

*Giants and Pygmies:
The Fallacies of the Sophisticated Investor Doctrine*

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Lawrence C. Melton

In 1974, Supreme Court Justice William O. Douglas, who had been in Chairman of the SEC before his appointment to the court by Franklin D. Roosevelt, made the following critical statement about the Securities Exchange Act of 1934: "The Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market."¹ Remember that the next time a brokerage firm's attorney raises your client's so-called sophistication as a defense to his client's misconduct.

As experienced securities arbitration attorneys know, the 1933 Securities Act and the Securities and Exchange Act of 1934 are *silent* on the issue of investor sophistication. This is in keeping with the fundamental precept of American jurisprudence: the law should treat all individuals in an identical fashion, regardless of their wealth or status. Indeed, as the Federal Court for Southern District of New York stated in 1976: "As a general matter, the securities laws do not distinguish between sophisticated and unsophisticated investors; both are entitled to protection, of disclosure and antifraud provisions."² Though the law does not mandate a sophistication analysis, it does require - as its cornerstone to the administration of justice - that evenhandedness should prevail over the parties in a dispute.

If this is true, then why do attorneys for brokerage firms employ *the sophisticated investor defense*? The answer is clear: Even though there is no legal basis for the defense, arbitrators seem to be swayed by it. Perhaps this is due to industry bias. Perhaps this is due to ignorance. At any rate, it's not enough to argue that the sophisticated investor doctrine is not legally recognized. Investor counsel must go further. Counsel must *dissuade* arbitrators from the fallacious reasoning which lies at the heart of the sophisticated investor doctrine. They must expose the flawed reasoning for each and every cause of action.

It is the purpose of this article to suggest specific ways to deal with the defense. Sophistication is not a defense to securities fraud, unsuitable recommendations or negligence. It is also a fact that the standards to measure sophistication are inconsistent and that the use of the defense is really just an attempt to replace investor protection with *caveat emptor*.

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¹ *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 526 (U.S. 1974) (Douglas, J., dissenting).

² *In re Scientific Securities Litigation*, 71 F.R.D. 491, 512 (S.D.N.Y., 1976).

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I. Sophistication is NOT a Defense to Securities Fraud

In 1969, Mickey Mantle, the legendary Yankee, attempted to franchise a line of restaurants in his name. Turned out he was a better athlete than a business man. Soon after the initial public offering, the stock in Mickey Mantle's Country Cookin, Inc., struck out; it became worthless. This prompted one of the investors to sue the corporation's founder under Rule 10b-5, alleging numerous omissions of material fact.³ The trial court found 14 undisclosed facts, but held that disclosure was adequate because the plaintiff was financially sophisticated.⁴ The Fifth Circuit reversed, issuing the much-repeated epigram that "sophisticated investors, like all others, are entitled to the truth."⁵

Other courts followed the Federal Appeals Court, articulating this position in more expansive terms. Consider the following from the Northern District of Illinois:

The sophistication of the investor is immaterial when it comes to plaintiffs' claims based upon misrepresentation and omissions. The securities laws entitle all investors, experienced and novice, to full and truthful disclosure of material information. Moreover, § 12(2), of the Securities Act of 1933 does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer. Thus, whether or not plaintiffs were sophisticated investors has no bearing on whether or not they can sustain a cause of action under the applicable federal securities laws.⁶

One of the chief problems with the sophisticated investor defense is that it imposes a "graduated scale of duty" contrary to our system of equal justice. It places the "giants and pygmies," of which Justice Douglas spoke, on unequal footing. But that's not its only flaw. Its primary flaw is one of *false reasoning*. If fraud is involved in the sale of a security, sophistication is a meaningless concept. A sophisticated investor is no more able to guard against fraudulent conduct by the sellers of securities than an unsophisticated investor. In securities transactions, Rule 10b-5 prohibits omission of material facts necessary to make a statement not misleading. The failure to disclose information is a form of fraud regardless of one's level of sophistication. The same may be said with respect to untrue statements of material fact. No investor, sophisticated or unsophisticated, can safely buy and sell securities without having full disclosure and an intelligent basis for forming a decision to trade.

II. Sophistication is NOT a Defense to Unsuitable Recommendations

The suitability doctrine requires that a broker who makes recommendations to a customer can only recommend securities that he or she reasonably believes suitable for the customer.⁷ The SEC has held that a customer's sophistication does not allow a financial adviser to disregard the customer's investment objectives in recommending investments.⁸ Even the most sophisticated investor deserves suitable recommendations.⁹

³ *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973).

⁴ *Id.*

⁵ *Id.* (emphasis added).

⁶ *In re Olympic Brewing Co. Securities Litigation*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461, 1985 WL 3928 at *9 (N.D. Ill. Nov. 13, 1985) (citations omitted).

⁷ NASD Conduct Rule 2310.

⁸ *Dale E. Frey*, Release No. 221, 79 S.E.C. Docket 1727, 2003 WL 245560 (Feb. 5, 2003).

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As recently as December 11, 2006, The Honorable Roger T. Benitez of the Southern District of California stated:

It is well-established that wealth of the customer (however accumulated) and sophistication are not bases for recommending risky investments, nor are they defenses to claims of unsuitability. Had the arbitrators accepted these defenses in response to the claim of unsuitability, they would have in manifest disregard of the law.¹⁰

According to the SEC., proper analysis requires a two-tier approach: (1) the customer must be able to understand the risk and (2) the customer must be able to bear the risk.¹¹ The sophisticated investor defense falls short of this required analysis because it only goes to the first tier. The second tier, pertaining to the ability to bear risk, is wholly unrelated to sophistication. The savviest investors may not be able to bear a high risk investment due to their current financial situations. Irrespective of the sophistication level, a broker must ensure that the investor can financially sustain the risk prior to recommending the investment.

The specific language of the governing rules is relevant. NASD Conduct Rule 2310, which requires securities recommendations to be suitable, has no sophistication element. Juxtapose this with NASD Conduct Rule 2860(b)(19) - the rule governing the recommendation of options - which arguably does have a sophistication element. NASD Conduct Rule 2860(b)(19) requires financial

advisers to have a "reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction..." Importantly, such language is missing from Rule 2310. If Rule 2310 was meant to have a sophistication element, it would have included the same or similar language as Rule 2860(b)(19). The absence of such language from Rule 2310 is telling. If sophistication is not an element of Rule 2310, it is likewise not a defense.

III. Sophistication is NOT a Defense to Negligence

The sophistication defense is also not legitimate in the context of a negligence action. It is noteworthy that the elements of a negligence claim are different from the elements of a claim under Section 10(b) and Rule 10b-5. Brokerage firms sometimes try to rationalize using sophistication as a defense on the basis of the "justifiable reliance" element in Section 10(b) and Rule 10b-5 claims. They argue that the investor must prove "justifiable reliance," which allegedly requires an inquiry into investor sophistication. This rationale, is not applicable to a common law negligence claim, because *justifiable reliance is not an element of negligence*.

⁹ See *Arthur Joseph Lewis*, 50 S.E.C. 747, 749 (1991) ("the fact that a customer ... may be wealthy does not provide a basis for recommending risky investments."); *David Joseph Dambro*, 51 S.E.C. 513, 517 (1993) ("Suitability is determined by the appropriateness of the investment for the investor, not simply by whether the salesman believes that the investor can afford to lose the money."); see also *Krull v. SEC*, 248 F.3d 907 (9th Cir. 2001) (giving deference to the SEC's interpretation of "unsuitability" under the NASD's Rules of Fair Practice) (citing *Alderman v. S.E.C.*, 104 F.3d 285, 288 (9th Cir. 1997)).

¹⁰ *Strobel v. Morgan Stanley Dean Witter*, No. 04cv1069-BEN (BLM), 2006 WL 3735739 (S.D. Cal. order filed Dec. 12, 2006) (Amended Order Denying Petition to Vacate Arbitration Award; Denying Cross Petition to Confirm Arbitration Award and Remanding with Instructions).

¹¹ *James Chase*, Exchange Act Rel. No. 47476, 79 SEC Docket 2251, 2003 WL 917974 at *4-5 (Mar. 10, 2003).

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IV. Inconsistent Standards

The standards by which sophistication are measured are not uniform. Nobody knows at what point an unsophisticated investor becomes sophisticated. This is because there are no common indices by which sophistication is identified. Presumably, investor sophistication, if it is to be considered by an arbitration panel at all, should at a minimum require a factual evaluation of the client's level of understanding of risk.

Erratic and unpredictable, the case law provides little guidance. Sometimes cases will include consideration of several factors when assessing sophistication, such as wealth, age, education, professional status, investment experience and business background.¹² Nonetheless, inconsistencies plague the entire system and the sophisticated-investor doctrine is frequently misapplied.

It is injudicious to equate sophistication with income or net worth. Ambitious individuals often achieve high levels of wealth with little or no understanding of the stock market.

Can one equate business experience with sophistication? This is doubtful, judging from prior decisions. The SEC once found an investor unsophisticated, even though he owned his own roofing company, had a degree in business administration and maintained a \$3 million brokerage account.¹³ In a different case, the SEC determined that a city finance manager was not sophisticated because of his inability to understand inverse floaters.¹⁴

What about education? Is there a precise level of education that establishes sophistication? Apparently not, says the S.E.C., which once held that an investor who was studying economics in college and was able to download information regarding the investment from the internet did not have sophistication.¹⁵ Going even further, the SEC once held that a graduate business degree from Harvard does not establish that a customer is a sophisticated investor.¹⁶ From these examples, all one can conclude is that an investor may be sophisticated in some areas, and unsophisticated in others.

There is, however, a codified definition of "accredited investor" in Section 2 (15) of the Securities Act of 1933, which assumes risk tolerance for the accredited investor.¹⁷ An accredited investor, it should be noted, is never exempted from the application of the anti-fraud provisions of any state or federal securities act. Even an accredited investor can be taken advantage of by failures to disclose facts necessary to make an informed decision about an investment. The NASD has cautioned that accredited status "is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage" of the customer's net worth.¹⁸

V. Sophisticated Investor Doctrine and Caveat Emptor (Let the Buyer Beware)

From a policy perspective, the sophisticated-investor doctrine is nothing more than an attempt to bring back the already rejected doctrine of "caveat emptor," or "let the buyer beware." It is well established that, in the

¹² *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1029 (4th Cir. 1997).

¹³ *Dale E. Frey*, Release No. 221, 79 S.E.C. Docket 1727, 2003 WL 245560 (Feb. 5, 2003).

¹⁴ *Kenneth R. Ward*, Release No. 8210, Release No. 47535, 79 S.E.C. Docket 2363, 2003 WL 1447865 (March 19, 2003).

¹⁵ *James Chase*, Exchange Act Rel. No. 47476, 79 SEC Docket 2892, 2897 (Mar. 10, 2003).

¹⁶ *Bucchieri*, 52 S.E.C. 800, 804 (1996).

¹⁷ 15 U.S.C. §77(b)(15) (1982).

¹⁸ NASD NTM 05-26.

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context of securities litigation, caveat emptor has been replaced by the policy of "full disclosure."

Historically speaking, Congress designed the securities laws to protect investors who are not capable of protecting themselves. There can be no question that caveat emptor, in the securities context, contributed to the stock market crash of 1929 and the depression of the 1930s. Thus, the securities laws were passed in 1933, 1934 and 1940 based on several concerns, which still apply today. First, investors were being fleeced in the financial markets due to inadequate disclosures. Second, investors were receiving misrepresentations about the products being sold to them. Third, investors were being sold securities products as a result of manipulative schemes. The securities statutes were passed to repair the general loss of confidence in the capital markets and the financial system. The

fundamental purpose, common to these statutes, was to substitute a philosophy of "full disclosure" for the philosophy of caveat emptor, and thus, to achieve a high standard of business ethics in the securities industry. The modern sophisticated-investor doctrine marks a significant movement away from the "full disclosure" doctrine and breathes life back into the discredited doctrine of caveat emptor.

VI. Nullification of Existing Securities Laws

Finally, the securities laws at both the state and federal levels contain anti-fraud provisions which apply to "all" investors. Therefore when a panel takes it upon themselves to only apply the law to what they perceive to be unsophisticated investors, the panel actually nullifies the law. This has led, and will continue to lead, to frustration and genuine distrust by the investing public.