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Brokers perform valuable services for the individual investor and the financial community. Their services range from the counseling of clients with respect to investment opportunities, to efficiently transacting buy and sell orders. Because of their utility, brokers are relied on extensively by the investing public. Such reliance ultimately leads to the need for some type of scrutiny into the activities carried on by this group of market participants in order to insure that their conduct is suitable.

The attention of this article first is turned to reviewing possible standards and guidelines by which brokers can be reviewed. This necessitates a discussion of suitability rules in terms of not only traditional legal guidelines, but also current economic thought, notably portfolio theory and the Efficient Capital Market Hypothesis as possible standards of review.

Additionally, attention is given to the conflicts that may arise between the current disclosure policy as formulated by the Securities and Exchange Commission (the SEC or the Commission) and economic theory as it pertains to suitability. This article attempts to

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I. "Broker" as used in this article also refers to broker-dealers, but does not refer to
resolve these conflicts while formulating sound suitability standards based on current market reality.

CURRENT LEGAL APPROACHES TO INVESTMENT DECISIONS

A. State Laws

Traditional legal guidelines for the investment of securities by market representatives such as brokers has been influenced greatly by the law of trusts as well as other laws. Existing law in this area basically prohibits certain acts and provides somewhat vague guidelines for investment decisions.

In general, the Second Restatement of Trusts and the Second Restatement of Agency, as applied to brokers, provide that they should invest prudently and should not speculate. Additionally, they should diversify the investment portfolio and sell off assets unsuitable for an account. Overall, they should make the portfolio productive.

In those jurisdictions relying on this approach, it is understood that despite these specific guidelines, the overriding standard for a broker's performance in the handling of a client's accounts is one of a duty to exercise the ordinary skill and care normally possessed by others in the profession and to invest prudently. This is known as the prudent-man approach and has developed from a mixture of tort, agency, and trust law. This approach promotes conservative investing.

Some jurisdictions take a different legal approach to proper investment techniques that further inhibits the exercise of a broker's judgment by forbidding him to enter into certain investments that are likely to depreciate. These statutes are known as legal lists and it is usually a per se violation to invest in these securities.
The common thread of both the prudent-man and legal list approach is the protection of the investor against an unnecessary risk of loss.\textsuperscript{12} This basic policy is based on the assumption that the customer is basically "risk-adverse."\textsuperscript{13} In accordance with this, the goal of both legal approaches is to minimize the possibility that an investor will suffer loss when he sells his investment for less than the amount of its purchase.\textsuperscript{14} Both approaches, however, are flawed.

\textbf{B. Problems with Current State Regulations}

The problem with both methods is three-fold. First, efforts to minimize risks under both methods have gone too far. Risk minimization leads to return minimization—the more conservative the investment, the lower the return.\textsuperscript{15} It would be erroneous to believe that all investors at all times would prefer to avoid risk at the expense of experiencing higher returns. The risk-of-loss-at-all-costs posture promoted by the legal approach is not in alignment with the desires\textsuperscript{16} of all investors.

A second problem caused by both legal approaches is their failure to measure risk reduction realistically. If risk of loss is the primary concern of these statutes, then adequate methods should be developed to ascertain whether in fact the risk level is appropriate for the particular investor. Unfortunately, when courts have applied these legal approaches, they have judged the broker's ability to reduce risk based on his success or failure to minimize the risk of each individual security in an investor's portfolio, instead of the risk of the portfolio as a whole.\textsuperscript{17}

The problem with this approach is that the focus on individual securities ignores the fact that the risk of an entire portfolio cannot be measured by the risk-levels of its individual securities. Different securities in a portfolio may perform in the same way or covary on

\textsuperscript{12} See Note, supra note 10, at 616.
\textsuperscript{13} Pozen, \textit{Money Managers and Securities Research}, 51 N.Y.U. L. REV. 923, 929 (1976); see also Lorie & Brealey, \textit{Modern Developments in Investment Management} 364 (2d ed. 1978).
\textsuperscript{14} See Note, supra note 10, at 616.
\textsuperscript{15} Lorie & Brealey, supra note 13, at 364.
\textsuperscript{16} In contrast to legal approaches, economic theory assumes that investors often are willing to take greater risks in the hope of receiving higher returns. See Cohen, \textit{The Suitability Rule and Economic Theory}, 80 YALE L.J. 1604, 1609 (1971).
\textsuperscript{17} See Note, supra note 10, at 617.
the happening of certain contingencies. Therefore, the risk of a security cannot be judged on an individual level because its risk or risk-free nature will be interdependent upon the other types of securities collected in the portfolio and their covariance. Hence, the concern should not be with the anticipated risk of each security, but with the effect on the risk level of the entire portfolio with the acquisition of each new security.

The third criticism that may be posited against current legal approaches is that they are inappropriate in insuring return maximization. As stated previously, investors also are concerned with returns as well as risk. However, current statutes only ensure risk minimization. A broker may be adjudicated prudent without exercising any efforts on his part to ensure that the investor reaps the highest return for his money invested. A broker who does not try to enhance return is as guilty of failing a client as when he neglects to reduce risk. In both instances the investor is hurt, yet current legal approaches only recognize one type of harm.

In summary, state law has based legal concepts not only on unrealistic assumptions as to the needs and concerns of an investor, but also has promoted irrational and inept methods of dealing with these assumptions. Besides being impractical in their application, an attitude of vagueness and uncertainty has pervaded the interpretation of state legal approaches. This particularly has been true of the prudent-man rule. The prudent-man rule is subject to various types of applications due to the fact that the judgment of various courts will differ as to what is prudent. Therefore, it is virtually impossible for both the courts and brokers to know what constitutes the current state of the law. Problems also abound under the suitability doctrines promulgated by national securities associations, stock exchanges, and the SEC.

C. Regulation by the NYSE, NASD and SEC

Apart from state laws, the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), and the SEC, have attempted to regulate broker activities by promulgating suitability rules or guidelines. The suitability doctrine guidelines originated as
a response to high-pressure "broiler-room" sales techniques used by some brokers. Broiler-room operations were designed to influence prospective investors in making hasty decisions to buy stock in new security issues without providing them the time to consider whether the investment was advisable in light of their particular financial capacity. Whatever information was given about the security or securities was usually vague, incorrect or inaccurate. In these circumstances, investors often fell victim to such pressure tactics and found themselves financially worse off than before.

As a result of these harmful practices, reform was forthcoming in the embodiment of the suitability doctrine, which, as stated previously, was developed by the SEC, the NASD, and impliedly by the NYSE. The SEC suitability doctrine formerly was embodied in Rule 15b10-3. This rule, however, recently was rescinded by the SEC. The SEC, in its formulation of this suitability rule, had the ordinary investor as its target for protection. The rule required that the broker not only affirmatively ascertain the essential facts relevant to the customer's financial status and investment objectives, but also required that any recommendation by the broker be suitable and in accordance with the information obtained.

Those brokers who were not members of the NASD were covered by the SEC suitability rule. The rule stated:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any

enacted under the SEC SECO (SEC-registered only) program, which empowered the SEC to issue regulations governing registered brokers who were not members of a national securities association such as the NASD. The purpose of these rules was to promote just and equitable principles of trade.

21. Bines, supra note 2, at 725 n.20. Judge Friendly provides the best description of a typical broiler-room operation:

The process would begin by sending to persons on various occupational lists, "such as doctors, plumbers, anything you want," which Kimball owned or would purchase, "teaser letters" describing the bright financial future afforded by low-priced stocks. These were followed by sales literature touting some particular stock. Next would come a telephone call from a salesman called an "opener," who "would try and sell the prospect as much as or as little as he could." This would be followed by more mail relating to the "good news about the company," and then by the knock-out blow, a call from a "high-pressure salesman," colorfully characterized as a loader who would "try and increase the purchase of the stock."


22. See generally SEC Securities Exchange Act Release No. 20409, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,457 at 86,415 (1983). This release formally eliminates direct regulation by the SEC of broker-dealers previously governed by the SEC SECO rules. As a result, one of the rules that was rescinded was the SEC suitability rule embodied in Rule 15b10-3. Any broker-dealer engaged in an over-the-counter securities business now must join a registered securities association. The release was effective December 6, 1983. Id.

security shall have reasonable grounds to believe that the recommendation is not unsuitable for the customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person.\[24\]

In comparison, the suitability guidelines of the NASD and NYSE are not as broad. The NASD suitability provision provides: 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 financial situation and needs.\[25\]

Unlike the SEC suitability rule, the NASD does not impose upon the broker an affirmative duty to investigate the client's financial status, but only requires that any recommendation that the broker make be suitable, based upon such information that the client voluntary discloses.\[26\]

The NYSE Rule 405,\[27\] otherwise known as the Know-Your-Customer rule, together with the NYSE fair dealing provisions found in Rule 401,\[28\] have been interpreted by many as imposing some kind of implied suitability obligation,\[29\] even though Rule 405 originally was instituted for the protection of its own firms from the irresponsibility of customers.\[30\] Rule 405 states:

Every member organization is required . . . to . . . [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.\[31\]

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27. Rule 405, N.Y.S.E. Guide (CCH) ¶ 2405.
28. Id. at ¶ 2401.
Rule 401 provides:

Every member, allied member and member organization shall at all
times adhere to the principles of good business practice in the con-
duct of his or its business affairs.32

The NYSE suitability obligations have been interpreted to require
brokers not only to investigate the financial status and objectives of
the investor, but also to recommend a suitable investment in accordance
with the obtained information.33 These duties, however, may apply
only in situations where the client wishes to purchase speculative
securities.34

A comparison of the suitability guidelines of the NYSE, NASD,
and SEC indicates that the SEC suitability rule was the most far-
reaching of the three. With the investor as its primary concern, the
SEC suitability doctrine had regarded the handling of customer
accounts as an investment activity which should be subject to
regulation.35 Besides recognizing the need for suitability guidelines,
the SEC, pursuant to its anti-fraud provisions, had provided that if
there were an unsuitable recommendation or sale of speculative
securities, as well as nonspeculative securities, to investors who could
not bear the risk, a violation was found which would most probably
result in stringent remedial procedures.36 Brokers who violate the cur-
rent NASD and NYSE suitability provision also may be subject to
disciplinary action.37 The suitability doctrine of the NYSE and NASD,
however, also is flawed.

D. Problems with Regulation by the NYSE and NASD

The problems with regulating investment decisions through the
suitability doctrine as formulated by the NASD and NYSE are twofold.
First, neither the NASD nor the NYSE has stated explicitly what
"suitable" means.38 Instead, certain guidelines have evolved, primarily
pursuant to case law in the federal securities law area, that have served
to direct brokers in the making of recommendations and investment
decisions. Pursuant to prior case law, a broker has been held to a

32. Id. at ¶ 2401.
33. N.Y.S.E Supervision and Management of Registered Representatives and Customer
Accounts at 7-8 (1973 ed.).
34. Id. at 7.
35. Bines, supra note 2, at 725.
36. Id; see also Hecht v. Harris, Upham and Co., 430 F.2d 1202, 1209-11 (9th Cir. 1970).
37. For example, see Article XIV, §6 of the N.Y.S.E Construction.
38. Cohen, supra note 16, at 1606; see also Roach II, supra note 29, at 1136.
duty to inquire about the customer's financial condition under certain circumstances. Also, it has been said that for a recommendation to be suitable, it must meet the investor's needs, objectives, and financial capacity. Additionally, if the risk of the customer's desired investment would exceed his capacity to bear it, then it is the broker's duty to inform him of such. Furthermore, the practice of churning, as it is known, has been considered to be per se unsuitable.

Absent a churning violation, a suitable recommendation seems to be contingent largely on the broker's ability to match the recommendation to the client. Whether or not the broker has done so is judged by his success or failure in exercising diligence and prudence in the questioned transactions. These are the same standards that have been applied by state laws. Therefore, the suitability of a recommendation for the most part depends on the application of amorphous legal standards which are applied on a case-by-case basis.

The second problem with the suitability guidelines promulgated by the NASD and NYSE is that their primary intent is to minimize the possibility of excessively risky recommendations. Their emphasis on the reduction of risk is greatly reflective of the state legal approaches, and therefore is subject to all the same criticisms. Since these suitability guidelines are focused on risk-averseness, methods for increasing returns go unnoticed or unused and, therefore, have not become a part of any suitability standard used by the NYSE or NASD. Thus, even though the investor may be assured that his investment risk is comparable to his financial capacity, he may not hold his broker to a duty of choosing an investment which reaps the highest return for that level of risk.

Because of the inherent problems in the legal approach to the suitability doctrine, it is necessary to focus on a different approach which will give suitability a new meaning and provide concrete

42. Roach II, supra note 29, at 1030-33. Churning is defined as the unnecessary and excessive trading by a broker of securities in a client's account when done to increase brokerage commissions without any intention of economically benefiting the client. See e.g., Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1209-10 (9th Cir. 1970).
43. Note, supra note 39, at 1086.
44. Id.
45. Id.
46. If portfolio theory is adopted as a standard of suitability, such a duty would be imposed. See infra notes 77-81 and accompanying text.

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guidelines for future investment decisions. Hence, there is a movement towards defining suitability in terms of economic theory based on modern portfolio theory and the Efficient Capital Market Hypothesis (the ECMH) in order to provide the broker with definite approaches for making investment decisions which are more in line with the customer's desire for increased returns.

**MODERN PORTFOLIO THEORY**

Economists through the years have developed what is known as portfolio theory. Portfolio theory attempts to standardize a method for brokers to follow in recommending suitable investments. Generally, this theory propounds that every investment features two elements: these elements are referred to as expected return and risk. The expected return of a portfolio generally is defined as the weighted average of all the expected returns of its component securities. Risk, on the other hand, most commonly is considered to be the average amount of variation among all possible returns from an investment.

Expected return is further broken down into two components. The first is known as a risk-free component which equals the rate of return on risk-free investments and rewards the investor for deferring the use of his funds. The second is known as a risk component which compensates the investor for reconciling himself to the possibility of variation in his anticipated return.

The two elements—risk and expected return—may be condensed into a single number, which serves to calculate the return per unit of risk. Generally, risk and return are considered to be positively

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47. Portfolio theory is highly technical and complex. This article attempts to highlight only the more important concepts of the theory. For more information regarding this theory, see Markowitz, Portfolio Selection, 7 J. Fin. 77 (Mar. 1952); Tobin, Liquidity Preference As Behavior Toward Risk, 25 Rev. Econ. Stud. 65 (1958); W. Sharpe, Portfolio Theory and Capital Markets (1970); see also J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence 10-14 (1973); Lorie & Brealey, supra note 13; Bines, supra note 2.


49. Pozen, supra note 13, at 929.

50. Sharpe, supra note 47, at 42. "The actual return on a portfolio is the weighted average of the actual returns on its component securities, using the proportions invested as weights." Id.


53. Id.

54. Id. To find out how this is computed, see Lintner, A Model of a Perfectly Functioning Securities Market, Economic Policy and the Regulation of Corporate Securities, at 127, (H. Manne ed. 1969).
correlated. In accordance with this, low risk or risk-free securities, such as United States Savings Bonds and insured savings accounts, will have a low return. An investment with a high risk, like speculative stock, usually has a high return. To compute a securities return per unit of risk with accuracy, one need only subtract the risk-free rate of return from the expected rate of return of the investment, then divide by the degree of risk affiliated with that security.

The basic underlying assumption of portfolio theory is that investors are generally risk-adverse. Accordingly, the greater the risk, the greater are the desires and expectations on the part of investor for more rewarding returns. The primary objective of a broker using portfolio theory, therefore, is the development of a portfolio which will yield the highest return per unit of risk selected, or otherwise stated, the lowest risk for any given return.

To achieve this objective, two possible avenues of procedure have been pursued. One approach directs the broker to find undervalued stocks with higher returns than stocks of the same risk level and include these in the portfolio. The second approach tries to meet the above objective through diversification by decreasing the aggregate risks of the portfolio without lowering the average returns. Thus, the difference in methods is that one focuses on the prediction of returns, while the other is concerned with the reduction of aggregate risk in the portfolio.

For any approach to be of significant value in predicting both the expected return and investment risk, it must be reliable. Studies have shown that the second procedure is more effective and reliable than

57. LORIE & BREALEY, supra note 13, at 364.
60. Id.
61. This is known as the best or optimal portfolio. Since the needs of an investor may vary from time to time, the best or optimal portfolio may need to be adjusted to meet the investor’s immediate desires. Adjustment can be accomplished through borrowing, which increases the risk level, or through investing some funds in risk-free assets, which decreases the risk level. See Cohen, supra note 16, at 1609-10; see also Sharpe, Adjusting for Risk in Portfolio Performance Measurement, in LORIE & BREALEY, supra note 13, at 442; POZEN, supra note 13, at 930; C. GRANGER & O. MORGENSTERN, THE PREDICTABILITY OF STOCK MARKET PRICES, at 9-12 (1970); R. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS, at 115-22 (1969).
63. See infra notes 77-81 and accompanying text.
the first and should be used to further the objective of portfolio theory. Both procedures, however, will be discussed below and each will be defined relevant to its significance to the portfolio objective of maximized return for each level of risk.

Today many brokers purchase research which is designed to detect undervalued stocks with higher returns than stocks at the same risk level. The method of finding potential undervalued stocks may be made by technical or fundamental analysis. Technical analysis provides information on prices based on the underlying assumption that investors expect certain buying and selling patterns to repeat themselves with some degree of reliability and regularity. Therefore, technical analysts scrutinize the historical data on prices and the volume of stock trading in order to discover repeating patterns for individual securities or for the stock market as a whole. This is done in an attempt to predict future price movement. Empirical studies have shown, though, that fluctuations in securities prices statistically are unrelated to past securities prices and, instead, are random. In general, there seems to be no significant predictable relationship between securities prices, the direction of price movements, and trading volumes.

Fundamental analysts believe that the performance of a company impacts upon the price of its securities. The basis for this belief is grounded in well-known studies which have shown that future changes in stock prices covary with future changes in corporate earnings. Fundamental analysts believe, therefore, that if future earnings can be predicted, then so can future stock prices.

In predicting the performance of a company, fundamental analysts attempt to predict future securities prices by examining the historical

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69. See Pozen, supra note 13, at 931.
70. Bines, supra note 2, at 786.
71. Brealey, supra note 61, at 66-81.
The primary problem with fundamental analysis is that future changes in corporate earnings seldom relate to past records of corporate earnings. Any future prediction, therefore, has been characterized by randomness. Fundamental analysts have attempted to inject their theory with new credibility by stating that their theory may be reliable if analysts can make new interpretations of existing corporate earnings data or can discover new information about the earning potential of a company. This prospect is essentially unrealistic, however, due to the fact that few analysts have been gifted enough to do either of the above with any kind of regularity or reliability. Viewing the rarity of success that fundamental analysis has experienced along with its generally expensive transaction costs, efforts directed toward this method of research, as well as technical analysis, should be discouraged.

In summary, methods of research which are oriented towards increasing an investment’s expected return through finding undervalued securities are basically unreliable and inadequate. These research methods, therefore, should not be used in conjunction with portfolio theory in the formulation of any kind of suitability standard.

To adequately use portfolio theory brokers should try to focus on the reduction of risk in trying to obtain the greatest expected return available at a client’s particular risk level. In reducing risk, portfolio theory does not concentrate solely on the nature of the investor’s risky assets. Instead, the theory looks to the entire degree of risk incurred by the investor’s total portfolio.

Diversification is a proven method for the reduction of risk. Diversification has been found to decrease the aggregate risk of a portfolio without generally decreasing the aggregate returns. It is, therefore, the goal of the broker when applying portfolio theory, to increase the number of holdings in a portfolio in an effort not only to reduce the aggregate portfolio risk but also to identify the risky

72. Bines, supra note 2, at 786.
74. Pozen, supra note 13, at 933.
77. Id.
79. This is the reduction of nonmarket risk. See infra notes 85-103 and accompanying text; see also Bines, supra note 2, at 794.
80. Pozen, supra note 13, at 940.
portfolio which is the optimal or promises the highest overall return per unit of risk.\textsuperscript{81}

Diversification results from the interplay of three elements: (1) the number of different holdings; (2) the proportions in which different securities are held; and (3) the extent to which the securities held react in a dissimilar fashion to the same future contingencies.\textsuperscript{82} Significant diversification increases with relatively few stocks: such increases diminish with additional stocks above a certain number.\textsuperscript{83} Major empirical studies have been conducted and all have agreed that, for the small or average investor, the best portfolio of risky assets is likely to hold no more than twenty different securities.\textsuperscript{84}

One method\textsuperscript{85} commonly used to attain efficient diversification involves a division of all the risks of a security into two elements—alpha and beta coefficients.\textsuperscript{86} Alpha or nonmarket risk is related to that part of the price variation of a security attributable to the particular business of the issuer.\textsuperscript{87} Beta or market risk is defined as that portion of the price variation of a security attributable to the price movements of the stock market as a whole.\textsuperscript{88} Generally, beta risk will rise or fall with an equivalent rise or fall in the stock market.\textsuperscript{89} Alpha risk will rise if the returns in the business are favorable and fall if business declines for some reason.\textsuperscript{90}

In order to calculate beta risk, one looks to the historical relationship of changes in the return of a security or a portfolio to changes in the return of the stock market.\textsuperscript{91} The beta level of the portfolio

\textsuperscript{81} Sharpe, supra note 47, at 69-73.
\textsuperscript{82} Cohen, supra note 16, at 1613.
\textsuperscript{84} Cohen, Zinburg & Zeikel, supra note 59, at 614-25.
\textsuperscript{85} Pozen, supra note 13, at 942-43. Harry Markowitz developed the first approach to portfolio diversification which was modified and simplified by William Sharpe. See Markowitz, supra note 47, at 78-91; Sharpe, supra note 47, at 58-73; Sharpe, A Simplified Model for Portfolio Analyses, 9 MGMT. Sci. 277 (1963).
\textsuperscript{86} Sharpe, Risk, Market Sensitivity and Diversification, in Lorie & Brealey, supra note 13, at 347.
\textsuperscript{87} Id. at 342.
\textsuperscript{88} Cohen, Zinburg & Zeikel, supra note 59, at 769-70. Beta tends to rise when the market rises and to fall when the market falls. Lorie & Brealey, supra note 13, at 342.
\textsuperscript{89} Cohen, Zinburg & Zeikel, supra note 59, at 760.
\textsuperscript{90} Lorie & Brealey, supra note 13, at 342.
\textsuperscript{91} Beta risk is calculated in different ways. For more information discussing actual computations, see Jensen, Capital Markets: Theories and Evidence, 3 Bell J. Econ. & Mgmt. Sci. 357, 369-71 (1972); see also Lorie & Brealey, supra note 13, at 342-44, 346. The use of historical returns in the estimation of beta risk does not cause the traditional problems of randomness or unreliability because beta coefficients are not subject to random walk findings. Future returns are statistically independent of historical returns.
then may be adjusted to meet the investment objective.\textsuperscript{92} The appropriate beta level may be selected by combining the best portfolio of risky assets with risk-free assets or borrowed funds.\textsuperscript{93} Beta, when used with a diversified portfolio as distinguished from individual securities, has been a reliable factor in predicting future associations between portfolio returns and market returns.\textsuperscript{94}

The alpha risk of a portfolio may be eliminated without affecting returns through perfect diversification of a securities portfolio since it is not correlated to the price movements of other securities.\textsuperscript{95} Beta risk then becomes the total risk of a diversified portfolio.\textsuperscript{96} Because beta risk is defined as the degree to which each security reacts in the same way as all other securities, one cannot reduce it by diversification without reducing returns.\textsuperscript{97} Since beta or market risk represents the total risk of the portfolio, evaluation of the investment risk of the total portfolio need only be compared with that of the stock market as a whole.\textsuperscript{98}

In summary, the approach that is most often used towards efficient diversification divides risk into alpha and beta risk.\textsuperscript{99} A perfectly diversified portfolio will eliminate alpha risk, leaving the measurement of risk of the portfolio based on market performance or beta risk. Thus, the portfolio will fall and rise with the market and is therefore said to be as risky as the stock market with a beta of 1.0.\textsuperscript{100} The beta level then may be adjusted above or below 1.0 to accommodate the desired investment objectives.\textsuperscript{101}

Portfolios with betas that are greater than 1.0 rise proportionately higher than the stock market when the market is rising, and fall proportionately lower than the stock market when it is declining.\textsuperscript{102} Portfolios containing betas less than 1.0 rise proportionately less than

\begin{itemize}
\item \textsuperscript{92} The adjustment of the beta level is based on Sharpe's "Separation Theorem." For a more detailed description, see Sharpe, \textit{ supra} note 47, at 70-73, 251-55.
\item \textsuperscript{93} Sharpe's method for decreasing beta risk has been criticized for assuming that risk-free assets exist. See Pozen, \textit{ supra} note 13, at 946. For a discussion of this problem and its solution, see Cohen, \textit{ supra} note 16, at 1619. United States bonds and insured savings accounts may be subject to some kind of risk due to inflation, but this is deemed insignificant.
\item \textsuperscript{94} Pozen, \textit{ supra} note 13, at 950; see Cohen, Zinbarg \& Zeikel, \textit{ supra} note 59, at 825-32 (criticism of the beta concept).
\item \textsuperscript{95} Bines, \textit{ supra} note 2, at 752-53.
\item \textsuperscript{96} Id.
\item \textsuperscript{97} Id. at 753.
\item \textsuperscript{98} Pozen, \textit{ supra} note 13, at 943.
\item \textsuperscript{99} The Markowitz method for portfolio diversification has been criticized as too costly. Therefore, scholars suggested brokers use this method sparingly. See Pozen, \textit{ supra} note 13, at 942.
\item \textsuperscript{100} Loeh \& Hamilton, \textit{ supra} note 47, at 188-89.
\item \textsuperscript{101} See \textit{ supra} notes 91-93 and accompanying text for an example of how to make the adjustment.
\item \textsuperscript{102} Pozen, \textit{ supra} note 13, at 943.
\end{itemize}
the market and, when the market is in a downswing, fall proportionately less than the stock market. As a result, portfolios which possess betas greater than 1.0 are considered riskier than the stock market. Those containing betas below 1.0 are less risky than the market.

Based on the above, one can readily see that portfolio theory actually defines and delineates specific guidelines for proper investment management while satisfying the realistic expectations and desires of investors. Whether or not portfolio theory is a more appropriate medium for defining suitability standards than present approaches now will be explored.

**Portfolio Theory and the Suitability Doctrine**

As discussed previously, current legal approaches to suitability, including those formulated by the NASD and NYSE, are replete with broad, vague prohibitions against brokers recommending securities which are not suited to the particular investment needs of the individual customer. No specific suitability guidelines have been set forth to direct brokers to the proper investment approach that they should pursue with each individual customer. Instead, their investment advice is judged on an ad hoc basis with the use of legal standards which seem to measure investment performance in terms of diligence or prudence.

Thus, the pure legal approaches to suitability offer no more than amorphous standards in interpreting the adequacy of the broker’s investment recommendations to his client.

Portfolio theory, on the other hand, sets out specific guidelines for assembling a portfolio that achieves the highest returns possible for a client’s individual risk level. Economic analysis proves to be a better guide to regulating risk, not only because risk is defined in more realistic terms as far as the customer’s desires, but also because risk may be measured with some consistent reliability.

The legal concept of risk focuses only on the avoidance of risk of loss. This approach is concerned only with the possibility of the investment selling for less than cost rather than with the possible further values of the investment. The economic approach, however, sees the risk of a portfolio as the uncertainty associated with its market

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103. *Id.*
104. See supra notes 43-44 and accompanying text.
105. *L utter*, supra note 54, at 152-53; see also W. SHARPE, supra note 47, at 69-73.
106. See supra notes 55-58 and accompanying text.
108. Note, supra note 10, at 617.
value or expected rate of return at some future date. Thus, if a portfolio is subject to a sizeable variance in possible future values on a certain date, and no one value has a high level of probability, the portfolio is considered to be riskier than if all possible prices were subject to a slight variance and one possible price was highly probable. Hence, one portfolio might be riskier than another, even though it has a lower probability of loss. The economic approach emphasizes how simplistic the present view of risk of loss is since this view, represented by the legal approach, concentrates only on future values of a portfolio which are less than cost.

Portfolio theory, on the other hand, considers every possible future value, concentrating on and measuring what the investor is primarily concerned with—the future value of his portfolio. Portfolio theory realistically reflects the customer's desires and is more suitable for meeting the customer's needs in that it defines risk not solely in terms of loss, but in regard to future value.

Portfolio theory is more realistic in measuring risk than legal theory. The economic concept of risk or portfolio theory concerns itself with the relationship between the risk of a particular security and risk of the portfolio as a whole. Individual risk levels of securities cannot be judged in a vacuum as is done under legal theory, since the risk of the portfolio is the aggregate of the risks of securities that compose it. The economic approach realistically notes that the risk level of an entire portfolio must be judged, since the addition or removal of individual securities from the portfolio will affect the total risk of the portfolio. This shift may not necessarily be in accordance with the individual risk level of a security.

Portfolio theory also realistically reflects that investment decisions are made with regard to two factors: one, expected return, and the other, risk. Legal approaches are concerned exclusively with risk of loss, and as a result, fail in three ways. First, exclusive concentration on the avoidance of risk of loss provides no incentive for the broker to search for a possible way of increasing probable returns for any given level of risk. Second, the legal approaches fail to note that a larger than expected return often may offset the marginal risk

109. Id. at 618.
110. Id. at 618-19.
111. Id. at 619.
112. Id.
114.Lintner, supra note 54, at 152-53.
115. Roach II, supra note 29, at 1161.
a security adds to a portfolio. Third, these approaches do not take into consideration that many times an investor will be more concerned with returns and less so about risk and, therefore, would be willing to make a riskier investment with a higher probability of return. In general, legal approaches cater only to an investment conservatism which may not always be the realistic desire of a client.

Portfolio theory also provides guidelines for finding portfolios at any specific individual risk level which will offer the highest return in regard to the degree of risk the particular customer is willing to bear. No legal theory has calculated or has attempted to calculate the customer's preference for risk in regard to return. Portfolio does so and does it with a certain amount of accuracy and reliability.

In summary, legal approaches have failed miserably, not only in erroneously assuming what the customer's needs and desires are, but also in not requiring the broker-dealer to use methods that are effective in promoting investment returns. Suitability, then, must not be measured in these terms. Suitability, however, should be measured in terms of portfolio theory. As has been shown, the theory precisely and realistically defines customer preferences and expectations, adjusting these preferences to conform with an accurately calculated degree of individual risk which in turn generates the highest return in accordance with such risk.

Portfolio theory, though, is only as good as the methods used to promote it. Therefore, if suitability is to be defined in terms of portfolio theory, the underlying methods used in achieving the highest expected return for a particular level of risk must be suitable as well. Two procedures have been tried in accomplishing this goal: one method attempts to increase future returns while the other attempts to reduce risk. The method which focuses on predicting future returns uses various research methods such as technical and/or fundamental analysis, to find undervalued securities. However, all efforts used to predict returns have been unreliable. Therefore, the purchase of research should not be used in calculating the highest expected return per unit of risk. The second method, efficient diversification, should be used instead, since it meets the portfolio objective by reducing overall risk.

116. The application of portfolio theory does have some problems. The major problem, identification of the optimal portfolio of risky assets, may be solved if the ECMH is adopted as a necessary corollary to portfolio theory in any suitability standard. See Cohen, supra note 16, at 1617-25 (problems and solutions surrounding the application of portfolio theory).
117. Id. at 1609, 1629.
118. See supra notes 62-63 and accompanying text.
119. LORIE & HAMILTON, supra note 47, at 79; Bines, supra note 2, at 789 n.217.
120. See supra notes 79-81 and accompanying text.
Based on the preceding discussion, a new definition of suitability should be framed, and portfolio theory is more than adequate for fulfilling this role. Therefore, in making investment decisions, brokers should try to achieve the greatest expected return available at individually suitable levels of risk. As a necessary corollary to the new definition of suitability, portfolio theory must attempt to reduce risk instead of trying to use very unreliable methods of research to predict future returns. Diversification must be used properly to reduce nonmarket risk, while leaving market risk remaining. Adjustment of market risk can then be made to meet the investor's investment objectives. Economic theory, however, is at odds with the disclosure policy of the SEC.

SUITABILITY STANDARDS: EFFICIENT CAPITAL MARKET HYPOTHESIS AND PORTFOLIO THEORY WITH RESPECT TO SEC DISCLOSURE POLICY

Searching economic and legal theories in order to discover concrete guidelines in which a proper suitability doctrine can be formulated has led to a significant observation with respect to the nature of suitability and the SEC present method of disclosure. If economic theory were to be adopted in formulating suitability standards, a major conflict would arise between the new doctrine and current disclosure policy. This conflict results from the fact that current economic thinking utilizes in its variables the definition of information that is not the same as authorized under SEC disclosure policy.121

In their endeavor to establish concrete criteria by which to judge suitability standards, some members of the legal community recently have turned to theories advanced by economists which undertake to measure securities performance in the market and to study the factors influencing their performance. One economic theory widely studied is the Efficient Capital Market Hypothesis (ECMH) which is meeting growing acceptance by security analysts.122 In general, the ECMH basically examines market functioning and draws conclusions as to the efficiency of the American capital markets.123 The ECMH


122. See B. Levi, FINANCIAL STATEMENT ANALYSIS: A NEW APPROACH, at 212-25 (1974); Fama, supra note 64; Lorie & Hamilton, supra note 47, at 97 (excellent background on this theory).

123. Saari, supra note 121, at 1031.
postulates that the market absorbs all relevant and available information with respect to the future financial position of companies resulting in the immediate adjustment of stock prices.\textsuperscript{124}

In contrast, the SEC attempts to regulate the dissemination of information through its disclosure policies. The function of the federal securities laws has evolved from a primary concern with proper allocation of financial resources,\textsuperscript{123} to an overwhelming emphasis on the protection of the individual investor.\textsuperscript{126} To achieve this protection, the SEC has structured rules and regulations in such a manner as to regulate the type of information that may be disclosed to investors as well as the manner in which it is disseminated.\textsuperscript{127} The function of the SEC is to assure that this information reaches individual laypersons for use by them in making informed investment decisions.

The SEC believes that in order to protect the investing public fully, information necessary in making an informed investment decision must be made equally available to all potential investors.\textsuperscript{128} To achieve the goal of egalitarian disclosure, the SEC has attempted to regulate and direct the flow of useful information so that it is available to and comprehensible by all investors.\textsuperscript{129} The ECMH, however, raises serious doubts about the utility of the information required or regulated by the current policies of the SEC. With respect to this conflict, the following section will examine the operation of the ECMH and its utility with portfolio theory in formulating a standard for suitability.

A. Efficient Capital Market Hypothesis Defined

The ECMH evolved from studies by both the mathematics and economics professions regarding the process of price determination in the securities market.\textsuperscript{130} Empirical studies have tested the ECMH


\textsuperscript{125} "[W]hatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been the wanton misdirection of the capital resources of the Nation." H.R. Rep. No. 85, 73d Cong., 1st Sess. 203 (1933).


\textsuperscript{128} Saari, supra note 121, at 1032-33.

\textsuperscript{129} See supra note 127.

\textsuperscript{130} See generally Fama, supra note 64; Lorie & Hamilton, supra note 47.
in three forms, known as the weak, semi-strong, and strong. Each form varies with respect to the type of information studied and the effect on market efficiency.

The weak form concentrates on the effect, if any, that information regarding past price movements has on current stock prices in the market. The weak form asserts that there is no relation between past price movements and future stock prices. Through empirical research it was determined that security price movements essentially are random, having little discernable pattern. The ECMH in weak form has a direct bearing on the use of portfolio theory as a standard of suitability. Portfolio theory indicated that the rational investor (or his broker) should maximize the amount of return per unit of risk on the risky portfolio. There are two general ways in which this may be accomplished. First, as noted above, the investor can diversify his holdings. Second, he can attempt to purchase securities which are undervalued by the market. However, if all information about any given security at any particular time is reflected in the price of the security, it would be impossible to identify and acquire undervalued securities.

If the ECMH accurately describes reality and undervalued securities do not exist, an investor seeking to maximize the return per unit of risk only could have one course of action, diversification. Once the portfolio is efficiently diversified, a search for undervalued securities should be futile. In terms of suitability standards, the broker would perforce have to apply this rationale and apply diversification pursuant to the circumstances of his customer. Any other recommendation could produce an "unsuitable" result, should portfolio theory in this form be adopted as a standard.

The semi-strong form of the ECMH concentrates on the effect that the release of new public information has on stock prices. The semi-strong form asserts that securities prices react extremely rapidly and

131. Note, supra note 39, at 1090.
132. Fama, supra note 47, at 389-400; see also Fama, supra note 66, at 56-57.
133. See supra note 62 and accompanying text.
134. See supra note 63 and accompanying text.
137. The public information studied pertained to changes in accounting methods, stock splits, annual reports and new security issues. See Ball, Changes in Accounting Technique and Stock Prices, 10 J. ACCT. RESEARCH 1 (Supp. 1972); Fama, Fisher, Jensen & Roll, supra note 73; Miller & Modigliani, Dividend Policy, Growth and the Valuation of Shares, 34 J. Bus. 411 (1961); Sunder, Relationships Between Accounting Charges and Stock Prices: Problems of Measurement and Some Empirical Evidence, 11 J. ACCT. RESEARCH 138 (Supp. 1973); Sunder,
in an impartial manner to public information. Additionally, empirical studies on the semi-strong form of the ECMH discovered that the market reacted to public information before it was announced formally. This is explained by virtue of how an efficient market works. It is constantly absorbing all information, whether or not it is released through the formal disclosure system. Further studies revealed that the market reflects actual changes in the financial condition of corporations, regardless of misleading or confusing financial statements that were released to the public.

The third form of the ECMH is the strong form. It stands for the proposition that the market reacts rapidly to both public and non-public information. To validate this proposition, researchers have studied whether it is possible for investors to have access to non-public information and, if so, whether this information has been used by them to reap returns which are considered to be above average. It was found that two groups of investors, corporate insiders and New York Stock Exchange specialists, have been able to achieve slightly superior results through access to inside information.

In summary, empirical studies of the weak and semi-strong form of the ECMH have served to validate the theory of market efficiency. There has been, however, some deviation from strong-form efficiency, since two groups of investors reaped better results due to some market inefficiency. Additionally, it has been found in all three forms that the market analyzes and subsumes rapidly all information, whether or not it is released through the formal SEC disclosure system. The three forms of the ECMH, moreover, all demonstrate that the SEC disclosure policy is inadequate.

Stock Price and Risk Related to Accounting Changes in Inventory Valuation, 50 ACCT. REV. 305 (1975).

138. LORIE & HAMILTON, supra note 47, at 83-87.
140. SAArI, supra note 121, at 1048.
141. Sunder, supra note 137, at 314.
142. LEV, supra note 68, at 217-18, 220.
143. SAArI, supra note 121, at 1050-54.
145. Studies show that all information is reflected in stock prices, not just that which is disseminated pursuant to the SEC disclosure rules and regulations. Other sources of information besides SEC-mandated statements are trade papers, government reports, statements by corporate officials, and public and private sector reports on the economy. See SAArI, supra note 121, at 1054.
B. ECMH and Portfolio Theory—The Conflict with Disclosure Policy

Three considerations become evident after discussing the ECMH in its three forms. First, the ECMH should be viewed as a necessary corollary of portfolio theory; if it is decided that portfolio theory should be made a part of any suitability standard, the ECMH should be included as well.146 Second, the attempt to integrate the ECMH into a legal suitability standard would be in conflict with the current SEC disclosure system. Third, the ECMH points out that the SEC goal of informing the investor through its present disclosure rules is inadequate.

The ECMH should be integrated into any standard of suitability since it is a necessary corollary to portfolio theory. The objective of portfolio theory is the maximization of the amount of return per unit of risk on the risky portfolio.147 There are two possible procedures which could be used for achieving this objective. They are the purchase of undervalued securities and the diversification of holdings. The ECMH supports the position taken by other studies previously mentioned that maximization of returns through use of securities research to find undervalued securities is fruitless.148 The ECMH stands for the proposition that diversification should be instituted as a method for selecting securities, since any attempts made by brokers at discovering undervalued securities would be futile.149 It has, in fact, been vigorously argued before that the ECMH should be integrated into a suitability standard.150

The integration of the ECMH into a suitability standard, however, leads to a discussion of a second consideration. It is posited that any attempt to integrate the ECMH into a suitability standard would create a paradox in that its adoption would be in conflict with the adoption by the SEC of an integrated disclosure system in 1982.151

It has been said that when the SEC adopted this new system, it

146. As to why portfolio theory should be included in any kind of suitability rule, see supra notes 104-20 and accompanying text.
147. See supra note 77 and accompanying text.
149. See supra note 76 and accompanying text.
also had adopted the ECMH. There is in fact some acknowledgment of the ECMH by the SEC. The integrated disclosure system has streamlined disclosure requirements in recognition that all market information, whether or not SEC mandated disclosure information (e.g., periodic reports), is disseminated rapidly and reflected immediately in the price of securities. Streamlining has occurred mainly through the tool of incorporation by reference.

Recognition by the SEC of the ECMH has only been partial, however. It has been said that the ECMH has been adopted only in form and not in substance. This conclusion is valid in that if the ECMH were recognized fully, the SEC streamlined disclosure provisions would be available to all issuers. This is not the case. It has been posited that the Commission largely has accepted the efficient market theory only for that strata of issuers that the Commission believes are most likely to have securities that behave in the manner suggested by the theory. Another indication that the SEC only partially has recognized the ECMH is that the tool of incorporation by reference goes against efficient market theory. It injects useless information into the prospectus that already has been absorbed by the market.

Other SEC policies also belie the idea that the ECMH has adopted. Long form registration under S-1, which does not even permit incorporation by reference, is still very much alive. Further, certain liability provisions under the securities laws are not in line with the so-called adoption of the ECMH by the SEC. This can be seen particularly in the area of projections, where not all forward-looking information is protected by the current SEC safe harbor rule on projections. Additionally, liability provisions with respect to underwriter due diligence requirements are in conflict with the efficient market theory. Other areas of the law that appear to be in conflict

153. Id. at 138.
155. Pickholz & Horahan, supra note 121, at 944-45.
156. Id. at 944-56.
157. Banoff, supra note 135, at 139.
158. Pickholz & Horahan, supra note 121, at 954; see also Greene, supra note 151, at 759 n.23, 783.
159. Pickholz & Horahan, supra note 121, at 949-50.
161. Only three categories of forward-looking statements are covered by the rule. A projection falling into one of the categories will be protected only if certain requirements are met, such as good faith or reasonable basis. Sec. Act Rel. 6084, 17 SEC Dock. 1048 (1979); see also Rule 175, Securities Act of 1933.
162. Pickholz & Horahan, supra note 121, at 952.
with the ECMH are the liabilities provisions under the anti-fraud provisions of the federal securities law. In summary, the SEC still prohibits or slows down the dissemination of certain information. The ECMH, however, recognizes that all information is absorbed immediately into the market, regardless of SEC regulations.

This discussion leads to the third and final consideration. The current SEC disclosure system is inadequate because it does not effectively do what it proposes to do—regulate information disseminated to the public. As mentioned above, the market receives information immediately despite SEC efforts to slow down or prohibit its dissemination. This conclusion results from the application of the ECMH.

Acknowledgment by the SEC of the paradox created in the second consideration must lead to a choice of one of two alternatives. Either the SEC will maintain its current disclosure policy or it will integrate the ECMH in its entirety into a suitability standard and thereby adjust its disclosure requirements accordingly. The consequences of a decision not to integrate the ECMH would be numerous. First, it would be likely that economic theory would have little, if any, impact on suitability standards. Without the application of the ECMH, portfolio theory would be virtually useless. As discussed above, the ECMH assures that the maximization of returns under portfolio theory will be accomplished through diversification rather than investment in undervalued securities. Without the ECMH as a rule of suitability, brokers may fail to diversify and investors may be charged unnecessary costs which have resulted from futile attempts to discover undervalued securities. Portfolio theory, therefore, would fail to work with any regularity and would not be suitable, by itself, as a method of selecting securities.

Even if diversification were chosen by brokers as a method to maximize returns, efficient diversification may not be achieved without regard to the ECMH. The ECMH not only necessitates diversification, but also calls for efficient diversification. The ECMH states, and market reality confirms, that diversification results from the analysis of all information, not just information mandated by the SEC. Without the ECMH as a rule of suitability, brokers likely would be compelled out of a fear of being sanctioned by the SEC only to

164. Even if undervalued securities existed, the costs incurred by a broker (and charged to the investor) in locating such securities through fundamental or technical analysis probably would not be offset through superior returns. Saari, supra note 121, at 1054-55.

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use information permitted by the SEC in diversifying an investment portfolio. Without efficient diversification through the ECMH, expected returns would vary for portfolios at the same risk level.\textsuperscript{166} It therefore would be impossible, under portfolio theory, to define the optimal portfolio of risky assets.\textsuperscript{167} Portfolio theory without the ECMH would be rendered useless. Denial of the ECMH as a standard of suitability leads to the refusal to recognize economic theory as a whole in developing suitability standards.

The failure to integrate the ECMH into a standard of suitability leads to a second major consequence—the failure of the SEC to recognize market reality. According to the ECMH, prices of securities in the market reflect all information about the securities, whether or not that information is permitted by SEC disclosure laws.\textsuperscript{168} Regulation by the SEC in this area, however, has been ineffective. Prohibited or nonmandated SEC information is absorbed by the market regardless of SEC regulations. This has been primarily due to the fact that the purpose behind SEC disclosure laws is not in alignment with economic reality.

The primary purpose behind SEC disclosure laws is the protection of investors by providing equal access to all information useful in valuing securities.\textsuperscript{169} By prohibiting the disclosure of certain types of information,\textsuperscript{170} or by attempting to slow down the informational process through mandating repetitive disclosure\textsuperscript{171} or long-form disclosure,\textsuperscript{172} the SEC assumes not all information pertaining to securities is valuable in making an investment decision.\textsuperscript{173} This assumption, however, is in direct contradiction to market reality, where all information is deemed to be valuable. This is proven by the fact that all information pertaining to any security is reflected in the price of a security at any given moment.\textsuperscript{174}

The failure to recognize market reality leads to the third and final consequence—unequal access to investment information. Though the primary goal behind SEC disclosure rules has been egalitarian access, the SEC has defeated its own purpose by failing to recognize market

\begin{itemize}
\item \textsuperscript{166} Id. ECMH posits that all portfolios that are efficiently diversified and have the same degree of risk will have the same expected return.
\item \textsuperscript{167} Id.
\item \textsuperscript{168} This has been proven in the semi-strong form of the ECMH. See supra notes 137-41 and accompanying text.
\item \textsuperscript{169} See supra notes 125-27 and accompanying text.
\item \textsuperscript{170} See supra note 161 and accompanying text.
\item \textsuperscript{171} See supra note 159 and accompanying text.
\item \textsuperscript{172} See supra note 160 and accompanying text.
\item \textsuperscript{173} See supra note 121, at 1063.
\item \textsuperscript{174} LORIE & HAMILTON, supra note 122, at 97.
\end{itemize}
reality completely. By attempting to prohibit or slow down the dissemination of certain information, the SEC is promoting unequal access to those investors whose only source of information is that which is permissible under the SEC rules. The SEC clearly must amend the disclosure rules to reflect market realities.

C. Adjustment of Disclosure Policy to Accommodate Economic Theory

The failure to integrate the ECMH and portfolio theory into suitability standards has resounding consequences and is, in fact, an untenable position. The question then becomes how the SEC should adjust its disclosure rules to recognize economic reality fully, accommodating the inclusion of the ECMH and portfolio theory into its suitability rules.

While some investors make their own investment decisions without first consulting a broker, the vast majority rely on the services of a broker before investing. This phenomenon may be due to the way information is presented in SEC documents. Boiler-plate provisions and financial statements which are extremely sophisticated and incomprehensible by the untrained investor are contained in such documents. A typical prospectus usually cannot enable a lay investor to achieve an informed investment decision. This is true regardless of the changes made under the integrated disclosure system. Much of the information which is now incorporated by reference into the prospectus under the new system is sophisticated information contained in annual and periodic reports. Because of the naivete of the average investor, it is assumed that he will rely heavily on his broker's expertise in making the right investment decisions. However, it has been recognized that the layman will only benefit from the broker's knowledge if the broker is working in an efficient market.

The current SEC disclosure policy is little help in enabling brokers to give their investor customers full and complete information. It is not completely in tune with market reality and only allows partial

175. The text refers to mandatory disclosure items, such as prospectuses and annual reports. See Saari, supra note 121, at 1057.
176. Note, supra note 39, at 1083.
178. Kripke, Dead Wood, supra note 177, at 841.
179. Id.
dissemination of market information. The SEC, in effect, has put the broker in an extremely precarious position. By virtue of the current legal suitability requirements, responsibility for making inappropriate investment decisions has been shifted from the customer to the broker. This is due to the belief of the Commission that the "disclosure requirements and practices alone have not been wholly effective in protecting the investor." The Commission, therefore, places a heavy burden on brokers without allowing them the means to fully support the weight.

The solution must be either to allow the prospectus and other SEC documents to reflect all information in the efficient market or to develop a two-tier disclosure approach. The SEC has been aware of past demand for two types of disclosure documents, which are needed to adequately inform both individuals and their market representatives.

It has been suggested by one securities scholar that the disclosure policy be directed toward the representatives of market participants: brokers make the vast majority of investment decisions for the lay investor and are the best qualified persons to do so. What may be needed "is a new departure, with disclosure oriented towards the sophisticated person able to handle it, through whom suggestions for action will filter down to the layperson." This "departure" would entail an administrative recognition that, although current disclosure documents such as the prospectus are intended for the unsophisticated investor, the theory that the prospectus can be and is utilized by the lay investor is a myth. A new SEC disclosure policy geared to market professionals would allow them to function in an efficient market by giving them access to all available information.

181. See supra notes 23, 34-37 and accompanying text (brokers' responsibilities under current suitability laws).
182. Statement of Wm. J. Casey, Chairman of the Securities Exchange Commission before Subcommittee on HUD-Space and Science, U.S. Senate, May 26, 1971:
I am not going to be satisfied with the job we are doing in the disclosure area as long as the philosophy prevails that no one really reads a prospectus or a proxy statement. We will have to find and develop presentation so that the average investor will have something he will read and understand and, at the same time, give the professional the information he should have for deep analysis.
184. Id. at 638.
185. Id. at 632.
CONCLUSION

The SEC needs to go further in establishing a more meaningful disclosure policy for brokers and other market representatives. The new policy should more closely resemble true market needs, whether or not that policy is contained in a one- or two-tier approach. Disclosure documents geared to market professionals should reflect all market information in accordance with the ECMH. If the proposition of the ECMH is accepted, that is, if all available market information is reflected in the price of any given security at any one time, then portfolio theory would mandate diversification to maximize returns. A suitability standard predicated on these theories would encompass all market information.

If a suitability theory could be aligned with this meaningful disclosure policy, both the professional and layman would benefit. The market professional could be judged pursuant to guidelines which are concrete, yet encompass realities of everyday market functioning. Laymen, the majority of which seek the professional's advice, would profit by receiving investment recommendations that have been derived through studies of an efficient market system.