

A Duty Not Satisfied: When Risk Tolerance Neither Is Asked Nor Answered

We recently arbitrated a claim to recover investment losses for a retiree against an investment advisory firm that describes itself as different and better. Though certainly different, we found that the firm fell (and continues to fall) far short even in its most basic duty to clients. That duty is known as investment suitability, and includes elements such as the ability of an investor to understand the particular risks associated with an investment recommendation and his or her ability to bear those risks.

As background, investment advisory firms and their investment adviser representatives owe investors a fiduciary duty, which is the highest duty recognized in the law. By comparison, brokers (technically known as registered representatives and sometimes referred to as financial advisers or financial consultants) generally owe a lesser duty to their clients. Finally, for most intents and purposes, discount brokerage firms and/or online brokerage firms generally owe their clients the lowest level of duty.

That said, all of those types of financial services firms and representatives owe their clients the duty of investment suitability when they make an investment recommendation to a client. As the Securities and Exchange Commission (SEC) noted in Release No. IA-1406: “Investment advisers are fiduciaries who owe their clients a series of duties, one of which is the duty to provide only suitable investment advice.” The SEC also stated in that release that, “A reasonable determination of an investment’s suitability for a client would require, for example, that certain kinds of particularly risky investment products be recommended only to those clients who can and are willing to tolerate the risks and for whom the potential benefits justify the risks.”

The SEC’s directive is consistent with years of jurisprudence from the self-regulatory organization governing brokerage firms (FINRA, formerly known as NASD) as well as from the SEC itself in reviewing disciplinary actions taken by both FINRA and NASD. For example, in *James B. Chase*, the SEC sustained NASD’s disciplinary findings, and stated that, “A registered representative must be satisfied that the customer fully understands the risks involved and is...able...to take those risks” (citing an earlier SEC decision, *Patrick G. Keel*).

Several important principles follow. First, all advisers and brokers making a recommendation must garner sufficient facts about the particular customer’s risk tolerance, and not merely rest upon assumptions about that particular customer’s financial and emotional ability to bear risk. Thus, in *Scott Epstein*, FINRA commented, “[W]e can discern no evidence that Epstein ever attempted to determine whether a customer had changed his or her...risk tolerance...” And further, “Epstein made few, if any, suitability inquiries, much less the customer-specific determinations that are required under NASD Rule 2310.” Similarly, in *David Joseph Dambro*, the SEC criticized a broker for making only “a cursory inquiry” into whether an investment accorded with the client’s objectives, “merely ascertaining” that that the client was willing to “speculate.” Likewise, in *JW Barclay & Co. et al.*, the SEC faulted the broker for not “ascertaining the customer’s understanding of the risks associated with the use of margin, among other things.”

A second important principle that follows is that advisers and brokers, not customers, are the individuals charged with the obligation of determining investment suitability, including risk tolerance. So, for example, it is not sufficient that a customer has acquiesced to an investment believing it to be suitable. *Paul F. Wickswat*. In *Jack H. Stein*, the SEC stated that, “Even in cases in which a customer affirmatively seeks to engage in a highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer’s financial profile.”

A third important principle that follows is that advisers and brokers do not satisfy their duty to determine risk tolerance by disclosing that risk exists. In *Jack H. Stein* the SEC wrote, “A registered representative does not satisfy the suitability requirement simply by disclosing the risk of an investment that he or she has recommended.” The SEC in the *James B. Chase* decision put it this way:

Similarly, [the broker] did not satisfy the suitability requirement simply by informing [the client] of the risks of investing [in the investment]. Mere disclosure of risks is not enough.

As one can see, determining risk tolerance – the ability to understand the risks and to bear the risks – is a fundamental duty. Let’s hope that all investment advisers and brokers learn that fact and incorporate it in their investment recommendations.

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