Sources of Securities Broker Liability and Defenses Utilized by the Broker

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I. *Background--Applicable Law*

A. *Federal Securities Laws.*

Federal securities laws spawned the ubiquitous Rule 10b-5, which makes it unlawful in connection with the purchase or sale of a security to (a) make an untrue statement of material fact; (b) make a statement that is misleading because of the omission of a material fact; (c) employ any device, scheme, or artifice to defraud; or (d) engage in any practice that operates as a fraud or deceit. *See* Section 17 of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77q; Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j; and Rule 10b-5 of the Securities Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5.

1. *1934 Act*. Rule 10b-5 provides the most common basis for a federal securities claim. There is a well-established private right of action for violations of the Rule. *Superintendent of Ins. v. Bankers Life & Cas.*, 404 U.S. 6 (1971). Note that scienter (an intent to deceive, manipulate, or defraud) must be proved to establish a claim under Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Recklessness may be sufficient to satisfy the scienter requirement. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990).

A Rule 10b-5 claim covers a broad area. So long as the fraudulent scheme touches upon a securities transaction, Rule 10b-5 applies. *E.g., Superintendent of Ins. v. Bankers Life and Cas.*, *id.*, 404 U.S. 6, 30 L. Ed. 2d 128, 132-34 (1971) (applying Rule 10b-5 to transaction involving defrauded seller of United States treasury bonds even though prices of securities were not distorted, because securities were used as part of the fraud). Rule 10b-5 covers public securities transactions, private transactions, initial offerings and trades on "secondary markets"—*e.g.* years after an initial offering IBM stock repeatedly changes hands on the NYSE or Microsoft through the NASDAQ.

2. *1933 Act*. The primary express remedy for securities fraud under the other federal act, 1933 Act Section 12(2) [15 U.S.C. § 78l], has been restricted to initial public offerings. *Gustafson v. Alloyd*, 513 U.S. 131 L. Ed. 2d 1 (1995). After *Gustafson*, the scope of a Section 12(2) rescission remedy for fraud in a prospectus is not much broader than the 1933 Act Section 11 remedy for fraud in a registration statement. 15 U.S.C. § 78k. Thus, the 1933 Act rarely helps a customer in a typical stockbroker case. Unlike the 1934 Act, the 1933 Act does not cover secondary market trading, discussed below, where most customer account activity takes place.

The statute of limitations for a Rule 10b-5 action is one year after discovery, with a three year period of repose. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). The equitable doctrine of tolling is not applicable in private actions based on violations of Rule 10b-5. *Id.* at 2782.

Generally, Rule 10b-5 damages are limited to those necessary to make the victim whole. *Burgess v. Premiere Corp.*, 727 F.2d 826, 837-39 (1984) (discussing tax issues surrounding remedy). *See also Rolfe v. Blythe, Eastman Dillon & Co.*, 637 F.2d 77, 84 (2d Cir. 1978) (excluding from damage award for a fraudulently mismanaged account the loss attributable to a general "bear market" decline).

3. *Reform Acts*. The Private Securities Litigation Reform Act, 15 U.S.C. Section 77z *et seq.* (the "1995 Act"), has little effect on customer-broker litigation. The 1995 Act was designed to stem the tide of meritless securities lawsuits, particularly class actions. Its primary features were a statutory "safe harbor" for forward-looking financial statements, a system of proportionate, rather than joint and several, liability for defendants in private actions who are not found "knowingly" to have committed a violation (as compared to "recklessly"), mandatory sanctions for violations of Federal Rule of Civil Procedure 11(b) and a requirement that courts choose a lead plaintiff to

represent a class, with a presumption that the best representative is one with the largest financial interest. The "several" liability provisions may come into play in a customer dispute involving a stockbroker who migrates among several broker-dealer firms. Under the right set of circumstances, each firm might be only proportionately liable for some percentage of the total loss suffered.

In 1998, the Securities Litigation Uniform Standards Act took effect, but it was directed to class actions. This act should have no impact on customer-broker disputes, which generally are arbitrated. Class actions cannot be arbitrated in industry forums. *E.g.* NASD Code of Arbitration Procedure Sec. 10301(d).

B. *Rules of Self Regulatory Organizations*.

Related to federal laws and regulations are rules of Self Regulatory Organizations ("SROs") established pursuant to federal law. The SROs are the eight active registered "national securities exchanges" (such as the New York Stock Exchange ("NYSE")), and one "national securities association," the National Association of Securities Dealers Regulation, Inc. ("NASD"). The exchanges and the NASD are required by law to adopt rules

> designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest ....

15 U.S.C. §§ 78(f)(b)(5) and 780-3(b)(6).

Generally, courts have held that a customer cannot base a private right of action under federal securities statutes on a violation of SRO rules. *See Touche Ross & Co. v. Redington*, 442 U.S. 560 (1975); *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980). Nevertheless, at a minimum, such rules represent professional standards of conduct, and may be used to support claims based on agency or tort duties. *Piper,*

Jaffray & Hopwood, Inc. v. Ladin, 399 F. Supp. 292, 298 (S.D. Iowa 1975); *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969). Furthermore, an intentional violation of the rules may be deemed a violation of Rule 10b-5. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978).

Section 15 of the 1934 Act (15 U.S.C. § 78o) requires securities broker-dealer firms to establish adequate systems of supervision over their individual brokers and enforce these internal rules. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1573-76 (9th Cir. 1990). In their procedure manuals, broker-dealers typically track the SRO rules, but add more detail. Customer claims may be based on individual broker misconduct that violates an internal firm compliance guide. Once the individual broker's misconduct is established, agency principals usually make the firm liable as well.

Even when an individual broker is selling securities not approved by the firm, the firm may be liable as a "controlling person" under Section 20 of the 1934 Act, unless the firm proves its good faith defense or demonstrates that the securities at issue were not the type typically traded in the public securities markets. *E.g., Hollinger*, 914 F.2d at 575, n. 16 and *Hauser v. Farrell*, 14 F.3d 1338 (9th Cir. 1994) (discussed below).

C. *State Securities Law*.

The Washington antifraud statute itself is virtually identical to corollary federal provisions. Compare RCW 21.20.010 to 1933 Act Section 17(a) and 1934 Act Section 10(b) and Rule 10b-5. The Washington State Securities Act (the "WSSA") expressly provides a private right of action for violations of its antifraud or registration provisions. RCW 21.20.430 (remedy). The statute of limitations is three years after a violation of RCW 21.20.010 (antifraud) or RCW 21.20.140 - .230 (registration) either was discovered or would have been discovered by a person exercising reasonable care. RCW 21.20.430(4). The "discovery rule," which enables a party pleading an antifraud

claim to delay the triggering of the three-year statute, does not apply to registration violations. *E.g.*, *Kilmartin v. Wainwright*, Fed. Sec. L. Rep. (CCH) ¶ 99,702 (D. Mass. 1984) (permitting investors to toll 1933 Act Section 13's one-year limitations period by proving fraudulent concealment and preserving their 12(2) antifraud claim but rejecting fraudulent concealment with respect to 12(1) registration claim, which was time barred) and *McCullough v. Leede Oil & Gas, Inc.*, 617 F. Supp. 384, 387 (W.D. Okla. 1985).

The WSSA is generally construed consistently with federal and uniform state acts. *See West v. Drexel Burnham Lambert, Inc.*, 623 F. Supp. 26, 29 (W.D. Wash. 1985) and *Haberman v. WPPSS*, 109 Wn.2d 107, 125 (1987) (RCW 21.20.430(1) tracks 1933 Act Section 12(2). Like 12(2), but in contrast to 1934 Act 10(b), scienter is not always required under the WSSA. *Kittilson v. Ford*, 93 Wn.2d 223 (1984) (*scienter* not required to prove violation of RCW 21.20.010(2), regarding material misrepresentation).

A person found liable under RCW 21.20.430 is subject to the rescission or damages remedy. The statute expressly requires a refund of the consideration paid *plus 8% prejudgment interest* from the date of purchase *plus attorney fees* and costs (less any income received by the buyer). 21.20.430(1). Under .430(1), a "seller" who has violated the antifraud or registration provisions cannot even avoid liability by proving "due diligence"—that is, that the seller did not know, and in the exercise of reasonable care could not have known, of the facts misleading the buyer.

In effect, a WSSA plaintiff need only prove "reliance" on the alleged misstatement (or a material omission) in order to hold a "seller" liable for rescission (or equivalent damages if the security was subsequently sold), statutory prejudgment interest and attorney fees. *Hines v. Dataline*, 114 Wn.2d 127, 134-35 (1990). Controlling persons, officers, directors, partners and the like, and even employees who materially aid a "seller," are exposed to vicarious liability for the "seller's" misconduct, but they can

avoid liability by proving that they did not know, and in the exercise of reasonable care could not have known, of the facts leading to the seller's liability. RCW 21.20.430(3). *Hines v. Dataline*, 114 Wn.2d at 135-152.

Our state Supreme Court has held a salesman who sold silver contracts liable under .430(1) as a "seller" and barred him from asserting the "due diligence" defense available to persons vicariously liable under .430(3). *McClellan v. Sundholm*, 80 Wn.2d 527, 534 (1978). *McClellan v. Sundholm* was cited in a later case that adopted an expansive definition of "seller"—anyone who is "a substantial contributive factor in the sales transaction." *Haberman v. WPPSS*, 109 Wn.2d 107, 124-133 (1987) (discussing the 1933 Act and a model state statutory scheme). Washington has rejected a newer and narrower federal definition of "seller." *Hoffer v. State*, 113 Wn.2d 148, 150-52 (1989) (rejecting "seller" test in *Pinter v. Dahl*, 460 U.S. 100 L. Ed. 2d 658 (1988)).

Another difference between the WSSA and a 1934 Act 10(b) claim is that a WSSA claimant does not have to prove "loss causation," an element not only of a common law fraud or negligence claim, but a Rule 10b-5 claim as well. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd.* and *rev'd. not in relevant part*, 459 U.S. 375 (1983) and *Arrington v. Merrill Lynch, Pierce Fenner & Smith Inc.*, 651 F.2d 615, 620-22 (9th Cir. 1981). For example, a company may induce an investor to buy stock by concealing its president's recurring brain tumors. If, however, the company's stock becomes worthless because its products have become obsolete, but the president is still healthy and working, a Rule 10b-5 claim may fail while a WSSA claim succeeds.

The WSSA provides a tempting theory for a customer. The elements of proof are minimal, "seller" liability is expansive, and prejudgment interest plus attorney fees are explicitly allowed. Unfortunately, in the typical customer-broker dispute, the WSSA

does not likely apply. The WSSA really addresses fraud by the issuer or underwriter of a security—*e.g.* a company selling its stock conceals the fact that its president is suffering recurring brain tumors and his prognosis is terrible. *Hines v. Dataline*, *supra*.

In a typical WSSA transaction, a "seller" may be one who receives the purchaser's consideration (i.e., the issuer) or is paid a commission *by the issuer* for the customer's purchase. In other words, the WSSA is likely to apply when a salesperson is acting as an agent of the *issuer* -- *e.g.*, assuming the role of an underwriter. In contrast, in a typical brokerage transaction, the *customer* pays the broker/salesperson a commission for acquiring the stock. A customer of a securities broker-dealer typically is purchasing securities in open secondary markets. The "sellers" are usually other customers who instructed their brokers to find buyers, or dealers who hold blocks of a particular company's stock in inventory for resale. Examples of a stockbroker acting not just as an agent of the customer but as a "seller" could include the sale of variable annuities and mutual fund shares, when the issuer pays the broker a commission.

A stockbroker acts as an agent, but usually on behalf of the customer. The Ninth Circuit observed this distinction in *Nesbit v. McNeil*, 896 F.2d 380, 387 (9th Cir. 1990) (*en banc*). There, the Oregon State Securities Act remedy, ORS Section 59.115(2), was held inapplicable to churning and unsuitable trading because the state securities act applied only to a "buyer-seller relationship," while the plaintiff customer and defendant broker "were in a principal-agent relationship." *Id*. *See also Naye v. Boyd*, Blue Sky L. Rep. (CCH) ¶ 72,393, at 71,777 (W.D. Wa. 1986) (holding RCW 21.20.430(1) inapplicable to class purchasers of Seafirst stock because neither Seafirst nor other defendants were "in any way connected with the innumerable persons who actually sold Seafirst common stock to the various members of the class").

The very agency principles that typically preclude application of a state act like Oregon's or the WSSA, however, provide other theories of recovery for the customer.

D. *Agency Law.*

1. *General Background.* Basic stockbrokers' duties arise from the principal-agent relationship. *See Robinson v. Merrill Lynch, Pierce Fenner & Smith Inc.*, 337 F. Supp. 107 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972). These duties include: (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing; (5) the duty to disclose any personal interest the broker may have in a particular recommended security; (6) the duty not to misrepresent any fact material to the transaction; and (7) the duty to transact business only after receiving prior authorization from the customer. *Leib v. Merrill Lynch, Pierce Fenner & Smith Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), Add, 647 F.2d 165 (6th Cir. 1981).

The "breach of fiduciary duty" theory is overrated, particularly in Washington, where punitive damages are not allowed outside of a few statutes. (In other states, a breach of fiduciary duty theory may expose a defendant to punitive damages.) Absent an investment advisor (money manager) agreement or proof of control over the account, the agency created by typical broker-customer dealings in a non-discretionary account creates no "fiduciary" relationship concerning investments -- other than to refrain from defalcations or misplacing the funds or securities deposited into a customer's account. *E.g.*, *Caravan Mobile Home Sales, Inc. v. Lehman Brothers Kuhn Lock*, 769 F.2d 561,

567 (9th Cir. 1985) (broker had no duty to advise customers of adverse developments affecting their securities positions after purchases).

The duties described above have not been extended to commodities trading. *E.g., Wasnick v. Refco, Inc.*, 911 F.2d 345 (9th Cir. 1990) (citing a Washington case—*Sherry v. Diercks*, 29 Wn. App. 433, 628 P.2d 1336, *rev. denied*, 96 Wn.2d 1003 (1981)—and other federal cases, the court barred a customer with a non-discretionary account from asserting a Section 4(b) claim under the Commodities Exchange Act [7 U.S.C. § 6b (1988)] in the absence of proof the firm intentionally induced trading by an emotionally unsuitable customer and finding that, regardless of internal firm compliance rules, a broker has no "obligation to stop [commodities] trading for an emotionally or financially unsuitable client"). *Id.,* 911 F.2d at 349-50.

2. *Clearing Broker Liability*. Some broker dealers, known as "introducing brokers," "travel light," and provide financial advice but no clearing services themselves. They typically retain independent contractor registered representatives, rather than employees. These independent contractor-brokers may have their own financial planning or insurance businesses.

Many introducing brokers are not members of the NYSE or other exchanges, so they contract with other broker-dealers to handle their transaction processing and record keeping. Firms that provide these processing and accounting facilities are known as "clearing brokers." Typically, in contracts with introducing brokers and customers, clearing brokers specify that they have no suitability or other non-clerical obligations because the customer relationship is with the introducing broker, whose job it is to make proper recommendations and supervise its representatives accordingly. Clearing relationships are "classic examples of division of labor." Harry Minnerop*, The Role and Regulation of Clearing Brokers*, 48 Bus. Law, 841, 843 (May 1993).

Over a decade ago, interpreting Illinois law, the Seventh Circuit refused to expose a clearing broker to federal or state law liability for any securities law violations of the introducing broker (in a registration case). *Carlson v. Bear, Stearns & Co.*, 906 F.2d 315 (7th Cir. 1990). This precedent was well-established. "[A] clearing agent is generally under no fiduciary duty to the owners of the securities that pass through its hands." *Edwards & Hanley v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 484 (2d Cir. 1979). More recently, *see*, *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22 (2d. Cir. 2000) (clearing broker not liable for introducing broker's fraud, even though clearing broker was market maker for manipulated stock). Of course, things can be different when a customer can prove that a clearing broker acted as a co-schemer in the introducing broker's fraud.

In recent years, customers have made inroads on the disclaimers of a clearing broker. For example, a clearing broker that gets too close to a "Long Island bandit" introducing broker and thereby participates in a fraud may find itself liable to the bandit's customer. *E.g., In Re Bear, Stearns Sec. Corp.*, Exchange Act Release No. 41,707, 1999 SEC LEXIS 1551 (Aug. 5, 1999) or *Koruga v. Victor Ming Wang, Duke & Co.*, NASD Case No. 98-04276 (Sept. 28, 2000) (full reasoned opinion supporting award for customer defrauded by introducing broker because clearing broker had "materially aided" introducing firm within the meaning of California and Washington securities statutes). A motion to vacate this roughly $2 million damage award was denied by the Oregon federal district court on May 10, 2001 (Case No. 00-1415MA), and the clearing broker, Fiserv, has appealed to the Ninth Circuit.

3. "*Selling Away.*" Sometimes individual stock brokers sell securities products that their firms know nothing about, and therefore have not included on their approved products lists. Often, these unapproved products meet the definition of a

"security" under state and federal securities statutes. *E.g.,* nine-month promissory notes secured by insurance company guaranty for oil drilling programs, golfing practice centers and television series, pay telephone contracts and other interests in trendy enterprises that can spice up a sales pitch.

Promoters of these ventures avoid raising capital through broker-dealers and instead pitch individual sales persons with explanations that the products are not securities or are exempt from registration. Sometimes gullible or unscrupulous registered representatives recommend such investments to investors who are customers of the representative's broker-dealer, but some investors are not firm customers. The representative typically collects a substantial sales commission from the illicit issuer, but reports none of it to the broker-dealer and falsifies compliance questionnaires addressing the sale of securities outside of the firm.

Because the sales representative is licensed with a broker-dealer, an investor who purchases such a product, whether or not a customer of the firm, may seek to hold liable not only the sales representative (who along with the promoters has spent all of the proceeds), but also the broker-dealer with which the sales person is licensed. The claim against the firm is based on misconduct by the sales person -- *e.g.*, negligence, negligent misrepresentation, state and federal securities fraud, common law fraud, etc., and *respondent superior* or failure to supervise.

Under the federal securities laws (and by analogy virtually all state securities statutes) a broker-dealer is necessarily a controlling person of any licensed representative, because of its 1934 Act Section 15 duty to supervise. *E.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1573-75 (9th Cir. 1990) (c*ert. denied,* 499 U.S. 976, 111 S. Ct. 1621, 113 L. Ed. 2d 719 (1991)). To avoid federal controlling person liability in the sale of securities "away from the firm," a broker-dealer would have to demonstrate

that the investor placed funds with the individual registered representative for purposes other than investment in markets to which the registered representative had access only by reason of the rep's relationship with the associated firm. *Hollinger v. Titan Capital Corp.,* 914 F.2d at 1575-76, n.26. *See also, Hauser v. Farrell*, 14 F.3d 1338, 1342 (9th Cir. 1994) (citing *Hollinger* and affirming summary judgment dismissal of brokerage firm, even though the plaintiff was a customer, since the plaintiff was told the securities purchased from the employee-representative in a non-public offering were not sold through his firm).

When the investor is not a customer of the broker-dealer, federal securities controlling person liability may be the investor's best hope:

> The undisputed facts show no special, duty-creating relationship existed between Dean Witter and [plaintiff]. [Plaintiff] had no account at Dean Witter. Moreover, no alleged fact indicates he was ever a customer of, had ever purchased a security from or had ever placed an investment with the Boca Raton branch of Dean Witter. Thus, even if Dean Witter were negligent in hiring and retaining the defrauding [brokers] no duty arose under the circumstances here.

Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 885 (7th Cir. 1992) (affirming summary judgment dismissal of Illinois state law claims for negligent hiring and retention but reversing summary judgment dismissal of federal securities claim for controlling person liability because extraordinary volume of activity in broker/rep's own Dean Witter account arguably triggered a supervisory duty to investigate these in-house transactions and uncover the promissory note scheme of the broker/rep that comprised most of the unusual trading in his account).

A California court has refused to apply state agency *or* controlling person law to hold a broker-dealer vicariously liable for the acts of a miscreant sales agent:

> We hold that where, as here, the registered representative is not an employee of the broker-dealer, has no actual or apparent authority to sell

> the investment at issue, and the broker-dealer had no notice of and did not in any way benefit from the transaction, the broker-dealer has no such duty [to supervise its registered representative].

Asplund v. Selected Investments & Financial Equities, Inc., (2000) 86 Cal. App. 4th 26 at 29. The Asplund court's observation that the rep was not an employee suggests that the rep-firm relationship may have an effect on common law vicarious liability theories, even if it has no impact on controlling person liability under federal and state securities statutes.

E. *Tort Law.*

The law of torts is often the basis of claims against stockbrokers:

> Unless he represents that he has greater or less skill or knowledge, one who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar circumstances.

RESTATEMENT (SECOND) OF TORTS § 299A. The level of care and skill required of a stockbroker is high. As one court has noted, "the broker/customer relationship is rife with implied representations as to the broker's honesty, diligence and competence." *Rolf v. Blythe Eastman Dillon & Co.*, 424 F. Supp. 1021, 1037 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d Cir. 1978), *opinion amended*, 637 F.2d 77 (2d Cir. 1980), *cert. denied*, 439 U.S. 1039 (1978).

The duty of care, agency duties, and the statutory duties noted above may form the basis of a negligence claim against a stockbroker. Common law fraud and negligent misrepresentation are also often asserted with federal and state securities claims. *See generally*, VOL. VIII, L. LOSS, SECURITIES REGULATION, pp. 3770-3902 (1991).

II. *Primary Types of Claims Against Stockbrokers***.**

A. *Misrepresentations and Omissions*.

Misrepresentations and omissions may be more readily found actionable against stockbrokers and their firms than against other potential defendants. As one leading commentator has noted:

> In light of the policies underlying the [securities laws] of equalizing bargaining positions, protecting investors, and fostering fairness and investor trust, a broker-dealer's special relationship to the securities system and its usually superior knowledge suggest that it should indeed be held to a higher standard. . . . In other words a misstatement or omission made by a broker may be actionable, while the identical statement made under the same circumstances by another person may not be.

A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 211.02 (1993) (hereafter "Jacobs"). This thesis, often nicknamed the "shingle theory," *see Charles Hughes & Co., Inc. v. Securities and Exchange Commission*, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943), ties into the "professional duty" underlying a negligent misrepresentation claim.

Washington has adopted the RESTATEMENT (SECOND) OF TORTS § 552(1), (2) (1977) which provides:

> (1) One who, in the course of his business, profession or employment or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communication the information.

> (2) . . . [T]he liability stated in Subsection (1) is limited to loss suffered. . .
>
> (a) By the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
>
> (b) Through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction. . .

Haberman v. WPPSS, 109 Wn.2d 107, 161-64 (1987). Like common law fraud, negligent misrepresentation must be proved by "clear, cogent and convincing" evidence. *Havens v. C & D Plastics*, 124 Wn.2d 158, 180 (1994) (*citing Sprague v. Sumitomo Forestry Co.*, 104 Wn.2d 751, 762 (1985).

Keep in mind that "forecasts and optimistic proclamations" are not necessarily actionable under Rule 10b-5:

> In the Ninth Circuit, projections and general statements of optimism are not actionable unless: (1) the statement was not genuinely believed; (2) the statement did not have any reasonable basis; or (3) the speaker was aware of undisclosed facts tending to "seriously undermine the accuracy of the statement." *In re Apple Computer Sec. Litig, 886 F.2d 1109, 1113* (9th Cir. 1989). The proper focus is on the facts available at the time the prediction was made. Evidence that a prediction turned out to be wrong does not prove that the prediction was false when made. *In re VeriFon Sec. Litig.*, 11 F.3d 865, 871 (9th Cir. 1993).

In re Cypress Semiconducter Sec. Litig., 891 F. Supp. 1369, 1375 (N.D. Cal. 1995).

B. *Lack of Reasonable Basis for Recommendations--Suitability vs. Unsolicited Orders.*

1. *Background*. The SEC and the courts have consistently taken the position that it is a violation of the anti-fraud provisions of the securities laws for a broker or brokerage firm to recommend a security without an adequate basis for the recommendation. *See e.g., Gochnauer v. A.G. Edwards & Co.*, 810 F.2d 1042, 1049

(11th Cir. 1987); *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969); *Rolf*, 424 F. Supp. at 1037-38, 1042-43. A broker has a duty to make investment recommendations that are "suitable" for his/her customer. The duty is expressed in the NASD's Rules of Fair Practice as follows:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NASD Rules of Fair Practice, Art. III, § 2. NASD Conduct Rule 2310. *See also* RCW 21.20.702; *DelPorte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1153 (5th Cir. 1977), *Rolf*, 424 F. Supp. at 1037-38, 1042-43.

This "reasonable grounds" duty is often mislabeled the "Know Your Customer" rule, which is NYSE Rule 405. NYSE Rule 405 requires a broker to learn "essential facts" about each customer, account, order, etc.

Many broker-dealers are not subject to NYSE Rule 405 because they are not NYSE members. Moreover, NYSE Rule 405 is said to have been enacted originally to reinforce a stockbroker's duty to the firm to investigate the creditworthiness and other characteristics of a customer in order to protect the firm, not the customer. *See Nelson v. Hench*, 428 F. Supp. 411, 419-20 (D. Minn. 1977), (Rule 405 enacted primarily to protect the broker-dealer); and Loss and Seligman, *Fundamentals of Securities Regulation*; 898 (3rd Ed. 1995) (Rule 405 "seems more designed to protect the member firm than the customer"). See *also* N.Y. Stock Ex. M.F. Educ. Circ. 234 (1968).

One commentator has observed the evolution of Rule 405 into some kind of suitability obligation:

> Although [Rule 405] was originally designed to protect stock exchange members from dishonest or insolvent customers, it is today also regarded

> as protecting investors from being induced to purchase securities whose risks they can ill afford.

Posner, N., *Broker-Dealer Fraud under the Securities Laws,* Section 3.3.1, at 306 (1st Ed. 1995). This evolution of NYSE Rule 405 could simply be a misapplication. The NYSE itself does not use Rule 405 to discipline a broker for making unsuitable recommendations. Instead, it uses Rule 476(a) -- conduct inconsistent with just and equitable principles of trade -- in unsuitability matters. *See Lowenfels & Bromberg*, *Suitability Securities Transactions*, 54 The Business Lawyer, 1557, 1571-72 (Aug. 1999).

Returning to NASD Conduct Rule 2310, the better predicate for a negligence claim, a broker has no "reasonable grounds" duties when a customer places an unsolicited order. *Pachter v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 444 F. Supp. 417, 421-22 (E.D.N.Y. 1978). *Parsons v. Hornblower & Weeks-Hamphill*, *Noyes*, 447 F. Supp. 482, 495 (N.D.N.C. 1971), *aff'd. per curiam*, 571 F.2d 203 (5th Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96, 525, n. 16 (2nd Cir. 1978) (simply executing orders can not create liability for "unsuitable" transactions); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 215 (7th Cir. 1993) ("Customer-directed transactions fall outside the 'suitability' requirement . . ."); *Loss & Seligman, Fundamentals of Securities' Regulation,* 902 (3rd Ed. 1990) ("Only time a broker-dealer is clearly relieved of a suitability duty is when his or her only relationship with the customer is that of an order clerk. . .").

Furthermore, in most situations, after the customer makes a purchase, a broker has no continuing duty to disclose facts it later learns, or to render subsequent investment advice regarding the security. *Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, *supra,* 769 F.2d 561, 567 (9th Cir. 1985); *Robinson v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, *supra*, 337 F. Supp. 107 (N.D. Ala. 1971).

2. *Notable Cases*.

Unity House, Inc. v. North Pacific Investment, Inc., 918 F. Supp. 1384 (D. Haw. 1996). Fidelity and Schwab, acting as discount brokers, owed no duty to prevent unsuitable trades in a non-discretionary customer account, nor did either have a duty to monitor the activity in a non-discretionary account. *Id.* at 1391-93 and n. 7. For good measure, the court observed: "[S]uch a proposed duty is 'a good example of a plaintiff's deep-pocket theory that attempts to stretch the securities laws beyond recognition.'" *Id.* at 1393, citing *Cumis Ins. Soc'y, Inc. v. E.F. Hutton & Co.*, 457 F. Supp. 1380, 1382 (S.D.N.Y. 1978).

Beckstrom v. Morgan Keegan & Co., Inc., 1998 La. App. Lexis 3426 (La. App. Ct. Nov. 6, 1998). With respect to an incompetent customer, this court contrasted the duties owed by a full service broker to the duties of an "order taker." The *Beckstrom* court held:

> [T]he shocking terms of this deleterious trade [a bond fund swap] should have put a broker on notice that the client's capability, and the financial relationship had changed. . . when faced when this elderly client, or indeed any client, whose judgment is patently adverse to his own best interest, a broker's duty encompasses written confirmation of the ramifications of the proposed transaction. [The broker's] provision of prospectuses and general information on each investment was insufficient under the

> circumstances. . . it was the broker's duty to 'do the math' and present the results in writing to the investor. . . This full service broker breached his fiduciary obligation to Mr. Beckstrom when he defaulted to performing as an 'order taker.'"

Id. at 3430. (This presumptuous court actually believes such a customer would read this "math" and heed a written warning. Cynics would say that customers who litigate rely solely on murky oral statements and never read anything from their brokers anyway.)

Chee v. Marine Midland Bank, N.A., [1990-91 Transfer Binder] Fed. Sec. L. Ret. (CCH) ¶ 95, 806 (E.D.N.Y. 1991). Customer could not state claim against discount broker for unsuitable option trading because the discount broker did not recommend the transactions at issue. The Court ruled that discount brokers had no duty "to monitor the independent investment decisions of their clients." In fact, "there is even greater reason to reject monitoring liability in the case of discount brokers whose admitted function is not to give advice so investors can save money on commissions." *Id. See also*, *Robinson v. Merrill Lynch, Pierce, Fenner & Smith, supra,* 337 F. Supp. at 111:

> [A] broker's office, without special circumstances not present here, is simply to buy and sell. The office commences when the order is placed and ends when the transaction is complete. The risk of the venture is upon the customer who profits if it succeeds and loses if it fails. When the transaction is closed in accordance with the understanding of the parties, the broker gets only his commission and interest upon advances. . . [w]here there is no special relationship of trust and confidence between a stockbroker and his customer, the stockbroker is not liable for [the customer's] improvident speculation."

First Union Discount Brokerage Serv., Inc. v. Milos, 744 F. Supp. 1145, 1157 (S.D. Fla. 1990), *Aff'd.*, 997 F.2d 835 (11th Cir. 1993). ("A discount broker's "only obligation to the [customers] was to enter their orders within a reasonable period of time.")

3. *What Constitutes a Recommendation or a Solicitation?* The SEC and NASD have declined to define the term "recommendation." They have chosen a case by case approach. *See* SEC Release No. 34-7588, 60 FR. 54530 (Aug. 20, 1996); *In re National Committee of Discount Securities Brokers*, 1980 WL 15131 (June 25, 1980) (SEC has not identified each act or practice that could constitute a recommendation); and NASD Clarification of Notice to Members, 96-60 (March 1997). Notwithstanding this position, the NASD and SEC appear to concede that a recommendation involves more than simply a general solicitation. More specifics are typically required.

For example, in its filing concerning day trading rules, the NASD acknowledged concerns about a broad definition of "recommendation" and altered proposed language to replace "recommendation" with "promoting a day trading strategy." The NASD was responding to commentor concern that a general advertisement (*e.g.*, a "solicitation") not be equated to a recommendation and thereby create a suitability obligation. *See* SEC Release No. CR-NASD-99-41 (Aug. 20, 1999). The SEC has already opined that general advertisements are not recommendations. *See* SEC Release No. 34-8135 (July 27, 1967) (concerning the SEC's rescinded suitability rule) and SEC Release 34-27160 (Aug. 22, 1989) (with respect to penny stocks, the SEC announced that absent a direct recommendation to an individual, general advertisements are not recommendations).

The industry position has been outlined by a firm that has featured low-cost services not usually involving recommendations. *See Charles Schwab & Co., Inc., White Paper, Suitability Obligations in Online Investing*, submitted by W. Hardy Callcot, Sr. Vice President and General Counsel, Charles Schwab & Co., Inc. to NASAA Roundtable

on Internet Issues, (Nov. 1, 1999). Generally, a recommendation that creates a suitability obligation is one in which an individualized statement is tailored and addressed to a specific investor regarding a specific security. Thus, impersonal, generalized statements about a security are not recommendations. Moreover, merely providing access to information or research, proprietary or otherwise, does not constitute making a recommendation. For example:

> A Charles Schwab investor who conducts her own trading on line also has access to Charles Schwab research. The analyst at Charles Schwab who follows Amazon.com stock has a "strong buy" recommendation on the Schwab website accessible by Schwab customers in late 1999. Customer purchases 1,000 shares of Amazon.com in 1999, while the recommendation remains in effect. Customer's purchase is "unsolicited," and no suitability obligation arises, notwithstanding Schwab's general recommendation to buy Amazon.com. No Schwab broker had contacted customer to suggest that she buy "X" shares of Amazon.com at "Y" dollars per share or fund an Amazon.com purchase by selling "A" shares of "B" stock in her Schwab account.

The NASD, although it has declined to define the term "recommendation," previously made then revoked the following statement:

> The NASD considers a transaction as recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communications, the delivery of promotional material through the mail, or the transmission of electronic messages.

NASD Notice to Members 96-60. After this pronouncement, the NASD subsequently issued a clarification in which it expressly declined to define the term recommendation. *See* Clarification of Notice to Members 96-60 (March 1997).

4. *Conflict of Interest Cases.* Since the NASDAQ "bubble burst," some investors have alleged that firms are liable because their staff securities analysts were

recommending the purchase of stocks in companies that a firm's investment bankers had been servicing by taking them public - helping to syndicate their public offerings or advising them in their capital-raising endeavors. One such case has been dismissed by a federal district judge in New York City, but the dismissal order permitted the plaintiffs to restate their claim and re-file their complaint within 30 days. The case involved prominent technology securities analyst Mary Meeker of Morgan Stanley.

5. *Emerging Online Business Issues*.

Customer Profiling. Online firms may gather background information on customers electronically, often for reasons unrelated to marketing, such as obligations imposed by money laundering rules. Some have questioned whether a broker, once it possesses customer profiles gathered for a purpose such as monitoring money laundering, is obliged to use that information in order to monitor for suitability. Such an obligation seems farfetched, but it has yet to be tested.

Hyperlinks and Portals. Some firms provide hyperlinks or portals to other websites discussing investments, such as Moodys, Standard & Poors and others. Once linked, customers can perform their own research. These linkage services typically do not create a suitability obligation. *See e.g. Charles Schwab Co., Inc.* SEC No-Action Letter (July 17, 1997).

Push or Pull Technology. A few online brokers use systems that direct or push customers to various categories or lists of investments. A customer may select from such a list, then execute a trade online without consulting the personal broker. While this service takes a step away from the "unsolicited" transaction in the direction of a

"recommendation," it probably does not contain the level of specificity in terms of price, quantity and other details typically encompassed by a recommendation.

Data Mining. Some online firms are building systems that could enable them to "data mine" customers' preferences and patterns reflected by past investment decisions. The firm might then use this information to target investment-related information to such customers. If the targeted communications are fairly specific and solicitous, they might well amount to "recommendations" by the firm and evoke suitability obligations.

Commentary on developing issues in online trading can be found in (i) GAO Report Online Trading, Better Investor Protection Information Needed on Brokers' Websites, GAO/GGD 00-43 (May 2000) and (ii) [SEC Commissioner] Laura S. Unger, *Online Suitability: One Year Later*, 14 Insights No. 11 at 2 (P.H. Nov. 2000). Other significant releases concerning communications with customers and prospects include (i) SEC Securities Act Release No. 7888 (May 9, 1996), (ii) a SEC Interpretive Release issued in April, 2000 and (iii) NASD Notice to Members 98-3 (listing rules concerning communications between firms and customers involving electronic delivery). Beyond the foregoing, the NASD has added two new rules requiring firms that *promote* day trading strategies to make specified risk disclosures to non-institutional customers as well as determinations whether a particular day trading strategy is appropriate for a non-institutional customer before opening an account. Rule 2360 and Rule 2361. *See NASD Notice to Members 00-62.* (Sept. 2000).

6 *State Law Theories.* A customer may recover net losses, but not attorney fees, by proving that an unsuitable trade resulted from professional negligence or a

negligent misrepresentation by the broker. If the customer can prove that the unsuitable recommendation was intentional (reckless), the customer may then recover under federal securities law - i.e. Rule 10b-5. Moreover, by proving scienter, the customer may establish the broker's violation of the first prong of Washington's antifraud statute, "to employ any device, scheme or artifice to defraud." RCW 21.20.010. A violation of .010, or alternatively a registration violation, is a prerequisite to the express remedy under RCW 21.20.430 for a refund of consideration, 8% prejudgment interest and attorney fees. Provisions of the Washington Administrative Code support the proposition that the WSSA will apply to some "principal-agent" transactions between customers and brokers.

RCW 21.20.110 provides for discipline of broker-dealer firms and their salespersons for misconduct. RCW 21.20.110(g) provides for discipline if one "has engaged in dishonest or unethical practices in the securities or investment commodities business." This language connotes scienter. *C.f., Ernst & Ernst v. Hochfelder*, *supra*. WAC 460-21B-060 and WAC 460-22B-090 list a number of acts that help define the phrase "dishonest or unethical practices" used in RCW 21.20.110(g). WAC 460-21B-060(2) and (3) identify churning and unsuitable recommendations as "dishonest or unethical practices" by a broker-dealer.

WAC 460-22B-090(6) and (7) list churning and unsuitable recommendations as "dishonest or unethical practices" by salespersons. Thus, a customer may argue that when a broker intentionally or recklessly recommends an unsuitable trade, the broker is acting in a "dishonest or unethical" manner and thereby violating RCW 21.20.010(1), rendering the broker and his/her firm liable under RCW 21.20.430(1). This argument

does not appear to have been made in *Nesbit v. McNeil*, *supra*, which barred recovery under the Oregon State Securities Act. Nevertheless, in Washington, the argument is supported by WAC 460-21B-010, which specifies that churning is a "device, scheme or artifice" covered by RCW 21.20.010(1). Of course, a churning claim necessarily requires scienter.

C. *Churning*.

Churning occurs when a broker who has control over a customer's account induces transactions "which are excessive in size or frequency in view of the financial resources and character of the account." SEC Rule 15c1-7, 17 C.F.R. § 240.15c1-7, 17; RCW 21.20.035. Churning requires an excessive volume and frequency of transactions for the purpose of deriving profit for a broker who disregards the interests of the customer. *Hecht*, 383 F. Supp. at 435-36. Churning constitutes a violation of federal and state securities laws. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980); RCW 21.20.035.

In order to establish a claim of churning, a claimant must show:

> (1) That the trading in the account was excessive in light of his investment objectives;
>
> (2) That the broker in question exercised control over the trading in the account; and
>
> (3) That the broker acted with the intent to defraud or with willful and reckless disregard for the interests of his client.

Mihara, 619 F.2d at 821.

The first element, excessive trading, is typically addressed by expert testimony. In fact, expert opinion could be "virtually essential." *Nesbit v. McNeil*, 896 F.2d 380, 382 (9th Cir. 1990). A good benchmark for assessing the level of activity is the turnover

rate, or "Looper formula" -- total cost of purchases for a time period divided by the average amount invested in the account for that period. *Looper & Co.*, 38 SEC 294, 297, n.6 (1958). Of course, the customer's objectives are critical, *e.g.* trading for quick profits versus holding to defer tax and attain long-term gains. The cost structure of the investment activity is also crucial. Compare 1000 trades within a month in a percentage-of-assets-fee-based account to two variable annuity switches within a year.

The second element of a churning claim, the broker's control over the customer's account, is automatically established if the account is a discretionary account (*i.e.* the broker has express written authority to make trading decisions for the account.) *Follansbee v. Davis-Skaggs & Co.*, 681 F.2d 673, 676 (9th Cir. (1982). Control can also be established by proof that the investor reposed trust and confidence in his broker and virtually always followed his advice. *Mihara*, 619 F.2d at 821. A finding of de facto control is made easier by the customer's naiveté and lack of business and securities experience. *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975). However, a claimant cannot establish that the broker controlled his account simply by alleging that he usually followed the advice of his broker. *Follansbee*, 681 F.2d 673. "As long as the customer has the capacity to exercise the final right to say 'yes' or 'no,' the customer controls the account." *Id.* at 677. "[A] customer retains control of his account if he has sufficient financial acumen to determine his own best interests and he acquiesces in the broker's management." *Carras*, 516 F.2d at 528.

The last element of a churning claim, the scienter element, is often presumed once excessive trading and control have been established. *Jacobs*, § 212.01. A broker can combat this presumption in a number of ways. For example, a broker may have recommended repositioning an account that had been quiet for years. A claimant's expert may create a high turnover ratio by focusing on a narrow period immediately

surrounding the major change. The broker and its expert will have to explain the reasons for repositioning, draw in the larger period the account had existed and demonstrate the low ratios that result from a more thorough, and less artificial, analysis. *E.g., Nesbit v. McNeil, infra.*

In *Van Alen v. Dominick & Dominick Inc.*, 441 F. Supp. 389, 401 (S.D.N.Y. 1976), *aff'd*, 560 F 2d 547 (2d Cir. 1977), a stockbroker successfully defended a churning claim by demonstrating that he was applying a market theory he had used successfully and that he had been investing his own assets consistently. *Id.* at 402. Because he had invested in accord with his recommendations, the broker disproved the element of scienter. *Van Alen*, 441 F. Supp. at 402.

Damages in a churning case may include both excessive commissions charged by the broker and the decline in value of the investor's portfolio resulting from the broker's fraudulent transactions. *Nesbit v. McNeil*, 896 F.2d 380, 385 (9th Cir. 1990). These are two separate items. Note that a broker can be held liable for excessive commissions obtained by churning a customer's account, even if the account increased in value during the period in which the churning took place. *Id.*

Conversely, customers should not be allowed to "cherry pick" losing trades and exclude "gainers" from damage calculations in churning cases. "Churning can only be identified when one considers the whole history of an account. . ." *Id., Nesbit v. McNeil,* 896 F.2d at 382 *(citing Shad v.Dean Witter Rentals, Inc.*, 799 F.2d 525, 530 (9th Cir. 1986). That is because:

> Churning is a unified offense: there is no single transaction, or limited, identifiable group of trades, which can be said to constitute churning. Rather, a finding of churning, by the very nature of the offense, can only be based on a hindsight analysis of the entire history of a broker's management of an account and of his pattern of trading that portfolio, in comparison to the needs and desires of an investor.

Nesbit v. McNeil, 96 F.2d at 384 (citing *Chad* and *Miley v. Oppenheimer & Co., Inc.*, 637 F.2d 318, 327 (5th Cir. 1981) and preventing defendants from selectively analyzing a portion rather than the entire account history).

D. *Consumer Protection Act.*

The Washington Unfair Business Practices Act, RCW Chap. 19.86 (Consumer Protection Act -- "CPA") may permit essentially strict liability for deception or unfair business practices, though negligence and intentional misconduct more often provide a basis for claims. The CPA also imposes the tricky burden of proving an impact on the "public interest." RCW 19.86.090 and *Hangman Ridge Training Stables, Inc. v. Safeco Title Ins. Co.*, 105 Wn.2d 778, 780 (1986).

More likely, a claimant will not have access to the CPA, if the WSSA applies. *Spinner Corp. v. Princeville Dev. Corp.*, 849 F.2d 388, 390-91 (9th Cir. 1988) (precluding application of Hawaii's CPA--which tracks Washington's CPA--to securities transactions). Of course, in many customer-broker disputes, as the *Nesbit v. McNeil*, court observed, the state securities act will not apply. In these instances, a customer can invoke the CPA to obtain statutory attorney fees in place of the WSSA. Given the unique nature of each customer's investment objectives and financial situation, however, a customer will have difficulty proving an impact on the public interest, which is usually shown by similar deceptive practices on a number of other victims.

A CPA claim expires after four years. RCW 19.86.120. *Simms v. Allstate Ins. Co.*, 27 Wn. App. 872, 875, 621 P.2d 155 (1980) (limitation period starts on date plaintiff had "a right to apply to court for relief" – the date an alleged deceptive sale occurred).

E. *Applicable State Law*.

Almost all customer-broker account agreements contain arbitration provisions. Likewise, almost all contain governing law clauses. Frequently, the account agreement

specifies that New York law will govern any dispute. A customer residing in Washington and dealing with a broker here might well prefer Washington law, particularly if it appears that the WSSA will apply, providing explicitly for prejudgment interest and attorney fees.

While New York law may generally permit punitive damages, a complex line of decisions will likely leave a Washington resident without access to punitive damages in an arbitration. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1312 L. Ed. 2d 76 (1995). Moreover, the New York State Securities Act is not investor-friendly.

Fortunately for Washington customers, Washington law would probably be chosen in a typical customer-broker dispute. *O'Brien v. Shearson Hayden Stone*, 90 Wn.2d 680, 586 P.2d 830 (1978) (applying the Washington usury statute to class action customer claims against a brokerage firm, notwithstanding the New York governing law clause in each class member's margin agreement with the broker).

III. *Defenses to Securities Claims Against Broker-Dealers.*

Most claims against a stockbroker are defended on the elements of the claim. For example, the most common defense against a suitability claim is that the security involved was suitable.

Another common attack focuses on the customer's proving "justifiable reliance." In *Kennedy v. Josepthal & Co., Inc.*, 814 F.2d 798 (1st Cir. 1987), the First Circuit noted that "blind faith cannot vitiate [an investor's] opportunity to detect the fraud." *Id.* at 805 (citations omitted); *see also Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1517 (10th Cir 1983) (investor cannot "intelligently close his eyes and refuse to investigate, concerning the circumstances, in disregard of a risk known to him, or so obvious that he must be taken to have been aware of it"); *Bull v. Chandler*, Fed. Sec. L. Rep. (CCH) ¶ 96,567, at 92,622

(N.D. Cal. 1992) (as a matter of law, plaintiff failed to demonstrate justifiable reliance where he "recklessly placed blind faith in [the defendant] and stuck his head in the sand"); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 682 (9th Cir. 1980) (under discovery rule applicable to statute of limitations, plaintiff's claim is barred where he "has actual or constructive notice of the facts constituting the fraud). Constructive notice is knowledge of facts sufficient to make a reasonably prudent person suspicious of fraud, thus putting him on inquiry"); *Allen v. State of Washington*, 118 Wn.2d 753, 759, 826 P.2d 200 (1992) (affirming summary judgment dismissal of claim as a matter of law under statute of limitations "discovery rule" where "the facts were all available for [plaintiff] to discover through the exercise of due diligence").

Often with the purchase of mutual funds, and in a customer's rare purchase of a new issue, a prospectus will be delivered. It may contradict a broker's oral misrepresentations, and prevent liability. A prospectus establishes risk and other disclosures through the preferred medium under federal (and state) securities laws – in writing:

> *Zobrist v. Coal X, Inc.*, 708 F.2d 1511 (10th Cir. 1983), deals with a stark contradiction between oral and written disclosures and holds that the written disclosures control. *Angelos* indicates this court's inclination to follow *Zobrist*, on two grounds. First, only "material" misstatements permit recovery under the securities laws [footnote omitted] and to be material a statement must significantly alter the total mix of information available to the investor. *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 983 (1988). An investor who knew the truth is hard put to say that the inconsistent oral statement significantly altered the total mix of information. Second, the securities laws are designed to encourage the complete and careful written presentation of material information. A seller who fully discloses all material information in writing should be secure in the knowledge that it has done what the law requires. Just as in the law of contracts, a written declaration informing one party of an important fact dominates a contrary oral declaration, so in the law of securities, a written disclosure trumps an inconsistent oral statement. Otherwise even the most careful seller is at risk, for it is easy to claim: "Despite what the written documents say, one of your agents told me something else." If such a claim of oral inconsistency were enough,

> sellers' risk would be greatly enlarged. All buyers would have to pay a risk premium to cover this extra cost of doing business.

Acme Propane, Inc. v. Tenexco, Inc., Fed. Sec. L. Rev. (CCH) ¶ 93,713 (7th Cir. 1988) at page 98,307.

As the foregoing principles manifest, there are affirmative defenses that should be considered.

A. *Ratification*.

One is ratification. The doctrine of ratification has been defined and illustrated in a leading case as follows:

> Ratification is a theory of agency in which a principal adopts a previous action performed by an agent in the principal's name, but which prior action would not bind the principal absent the ratification because the act as originally done was without authority. . . . For example, assume Investor instructs Broker-Dealer to purchase 100 shares of Acme Corporation stock for a total purchase price of $10,000. Instead of buying Acme's stock, as ordered, Broker-Dealer purchases 100 shares of Beta Corporation stock for a total price of $15,000. When Investor receives the confirmation slip two choices are open: (1) immediately disclaim the transaction as being unauthorized; or (2) elect to ratify the transaction, in which instance the previously unauthorized action of Broker-Dealer becomes ratified. . . .

Jaksich v. Thomson McKinnon Securities, Inc., 582 F. Supp. 485, 496 (S.D.N.Y. 1984) (quoting S. Goldberg, 2 *Fraudulent Broker-Dealer Practices*, 11-39 (1978)).

B. *Estoppel and Laches*.

Two other significant affirmative defenses are estoppel and laches. In a leading case applying both of these related defenses, the customer's claims of suitability were barred where: (a) she had received regular confirmation slips for each transaction in her account; (b) she had received regular monthly statements of her account; (c) she was in regular contact with her broker; (d) during the period of her account she had her own

income tax accountants with whom she consulted concerning personal tax deductions; and (e) during the period of her account she was represented on occasion by attorneys. With these facts in mind, and having found that the plaintiff had acquiesced in the conduct of her account, the court held that she was barred

> from suddenly taking the position that such trading of the account in securities and commodities was unsuitable for her needs and objectives, contrary to her instructions and should never have occurred.

Hecht, 383 F. Supp. at 429-30 (dismissing suitability, but not churning claim because customer at least arguably could not have ascertained whether her account was being churned).

As the Ninth Circuit stated long ago in *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 214 (9th Cir. 1962), the purpose of the securities laws "is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions" of the securities laws. *See also Straly v. Universal Uranium and Milling Corp.*, 280 F.2d 370 (9th Cir. 1961) (investor was interviewed by regulators about issuer fraud but kept stock, which had increased in value, then investor later filed suit after stock price plummeted--defenses applied) and *Sterlin v. Biomune Systems,* Fed. Sec. L. Rep. (CCH) ¶ 90,279 (1998) (negative magazine article triggered investor's duty to investigate and arguably the statute of limitations began to run, notwithstanding issuer's mailings refuting article).

C. *The "Bespeaks Caution" Doctrine*.

Another affirmative defense that has received increasing attention in cases involving offering materials, and that may find application in a broker-dealer case where the broker has provided the customer with such materials, is the "bespeaks caution"

doctrine. The doctrine holds that when a disclosure document contains substantial disclosure of specific risks, statements that express optimism about future performance—despite those risks—are not misleading as a matter of law. *In re Donald J. Trump Casino Securities Litigation - Taj Mahal Litigation*, 7 F.3d 357 (3d Cir. 1993); *In re Worlds of Wonder Securities Litigation*, 814 F. Supp. 850 (N.D. Cal. 1993), *aff'd in part and rev 'd in part*, 35 F.3d 1407 (9th Cir. 1994). The doctrine does not apply to protect a defendant from suit on false statements that the defendant knew were false when made. *Worlds of Wonder*, 814 F. Supp. at 858.

D. *Comparative Negligence*.

RCW 4.22.005 allows a claimant's comparative fault to diminish any award based on "fault" (*e.g.*, negligence) proportionately. *E.g. ESCA Corp. v. KPMG Peat Marwick*, 135 Wn.2d 820 (1998) (bank relied on accounting firm's negligent misrepresentation but received only partial award because it was 60% at fault for causing loss).

Under RCW 4.22.070(1), each respondent's liability is several, not joint, unless (i) parties were acting in concert or as principal/agent or master/servant, or (ii) the claimant is found to be faultless. *Id.* .070(1)(a) and (b).

In a typical customer-broker dispute, the stockbroker will likely be found to be an agent of his/her firm, the principal. In fact, the firm typically acts as an agent of the customer. The individual stockbroker and the firm will normally face joint and several liability. This might revert back to several (proportionate) liability only, if the broker were found to have been "selling away" from the firm. Selling away means selling securities not traditionally purchased through securities markets and outside the scope of a supervisory regimen. *See Hollinger*, *supra*, 914 F.2d at 575 and *Hauser v. Farrell*, *supra*, 14 F.3d 1338. Normally, comparative fault will play a larger role in the defense of a customer-broker case than proportionate liability.

A comparative fault finding may accomplish more than a proportionate reduction in damages. It may foreclose any prejudgment interest award.

In order to obtain prejudgment interest under a common law theory such as negligence, negligent misrepresentation or common law fraud, a plaintiff must establish that the damages were "liquidated." If the damages depend on "the opinion or discretion" of the trier of fact, however, they cannot be liquidated, and prejudgment interest cannot be awarded. *Hansen v. Rothaus*, 107 Wn.2d 468, 472-73 (1986). When an arbitration panel decides that a claimant shares in the fault in some proportion, the panel—the "trier of fact"—necessarily is exercising its "opinion or discretion." Thus, prejudgment interest cannot be awarded.

E. *Mitigation of Damages*.

In a securities case, "a plaintiff is obligated to mitigate his damages when he has reason to know of the wrongdoing and the nature of the danger of holding the securities is apparent." *In re Cypress Semiconductor Securities Litigation*, 863 F. Supp. 711, 713-14 (N.D. Cal. 1993) (*citing In re Fortune Systems Securities Litigation*, 680 F. Supp. 1360, 1370 (N.D. Cal. 1987) but finding plaintiffs could not have known of danger in time to sell before prices declined). Thus, for Rule 10b-5 claims, under some circumstances the Ninth Circuit requires mitigation as a limitation on damages. *See also Arington v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 651 F.2d at 620-22.

F. *Other Claims and Defenses*.

Statute of limitations defenses may also be asserted, as well as contractual limitations:

> A dispute, claim or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim or controversy. This Rule shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.

NASD Code of Arbitration, Section 10304 (former Section 15).

Many courts have held that eligibility is an issue for courts, not NASD arbitrators, to decide. *See e.g.*, *Ohio Company v. Nemecek*, 98 F.2d 234 (6th Cir. 1996); *Cogswell v. Merrill Lynch*, 78 F.3d 474 (10th Cir. 1996); *Merrill Lynch v. Cohen*, 62 F.2d 381 (11th Cir. 1995); *Smith Barney v. Schell*, 53 F.3d 807 (7th Cir. 1995); *PaineWebber v. Hofmann*, 984 F.2d 1372 (3rd Cir. 1993); and *Edward D. Jones and Co. v. Sorrells*, 957 F.2d 509 (7th Cir. 1992). Other courts believe that arbitrators should make the eligibility determination. *See e.g., PaineWebber v. Elahi*, 87 F.3d 589 (1st Cir. 1996); *PaineWebber v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996); *Smith Barney Hearson v. Boone*, 47 F.3d 750 (5th Cir. 1995); *FSC Secs. Corp. v. Freel*, 14 F.3d 1310 (8th Cir. 1994). Most courts hold that fraudulent concealment does **not** toll the eligibility period. *Ohio Company v. Nemecek*, 98 F.3d 234 (6th Cir. 1996).

Generally, the language of the arbitration agreement itself must be consulted to determine whether a court or an arbitration panel decides the arbitrability/eligibility of the dispute. *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920, 131 L. Ed. 2d 985 (1995). If the arbitration agreement is silent on the issue, the arbitrators will likely have the power to determine eligibility. *Id.*

A proposed new eligibility rule has been percolating for years. If adopted, the proposed rule would:

1. Retain the six-year eligibility requirement, but make all filed claims eligible unless successfully challenged (the Director of Arbitration would likely decide this issue, rather than the panel of arbitrators or a court);

2. Provide a bright line transaction date test for eligibility, thereby precluding the "equitable tolling" doctrine or "discovery rule";

3. Permit ineligible claims to be brought in court (and not barred under the election of remedies doctrine);

4. Perhaps provide claimants the option, after a ruling that some claims were ineligible, to consolidate their eligible and ineligible claims in court rather than face parallel proceedings; and

5. Apply to all claims filed by customers and industry personnel.

As of October, 2001, the NASDR's "old [1984] rule," NASD Arbitration Code Sec. 10304, was still in effect. *See* www.*nasdadr.com* for the latest version.

Eligibility defenses may not persuade arbitrators, unless a respondent demonstrates some real prejudice resulting from the claimant's delay.

Other defenses, although rare, may apply from time to time -- *e.g.*, accord and satisfaction, compromise and settlement, lack of standing, intervening cause of damages, statutory good faith or reasonable care defenses, etc.

As a final note, one statutory claim conspicuously absent from this discussion is the federal Racketeer Influenced Corrupt Organizations Act ("RICO"). 18 U.S.C. §§ 1961-68. Since the 1995 amendment of RICO, conduct that would have been actionable as securities fraud and a predicate offense for RICO liability can no longer serve as the basis for a RICO claim (and RICO's treble damage recovery plus attorney fees) unless the defendant has been criminally convicted in connection with the securities fraud. 18 U.S.C. § 1964(c).