interest rate risk.\textsuperscript{41}

\[
\sigma_r = \sqrt{\frac{1}{n-1} \sum_{i=1}^{n} (r_i - \bar{r})^2}
\]

where
- \(r_i\) is defined as the return in period \(t\),
- \(\bar{r}\) is defined as the arithmetic mean of the returns designated by \(r\), and
- \(n\) is defined as the number of periods.

\textit{Id.}

\textsuperscript{39} See Peter L. Bernstein, \textit{If Beta is Dead, Where is the Corpse}, \textit{Forbes}, July 20, 1992, at 343.

\textsuperscript{40} Although the standard deviation of corporate bond returns appears to be equal to that of government bonds, in the authors' opinion this is probably a statistical anomaly resulting from a measurement error of imperfectly matched samples.

\textsuperscript{41} An overview of the quantitative methods employed to facilitate a comparison of the performance of the various classes of investment vehicles can be found in \textit{Stocks, Bonds, etc.}, supra note 37, at 27-41. This overview includes a discussion of common stocks, small capitalization stocks, long-term corporate bonds, long-term government bonds, intermediate-term government bonds and U.S. Treasury bills.

With respect to common stock, the total return index is based upon the Standard & Poor (S & P) Composite Index. This index is market-value weighted and therefore calculated by giving a proportionate weight to each stock based upon its price multiplied by the total number of shares outstanding. The S & P Composite Index currently consists of the stock of 500 of the largest corporations based upon their respective market capitalizations. As for months prior to March 1957, however, only 90 companies are included in the S & P Composite Index.

Analysis of returns from equity issues of smaller enterprises from 1926 to 1980 are based upon the results of a historical series developed by Rolf W. Banz. These small capitalization stocks represent the companies with the least amount of market capitalization, or price multiplied by shares outstanding, on the NYSE. Only stocks in the bottom twentieth percentile based upon market capitalization are included. Results for 1981, however, are based upon calculations made by Dimensional Fund Advisors, Inc., utilizing Banz's methods.

Finally, results beginning in 1982 are defined as the small company stock return series, net of expenses, of the Dimensional Fund Advisors (DFA) Small Company Fund. This fund, based upon Banz's methods, serves as an ongoing market-value weighted index. There are some subtle differences, however, from the model as developed for the years prior to 1982. For example, in addition to the ninth and tenth deciles of the NYSE, stocks below the upper bound of the ninth decile of the American Stock Exchange (AMEX) and Over the Counter Market (OTC) are included. Note, however, that prior to 1987, the fund did not purchase stocks which did not have a market capitalization of at least $10,000,000.

Returns from long-term corporate bonds are based upon Salomon Brother's Long-
B. Options and Futures

Owing to the nature of derivative securities such as futures contracts and options, there is little available data similar to that above for debt and equity securities. Both of these derivative vehicles may be used for the purposes of hedging and/or speculation; under either scenario, the level of sophistication needed to understand their use is high. Excessive exposure in the futures contracts market can lead investors to financial ruin, as may writing puts and buying calls.

C. Margin Accounts

An individual may borrow money through a margin account to purchase securities. This is a high risk strategy and should be used only by sophisticated investors who fully understand the cost to them of borrowing funds and the potentially dangerous leverage involved.

IV. Mutual Funds as a Reference Point

In any event, the gamut of investment objectives is encompassed by the many different classes of mutual funds that have been formed

Term High-Grade Corporate Bond Index. This index, which includes most Aaa- and A-rated bonds, is a natural choice because most large corporate bond transactions take place over the counter and Salomon Brothers is a major dealer in that market.

Returns on long-term government bonds are based upon the results of research conducted at the University of Chicago's Center for Research in Security Prices (CRSP) for the years 1926 through 1976. After 1976, returns are based upon the results of a hypothetical one-bond portfolio consisting of an issue with a twenty-year term.

Similarly, total returns of intermediate-term government bonds for the years 1934 through 1986 are based upon a CRSP index. Results for 1987 were calculated using the method described above for long-term government bonds.

Lastly, the U.S. Treasury Bill Index is based upon data from the CRSP U.S. Government Bond File for years through 1976. Thereafter, results are based upon a monthly one-bill portfolio consisting of the shortest-term bill not having less than one month to maturity.

Id.

The writing of call options against stock held is often viewed as an acceptable strategy for increasing income. This practice does increase current income, but at the same time limits price appreciation potential because the stock would be called away if it rose in price.

A "call option" is a contract to purchase a specified number of specified securities at a specified price on a date stated in the contract. See Munn & Garcia, supra note 33, at 163.

For example, a financially unsophisticated elderly widow whose investment objectives are stable income and moderate principal growth would require dividend-paying, non-speculative securities to meet her objectives. Needless to say, such an account would be poorly served by the use of borrowed money. In addition to the increase in leverage from using borrowed funds, the account would incur expected interest expense greater than the expected increase in income.
to meet the needs of investors. The objectives of these funds range from preserving principal, through investment in short-term U.S. Government securities, to speculating for large profits in the highly volatile, and thus highly risky, futures markets. The range of fund types, taken from the Mutual Fund Source Book, along with the type of investment vehicles they employ in seeking their investment objectives, are listed in Table 1.

Table 1

Fund Category and Investment Vehicles Held

<table>
<thead>
<tr>
<th>Category</th>
<th>Vehicles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggressive Growth</td>
<td>Common stock in fast-growing, often speculative companies</td>
</tr>
<tr>
<td>Growth</td>
<td>Common stock in established growth companies</td>
</tr>
<tr>
<td>Growth-Income</td>
<td>Common stock in established growth companies, emphasizing dividend yield</td>
</tr>
<tr>
<td>Equity-Income</td>
<td>Common stock in mature companies, emphasizing dividend yield</td>
</tr>
<tr>
<td>Balanced</td>
<td>Common stocks and bonds in established companies</td>
</tr>
<tr>
<td>Income</td>
<td>Government or corporate bonds</td>
</tr>
<tr>
<td>Option-Income</td>
<td>Common stocks, with emphasis on income and puts and calls</td>
</tr>
<tr>
<td>Small Company</td>
<td>Common stock in small, young companies</td>
</tr>
</tbody>
</table>

Because an individual investor's objectives are likely to be consistent with a particular type of fund's objectives, the invest-

---

45 The construct of complete markets, wherein vehicles are formed because of market demand for them, is the rationale for holding that the range of mutual fund objectives effectively encompasses investor objectives.

46 For the categories and descriptions from which those in Table 1 were developed, see Mutual Fund Source Book (1991) [hereinafter Source Book].

47 See Investment Company Institute, Mutual Fund Fact Book (31st ed. 1991). In 1975 mutual funds fit neatly into seven main categories, but because of innovations these categories have doubled. Although there are more categories today than earlier, we will address eight primary categories, some of which lump together various specialty funds. Id. at § 5.
ment vehicles appropriate for that individual would be similar to those utilized by the particular type of fund. The concentration of investment by the professional managers of mutual funds in specific types of vehicles lends support to the thesis that these vehicles are suitable for the objectives of each respective fund.\textsuperscript{48}

For example, an investor seeking aggressive growth may short-term trade in securities such as those held by a fund similar to the AIM Constellation Fund.\textsuperscript{49} Common stocks held by aggressive growth funds are often very risky shares of young growth companies. Such holdings may be contrasted with growth funds, which typically hold shares in companies with high public visibility such as Philip Morris, Merck, Coca-Cola, and similar highly capitalized entities. Both aggressive growth and growth fund holdings can be compared and contrasted with the holdings of an equity-income fund, which seeks income primarily and long-term capital appreciation secondarily by focusing on high-yield common stock. Obviously, the three fund types described above hold securities that are more risky than those held by a bond fund seeking high quality income.

V. CALL FOR A MORE THOROUGH OBJECTIVE STANDARD

Suitability issues may arise for several reasons. One reason for suitability problems may be that the customer did not clearly delineate his or her objectives to the account representative. Also, it is not uncommon for a customer to be unclear as to his or her own objectives. But the broker has the best chance to control the issue by thoroughly questioning the new customer. In addition, further steps could be taken to ensure that the broker will not misunderstand the customer’s expressed intent.

An examination of current practices reveals that brokers could do a better job of resolving suitability issues in individual cases. These current flaws lie in the information-gathering techniques currently employed by brokers and in the resultant communication failures between the broker and the customer concerning the latter’s investment goals.

\textsuperscript{48} See Desk Book, \textit{supra} note 28, at 5.14-.15.

\textsuperscript{49} A description of this aggressive growth fund’s objective is as follows: “AIM Constellation Fund seeks capital appreciations, principally by trading in securities for the short term. Interest and dividend income will be incidental.” Source Book, \textit{supra} note 46, at 37.
An analysis of several major firms' new account forms shows a high degree of variation in the section of each firm's form addressing the objectives of the customer. For instance, Firm A's form asked the customer to rate in priority one or more of three objectives: (1) Income, (2) Growth, or (3) Speculation. It then asked the investor to rate his or her investing experience as (1) None, (2) Low, (3) Moderate, or (4) High. Firm B's form asked whether the customer sought (1) Appreciation with risk, (2) Speculation, (3) Income with safety, (4) Income with risk, or (5) Tax reduction, without specifying a priority requirement or a limitation on the number of boxes to be checked. Firm C asked whether the investor sought Income, Growth or Total Return, and whether he or she preferred Aggressive, Moderate or Conservative risk, with one goal apparently to be matched to one risk factor. Finally, Firm D offered four alternatives—Income, Investment Grade, Capital Gains, and Speculative—with all four to be prioritized in accordance with the client's investment objectives.

Each form used different terms to describe the investment objectives of the client. The only common element that the forms shared was that none asked the customer to describe the type of investment vehicles he or she would employ in attempting to reach his or her objectives. In particular, the ability of the customer to select more than one objective, even if prioritized, clouds the issue.

These practices should be compared to the much more descriptive and varied types of investment objectives and associated investment vehicles that can be derived from the Mutual Fund Source Book, as indicated in Table 1. We would not suggest that these categories of investments are the generally accepted means of describing these matters. And the categories listed in Table 1 should be expanded, in any event, to account for the more speculative types of goals that might call for investment vehicles such as futures or index options. We merely suggest that categories such as those...
in Table 1 represent a better attempt at full communication than what appears to be the current practice of both large and small investment companies.

The examples of new account forms given above reveal a pattern of oversimplification and inaccuracy, perhaps for a variety of reasons. First, Firm A's three types of investment objectives—Income, Growth and Speculation—are too simple for today's market. Similar comments could be made with respect to the forms of Firms C and D. Second, Firm B's categories show a tendency to suggest to clients that their only alternatives are safe investments such as certificates of deposit, which represent lower income but greater safety, or categories of investment vehicles that, while possessing the potential for great returns, also bear substantial risk. Perhaps this manner of presenting alternatives was chosen with the view of avoiding subsequent litigation. In any event, Firm B's categories do not accurately reflect the intermediate range of investment objectives. Much more reliable determination can be made simply by studying the categories in Table 1 and trying a systematic approach to determining the suitability of certain investments to the needs of certain investors.

A further problem of communication remains for some firms. Many brokers do not give the customer a copy of the agreement after the broker completes the new account form following an interview with the new customer.\textsuperscript{57} In any event, most brokers do not require the customer to sign the form.\textsuperscript{58} These are obviously poor practices.

The potential for misunderstanding, or even abuse, presented by the use of such forms and procedures should be obvious. Such generality and open-endedness in categorizing "investors'" objectives more readily allow the unscrupulous broker the opportunity to churn an account using unsuitable vehicles that are too speculative in light of an investor's objectives. It also allows the broker to later argue that the customer's income objective was the basis for the broker's trading in high-yield junk bonds. Finally, if the customer does not see the broker's conclusions on the form, a greater potential for error is injected.


\textsuperscript{58} Id.
CONCLUSION

A law journal is obviously not the ideal forum for designing reforms for these practices. But it is the appropriate forum to identify the problem while advocating a policy position. The procedures should be tightened and made uniform by the governing bodies of the investment industry. For example, the NASD already requires under its Rules of Fair Practice that a broker explore the customer's investment objectives prior to execution.\(^{39}\) The appropriate body to begin an examination of current practices and possible reforms for its members would be the Board of Governors of the National Association of Securities Dealers, Inc., the industry's self-regulating organization.\(^{60}\) The Board might evaluate this issue with two objectives in mind. First, the Board could consider the possibility of an interpretation or direction under its Rules of Fair Practice requiring NASD members to use a uniform new account form incorporating a less general "objectives" section than most of those currently in use by firms. The form might include a list of objectives similar to those listed in Table 1, with some expansion for investment objectives not covered by that listing. Such a list would facilitate greater precision in the individual's description of his or her investment objectives and risk preferences. Also, the form would list the major types of vehicles, such as blue chip stocks, government bonds, small company stocks, high-grade corporate bonds, junk bonds, options, etc., that the investor could select for realizing his particular objectives. Such a practice would be of great benefit to the investor. For example, if the naive customer initially stated that he wanted long-term growth and income through blue chip stocks, it would be much more difficult for the unscrupulous broker to introduce junk bonds into the account. Second, the Board should require that the broker review the completed form with the customer, have the customer sign it when it is made final, and give a copy of the finished form to the customer. The customer would then know what the broker wrote on the new account form.

\(^{39}\) See NASD Manual, supra note 7, ¶ 2152, at 2051-52.

\(^{60}\) The Rules of Fair Practice are adopted under section 1 of Article VII of NASD's bylaws. NASD Bylaws, art. VII, ¶ 1, NASD Manual, supra note 7, ¶ 2001, at 2011. These bylaws grant the Board of Governors authority to adopt for submission to the members amendments to the Rules of Fair Practice. NASD Bylaws, art. VII, ¶ 1(a)(1), NASD Manual, supra note 7, ¶ 1181, at 1351. It can also "make such regulations, issue such resolutions, interpretations including interpretations of the Rules of Fair Practice, and directions and make such decisions as it deems necessary or appropriate." Id.
These reforms should encourage a better approach to the suitability issue. A firm’s refusal to use such a form might even be considered a deceptive practice under the federal securities laws in a contest over whether an investment was suitable. A firm’s adoption of the form would indicate a willingness to address potential abuses before they occur. Such a firm should be deemed to have made every reasonable effort to be clear with the customer about investment strategy if that strategy is later challenged. Suitability could therefore be more accurately determined in each individual case.