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SOPHISTICATED INVESTORS UNDER THE FEDERAL SECURITIES LAWS

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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.

—Justice William O. Douglas¹

The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment.

—Judge Irving R. Kaufman²

INTRODUCTION

A fundamental idea in American jurisprudence is that like cases should be treated alike, and different cases should be treated differently. Another is that the law should treat all individuals identically, regardless of their wealth or status. These principles—one based on evenhandedness and the other on individual dignity—come into conflict when the law must apply to individuals with multiple characteristics, only some of which distinguish these individuals from one other. In such cases, the law must determine whether these differences are legally significant (evenhandedness prevails) or insignificant (individual dignity prevails). These cases frequently arise under the securities laws when courts decide whether to treat sophisticated and unsophisticated investors differently.

Investors possess vastly different degrees of financial sophistication. Some are institutional investors or professionals with vast resources, educations from top business schools, and substantial investment experience. Others are individuals with few resources, little or no education, and even less experience in the securities markets. Although, as Justice Douglas has correctly remarked,³ the securities laws themselves make almost no mention of investor sophistication,⁴ courts do in fact distinguish between sophisticated and unsophisticated investors.

In some cases, plaintiffs' sophistication actually bars recovery.⁵ A

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

2. *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977).

3. See *supra* text accompanying note 1.

4. The definition of "accredited investor" in section 2(15) of the Securities Act of 1933, 15 U.S.C. § 77b(15) (1982), is a notable exception. See *infra* notes 236-77 and accompanying text (discussing treatment of sophisticated investors in connection with registration exemptions).

5. See, e.g., *Hirsch*, 553 F.2d at 762-63 (finding for defendants, largely because of plaintiffs' position in securities industry); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Brooks*, 548 F.2d 615, 616 (5th Cir.) (no liability for violation of margin rules where plaintiff was sophisticated investor), *cert. denied*, 434 U.S. 855 (1977); *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981) (summary judgment for defendant on sophisticated plaintiffs' churning, suitability, and margin violation claims); *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 486 F. Supp. 56, 58 (E.D. Mo. 1980) (summary judgment under statute of limitations because sophisticated plaintiff should have discovered fraud earlier); *Bridgen v. Scott*, 456 F. Supp. 1048, 1064 (S.D. Tex. 1978) (holding for defendant, largely because of plaintiffs' sophistication); *Scarfariotti v. Bache*

court of appeals, in one case, adjudged a plaintiff's claim frivolous in view of the plaintiff's sophistication, and awarded attorney's fees to the defendant.⁶ In other cases, courts have remarked on the plaintiffs' sophistication and eventually held for the defendants, but have failed to indicate how investor sophistication influenced their decisions.⁷

One might draw several alternative conclusions from such cases. Perhaps sophistication affects case outcomes subtly, silently, and without judicial knowledge. Or, perhaps judges feel that sophistication should count against plaintiffs, but are unable to articulate a justification for this feeling. One might even conclude that sophisticated investors simply make less credible witnesses, particularly if they try to present themselves as poor, innocent, unsophisticated victims.⁸ The troublesome aspect of these cases is that neither the courts nor the commentators have articulated a coherent theory to justify different judicial treatment of sophisticated and unsophisticated investors—the kind of theory that might resolve the inconsistency and confusion in this area. This Article seeks to develop such a theory.

As part I demonstrates, based on a comprehensive study of cases involving investor sophistication, the federal courts' treatment of investor sophistication reflects a doctrine in disarray. The problem arises in more than a dozen different types of cases arising under the Securities Act of 1933 (the 1933 Act)⁹ and the Securities Exchange Act of 1934 (the 1934 Act),¹⁰ yet the courts' treatment of sophisticated investors shows little

& Co., 438 F. Supp. 199, 203-05 (S.D.N.Y. 1977) (holding for defendant in Rule 10b-5 case, largely because of plaintiffs' sophistication); *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 288-90 (E.D. La. 1974) (holding for defendant on plaintiff's action under 1933 Act section 12(2) and Rule 10b-5 where plaintiff was "sophisticated and knowledgeable investor"), *aff'd*, 512 F.2d 484 (5th Cir. 1975); *C. Leonardt Improvement Co. v. Southdown, Inc.*, 313 F. Supp. 1146, 1149 (C.D. Cal. 1970) (preliminary injunction denied when court, noting plaintiffs' investment experience, remained unconvinced of plaintiffs' ability to succeed at trial); *cf.* *North Am. Fin. Group v. S.M.R. Enters.*, 583 F. Supp. 691, 698 (N.D. Ill. 1984) (common law securities fraud claim dismissed because of plaintiff's sophistication, among other reasons).

6. *Zissu v. Bear, Stearns & Co.*, 805 F.2d 75, 80-81 (2d Cir. 1986). For an interesting discussion of this case and some recommendations concerning its use by litigators, see Note, *Turning the Tables: Investor Liability Under Rule 10b-5*, 17 STETSON L. REV. 196 (1987).

7. See, e.g., *McLean v. Alexander*, 599 F.2d 1190, 1193 (3d Cir. 1979); *Abell v. Elmer*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,448, at 92,728 (D.D.C. Oct. 31, 1985); *Gas-cogne Corp. v. Miceli*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,924, at 90,703 (S.D.N.Y. Mar. 20, 1981); *Sandor v. Ruffer, Ballan & Co.*, 309 F. Supp. 849, 851 (S.D.N.Y. 1970).

8. See, e.g., *Scarfarotti*, 438 F. Supp. at 203-05 (finding that plaintiffs were experienced investors and that their contrary claims were strong evidence of untruthful testimony); *Sandor*, 309 F. Supp. at 853 (basing decision in part on "demeanor evidence" after finding plaintiff was sophisticated).

9. 15 U.S.C. §§ 77a-77aa (1982).

10. *Id.* §§ 78a-78kk.

Although this Article comprehensively surveys the judicial treatment of sophisticated investors under the federal securities laws, the survey is necessarily incomplete. The Article focuses on the

coherence or, if you will, reflects little cross-fertilization among the different settings in which the sophistication issue arises. In addition, even within each context, courts often disagree strongly whether investor sophistication is relevant at all. If the law is to draw distinctions between legal actors and thereby downplay individual dignity,¹¹ it must explain why those distinctions are (or should be) legally relevant. Part II of this Article provides such an explanation. It presents a set of five propositions, which together lead to the conclusion that a court may properly treat sophisticated investors differently from other investors when the claim at issue involves either explicit congressional permission or a judicially created right of action. Finally, an appendix to this Article presents a set of criteria that both judges and lawyers may use in determining an investor's level of sophistication.

I. THE INCONSISTENT JUDICIAL TREATMENT OF SOPHISTICATED INVESTORS

Many cases arising under the 1933 and 1934 Acts involve the issue of investor sophistication. While the larger jurisprudential problem—justifying a legal distinction between sophisticated and unsophisticated investors—is common to all, the legal contexts of these cases vary. The following sections discuss these contexts one at a time.

A. *Investor Sophistication and the Causation Requirement of Rule 10b-5.*

Rule 10b-5 has generated a staggering quantity of law.¹² Yet, surprisingly enough, the cases demonstrate little precision or unanimity regarding the elements of a *prima facie* Rule 10b-5 case.¹³ Almost all

1933 and 1934 Acts; however, the principles discussed apply to other areas of securities law in which the issue of investor sophistication arises.

11. See *supra* text accompanying notes 2-3.

12. At least two multivolume treatises are now devoted primarily to Rule 10b-5. See A. BROMBERG & L. LOWELFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* (1979); A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10b-5* (2d ed. 1988).

13. See, e.g., *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983) (plaintiff must show that defendant, in connection with purchase or sale of securities, falsely represented material fact on which plaintiff justifiably relied to her detriment); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979) (Rule 10b-5 elements: use of jurisdictional means, deceptive or manipulative practice committed with scienter in connection with purchase or sale of security; causation; damages); *HSL, Inc. v. Daniels*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,557, at 97,194-95 (N.D. Ill. Dec. 1, 1983) (same); *Issen v. GSC Enters.*, 508 F. Supp. 1278, 1287 (N.D. Ill. 1981) (10b-5 elements: material misrepresentation, omission, deception, or manipulation; scienter; causal connection to plaintiff's harm); see also Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96, 99 n.17 (1985) (10b-5 elements: purchaser or seller; materiality; scienter; connection with purchase or sale; reliance; causation; jurisdictional means).

formulations, however, require causation: in a private damage action under the Rule, a defendant's acts must bear a causal connection to a plaintiff's injury.¹⁴

Perhaps no aspect of Rule 10b-5 has perplexed as many people as this causation requirement.¹⁵ Although courts agree that the Rule requires some sort of causal connection, they agree on little else and take a variety of approaches to the requirement.¹⁶ Some courts wrestle with it under the rubric of reasonable reliance¹⁷ or due diligence,¹⁸ while others treat it in terms of reckless reliance or *in pari delicto*.¹⁹ The task in all four approaches is the same: establishing a nexus between the defendant's conduct and the plaintiff's injury.²⁰ Moreover, regardless of which approach a court uses, the issue of investor sophistication arises.

1. *Reasonable Reliance and the Sophisticated Investor.* In Rule 10b-5 cases involving misrepresentations of material fact, courts most commonly decide the causation issue by considering whether the plaintiff

14. See, e.g., cases cited *supra* note 13.

15. Several authors have made helpful attempts to sort out this confusion. See Helman, *Rule 10b-5 Omissions Cases and the Investment Decision*, 51 *FORDHAM L. REV.* 399 (1982); Wheeler, *Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to An Implied Remedy*, 70 *NW. U.L. REV.* 561 (1975); Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 *COLUM. L. REV.* 562 (1972).

16. The problem is exacerbated by potential confusion of the causation element with two related, yet distinct, elements of Rule 10b-5: the materiality and "in connection with" requirements. Both are separate from the causation element and should not be confused with it. Materiality requires that the information given or withheld be of some importance to the investor at issue. *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1976); cf. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality in Rule 14a-9 action). Although the relevance of an investor's sophistication to the materiality issue remains an open question, see *infra* notes 89-104 and accompanying text, the materiality of information is unaffected by allegations of harm. That is, material misrepresentations or omissions need not cause harm. Of course, in nondisclosure cases, courts presume causation if material omissions exist. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972); Helman, *supra* note 15, at 403-06.

The "in connection with" requirement is likewise distinct from the causation requirement. The Rule's "in connection with" language demands that a plaintiff show some connection between the defendant's alleged misconduct and the purchase or sale of securities, whereas the causation requirement demands that a plaintiff show some connection between the misconduct and the harm he has allegedly suffered.

17. See *infra* notes 21-47 and accompanying text.

18. See *infra* notes 48-63 and accompanying text.

19. See *infra* notes 64-75 and accompanying text.

20. This fact has eluded at least one court. See *Flamm v. Eberstadt*, 814 F.2d 1169, 1173 (7th Cir.), cert. denied, 108 S. Ct. 157 (1987). The *Flamm* court declared that justifiable reliance is no longer an element in a Rule 10b-5 case, since the causation and materiality requirements serve the same function. The court apparently misunderstood that justifiable reliance constitutes a part of the causation element. For an excellent discussion of the causation element and the relevance of plaintiffs' conduct in Rule 10b-5 actions, see Gabaldon, *Unclean Hands and Self-Inflicted Wounds: The Significance of Plaintiff Conduct in Actions for Misrepresentation Under Rule 10b-5*, 71 *MINN. L. REV.* 317 (1986).

has reasonably relied on the defendant's misstatements.²¹ In cases involving nondisclosure of material facts, since the facts show nothing on which the plaintiff could have relied, courts shift the burden of proof to the defendant: the plaintiff's showing of material nondisclosure establishes causation²² and the defendant can prevail only by showing that the plaintiff would have made the same investment if full disclosure had occurred.²³ Thus, in both affirmative misrepresentation and nondisclosure cases, courts use reliance to determine causation,²⁴ and under that approach, a plaintiff's lack of reasonable reliance will cause her Rule 10b-5 claim to fail.²⁵

21. See, e.g., *HSL, Inc. v. Daniels*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,557, at 97,195 (N.D. Ill. Aug. 25, 1983) (Rule 10b-5's causation element usually satisfied by showing of reliance); *Capital Invs., Inc. v. Bank of Sturgeon Bay*, 430 F. Supp. 534, 539 n.1 (E.D. Wis. 1977) (same), *aff'd*, 577 F.2d 745 (7th Cir. 1978); cf. *Painter, Civil Liability Under the Federal Proxy Rules*, 64 WASH. U.L.Q. 425, 426 (1986) (courts continue to require reliance in Rule 10b-5 cases, except in cases involving pure nondisclosure).

22. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972). The inference of causation from materiality in nondisclosure cases has led one commentator to suggest, a little misleadingly, that materiality may satisfy the causation requirement in the same way that reliance and due diligence do. See Helman, *supra* note 15, at 402-08. Under a proper reading of *Affiliated Ute*, materiality is important for causation purposes simply because its presence in a nondisclosure case raises a rebuttable presumption of causation. See *Affiliated Ute*, 406 U.S. at 154.

23. See, e.g., *duPont v. Brady*, 828 F.2d 75, 78 (2d Cir. 1987); *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102 (1983). These cases rebut others that have misread *Affiliated Ute* as making reasonable reliance (and therefore, presumably, causation) irrelevant in nondisclosure cases. See *Little v. First Cal. Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,745, at 96,466 (D. Ariz. July 11, 1974) (rejecting defendants' contention that plaintiff had to plead reliance in nondisclosure case); see also *McFarland v. Memorex Corp.*, 96 F.R.D. 357, 363 (N.D. Cal. 1982) (suggesting that at certification stage of class action, due care and reliance are irrelevant, and only materiality is important).

24. This may not hold true for Rule 10b-5 claims brought under a fraud on the market theory. Under this emerging theory, a plaintiff's showing of reliance on the general integrity of the market satisfies the causation element. See, e.g., *Stoller v. Baldwin-United Corp.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,298, at 92,024-26 (S.D. Ohio June 4, 1985); see also Branson, *Collateral Participant Liability Under the Securities Laws—Charting the Proper Course*, 65 OR. L. REV. 327, 335 (1986) (suggesting that reliance requirement in 10b-5 cases is waning because of fraud on market theory). But see *Zandinan v. Joseph*, 102 F.R.D. 924, 931-32 (N.D. Ind. 1984) (indicating that even in fraud on market cases, sophisticated plaintiffs held to higher standard of justifiable reliance (quoting *J.H. Cohn & Co. v. American Appraisal Assocs.*, 628 F.2d 994, 998-99 (7th Cir. 1980))). For a cogent description of the fraud on the market theory and its application, see Note, *The Fraud on the Market Theory: Efficient Markets and the Defenses to an Implied 10b-5 Action*, 70 IOWA L. REV. 975 (1985). The theory relies on a canonical theory of market efficiency that has recently come under attack. See, e.g., Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 789-94 (1985) (suggesting that reliance on an efficient-market hypothesis may be unwise, since validity may depend on sophistication of actors involved); Donnelly, *Efficient-Market Theorists Are Puzzled by Recent gyrations in Stock Market*, Wall St. J., Oct. 23, 1987, at 7, col. 1 (reporting views of those criticizing efficient-market hypothesis).

25. See *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1518-19 (10th Cir. 1983); *Stern & Stern Textiles, Inc. v. LBY Holding Corp.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,122, at 95,522 (S.D.N.Y. Feb. 3, 1987); *Scarfaretto v. Bache & Co.*, 438 F. Supp. 199, 207 (S.D.N.Y. 1977);

In conducting the reasonable reliance inquiry, most courts have recognized the relevance of investor sophistication. In *Zobrist v. Coal-X, Inc.*, for example, the Tenth Circuit pointed to "the sophistication and expertise of the plaintiff in financial and securities matters" as one of eight factors that a court should consider in determining a plaintiff's reasonable reliance.²⁶ The court then noted that the plaintiff was a "sophisticated and knowledgeable investor,"²⁷ and held his reliance unreasonable as a matter of law.²⁸ Similarly, in *Kennedy v. Josephthal & Co.*, the First Circuit, citing *Zobrist*, listed a number of factors that affect the reasonable reliance inquiry.²⁹ Based on the plaintiffs' sophistication, the court held that the plaintiffs could not have *justifiably* relied on any alleged misrepresentations and affirmed summary judgment for the defendants.³⁰

Zobrist and *Kennedy* typify a long line of cases in which courts have found background,³¹ education,³² special expertise,³³ and general investment sophistication³⁴ relevant to the reliance inquiry. These cases clearly imply that the relevance inquiry is a subjective one,³⁵ and most courts that have considered the issue agree.³⁶ Some courts, however,

cf. North Am. Fin. Group v. S.M.R. Enters., 583 F. Supp. 691, 698-99 (N.D. Ill. 1984) (dismissing common law fraud claim because of plaintiff's failure to establish reasonable reliance on alleged misstatements).

26. 708 F.2d at 1516. For a similar list, see Note, *supra* note 15, at 567-75.

27. *Zobrist*, 708 F.2d at 1517.

28. *Id.* at 1518.

29. 814 F.2d 798, 804 (1st Cir. 1987).

30. *Id.* at 805.

31. See, e.g., North Am. Fin. Group v. S.M.R. Enters., 583 F. Supp. 691, 698 (N.D. Ill. 1984) (background as venture capitalist supported finding of sophistication).

32. See, e.g., Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277, 1299 (W.D. Mich. 1986) (education among factors leading court to conclude that reliance unjustified), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 108 S. Ct. 1227 (1988); *S.M.R. Enters.*, 583 F. Supp. at 698 (same).

33. See *S.M.R. Enters.*, 583 F. Supp. at 698 ("The background, special expertise or education of the plaintiff also may be considered incident to the reasonable reliance element.").

34. See, e.g., J.H. Cohn & Co. v. American Appraisal Assocs., 628 F.2d 994, 989-99 (7th Cir. 1980) (sophisticated investor may not be as justified in relying on material misrepresentation or omissions as others would be); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976) (sophistication worthy of consideration); *Platsis*, 642 F. Supp. at 1299 (in view of plaintiffs' sophistication, court not persuaded that reliance justified); Drobbin v. Nicolet Instrument Co., 631 F. Supp. 860, 891 (S.D.N.Y. 1986) (sophistication relevant to plaintiff's degree of reliance); Quintel Corp. v. Citibank, N.A., 596 F. Supp. 797, 801-02 (S.D.N.Y. 1984) (sophistication relevant to determine plaintiff's reliance); *S.M.R. Enters.*, 583 F. Supp. at 698 (venture capital firm's sophistication relevant).

35. *Cf.* Helman, *supra* note 15, at 408 (terming duty of due diligence "subjective and flexible").

36. See, e.g., Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Myzel v. Fields, 386 F.2d 718, 737 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). *But cf.* Long v. Abbott Mortgage Corp., 459 F. Supp. 108, 116-17 (D. Conn. 1978) (refusing to hold sophisticated investor to higher, "hypothetical reasonable man" due diligence test).

have taken a contrary position.³⁷ Instead of analyzing plaintiffs' sophistication under a subjective test, these courts ignore sophistication and treat all investors alike as stereotypical "reasonable men."³⁸ Such inconsistency in approach necessarily leads to inconsistent judicial treatment of sophisticated investors under Rule 10b-5.

Under a subjective test, a sophisticated plaintiff faces a higher standard of reliance. For example, in *Weinberg v. Lear Fan Corp.*,³⁹ the court considered the merits of a proposed class action settlement⁴⁰ in a Rule 10b-5 action by a group of educated professionals.⁴¹ The court held the settlement fair to the class members because their sophistication created a high probability of failure on the merits; under a reasonable reliance test, their sophistication made it less likely that they could prove causation.⁴² Similarly, in *Eichen v. E.F. Hutton & Co.*, the court held the plaintiff—a longtime investor in speculative ventures and a former mutual fund advisor—to a higher level of scrutiny as it evaluated his claim that he relied on alleged misrepresentations about the safety of an oil and gas program.⁴³ The court decided that his sophistication undercut his reliance claim.⁴⁴

Other cases imply a higher standard of reasonable reliance. Many courts simply note a plaintiff's sophistication and suggest that he gain-

37. See, e.g., Note, *supra* note 15, at 566-67 (noting that some courts use objective test to determine reasonable reliance, while others use subjective test).

38. See, e.g., *In re Olympia Brewing Co. Sec. Litig.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461, at 92,819 (N.D. Ill. Nov. 13, 1985) (rejecting defendant's affirmative defense that sophisticated plaintiffs failed to exercise due diligence, since sophistication irrelevant under federal securities law); *Abbott Mortgage*, 459 F. Supp. at 116-17 (refusing to hold sophisticated investor to higher standard of due diligence under objective test).

39. 627 F. Supp. 719 (S.D.N.Y. 1986).

40. Under FED. R. CIV. P. 23(e), a court must approve all class action settlements.

41. *Weinberg*, 627 F. Supp. at 723. The plaintiffs were a group of doctors, lawyers, educators, and business people. This Article's appendix, see *infra* notes 386-419 and accompanying text, considers what factors may or may not count in determining an investor's sophistication.

42. *Weinberg*, 627 F. Supp. at 723; see also *Kennedy v. Josephthal & Co.*, 814 F.2d 798, 804 (1st Cir. 1987) (holding sophisticated plaintiff to higher reasonable reliance standard); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516-17 (10th Cir. 1983) (same); *Colvin v. Dempsey-Tegeler & Co.*, 477 F.2d 1283, 1287-88 (5th Cir. 1973) (same); *Zandinan v. Joseph*, 102 F.R.D. 924, 931-32 (N.D. Ind. 1984) (same); Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 842 (1965) ("[R]ecovery would be denied to those who, because of their 'business sophistication,' acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings."); cf. *Fisher v. Plessy Co.*, 103 F.R.D. 150, 160 (S.D.N.Y. 1984) (reporting defendants' argument that plaintiff should not represent class because his sophistication would subject him to unique defense of lack of justifiable reliance).

43. 402 F. Supp. 823, 830-31 (S.D. Cal. 1975).

44. *Id.* at 830; see also *Kohner v. Wechsler*, 477 F.2d 666, 673 n.11 (2d Cir. 1973) (Timbers, J., concurring) (plaintiff's sophistication may make him unable to prove reliance); *Model Assocs. v. United States Steel Corp.*, 88 F.R.D. 338, 340 (S.D. Ohio 1980) (sophisticated investor may be expected to rely less on any alleged misrepresentations than unsophisticated investor would).

bled, lost, and is unfairly asking for compensation.⁴⁵ As the court in *Caan v. Kane-Miller Corp.* stated, "the securities laws are not to be used as an insurance policy for investors who choose voluntarily to disregard facts which would have been uncovered by any reasonable person in their position."⁴⁶

Sophistication, then, often reduces an investor's ability to show reasonable reliance. As a result, a sophisticated investor often faces a more difficult task of establishing causation under Rule 10b-5 than an unsophisticated one faces.⁴⁷

2. *Due Diligence and the Sophisticated Investor.* In analyzing Rule 10b-5 causation issues, courts often state that investors may not simply close their eyes to obvious risks, but must exercise due diligence in protecting themselves.⁴⁸ In considering whether a sophisticated investor has exercised such diligence, courts use an analysis similar to the reliance inquiry, although the relationship between due diligence and reasonable reliance is elusive.⁴⁹ In one view, due diligence charges plaintiffs with a duty to take affirmative steps to protect themselves, while reasonable reliance merely admonishes plaintiffs to be reasonable in their passive reliance.⁵⁰ A better analysis, however, suggests that any distinction between due diligence and reasonable reliance is insubstantial. Rather,

45. See, e.g., *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981) (granting summary judgment for defendant, since plaintiff was sophisticated investor with full knowledge of securities' speculative nature and failed to object until venture failed); *Eichen*, 402 F. Supp. at 830 (plaintiff's "level of sophistication and investment experience is significant and is not compatible with his claims of reliance" on alleged misrepresentations); *Canizaro v. Kohlmeier & Co.*, 370 F. Supp. 282, 288 (E.D. La. 1974) (no liability under section 12(2) or Rule 10b-5, in part because plaintiff was "sophisticated and knowledgeable investor" who must have known risk in buying stock for well below market price), *aff'd*, 512 F.2d 484 (5th Cir. 1975); cf. *Gleit v. Shearson, Hamnill & Co.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,799, at 90,887 (S.D.N.Y. Oct. 20, 1976) ("The scenario of the disappointed—but not defrauded—investor, who tries to recover his loss through means of the federal securities laws, has become all too common in the federal courts.").

46. [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,446, at 99,242 (S.D.N.Y. Feb. 5, 1976) (emphasis added). The court had already decided to take the plaintiff's sophistication into account in determining the reasonableness of his investigation.

47. Many cases hold sophisticated investors to a higher standard of due diligence as well. See *infra* notes 48-63 and accompanying text.

48. See, e.g., *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977); *North Am. Fin. Group v. S.M.R. Enters.*, 583 F. Supp. 691, 698 (N.D. Ill. 1984); *Eichen*, 402 F. Supp. at 831; cf. *Buder v. Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 690, 692 (8th Cir. 1981) (plaintiff could not deliberately close eyes to facts that average, reasonable person, let alone sophisticated investor, would have discovered, and then hope to toll statute of limitations).

49. See *Wheeler*, *supra* note 15, at 570-89 (tracing confusion regarding causation, reasonableness of reliance, and due care).

50. One commentator has suggested that judicial emphasis after *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), is moving away from reasonable reliance and toward due diligence. See *Helman*, *supra* note 15, at 407, 408.

both doctrines attempt to express the same idea about causation: for a plaintiff to recover, a defendant's acts, not the plaintiff's, must have caused the plaintiff's alleged injury.⁵¹

Perhaps because of the two doctrines' resemblance,⁵² most courts agree that the due diligence test, like the reasonable reliance inquiry, is subjective: these courts measure due diligence not by what an ordinary reasonable plaintiff would have done, but by what *the plaintiff at bar* should have done under the circumstances.⁵³ Some courts hold sophisticated and unsophisticated investors to the same due diligence standard.⁵⁴ This disparity necessarily leads to inconsistent judicial treatment of the sophisticated investor.

As with the reliance inquiry, courts using a subjective due diligence test hold sophisticated plaintiffs to a higher level of scrutiny.⁵⁵ In *Mc-*

51. See Wheeler, *supra* note 15, at 563 ("The gist of what might be called the lack of due care defense is simply that rule 10b-5 does not remedy private losses which are demonstrated to be, at least in part, the result of the plaintiff's own carelessness."); see also Helman, *supra* note 15, at 408 (suggesting that due diligence requirement is based on idea of reasonable reliance). The relationship between these causation concepts in securities law and more general notions of contributory fault, comparative fault, and proximate cause, while fascinating, is beyond the purview of this Article. At least one court has noted the similarity between Rule 10b-5's due diligence requirement and the tort concept of contributory negligence. See *McLean v. Alexander*, 420 F. Supp. 1057, 1078 (D. Del. 1976).

52. The connection between the two becomes most apparent in the cases that interpret Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), as shifting the causation inquiry's focus from due diligence to reckless reliance. See *infra* notes 64-71 and accompanying text.

53. See, e.g., *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); *Clement A. Evans & Co. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971); see also Helman, *supra* note 15, at 408 (plaintiff's duty of due diligence is "subjective and flexible" and depends on plaintiff's sophistication); Note, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753, 768 [hereinafter Note, *Due Diligence Requirement*] ("[T]he due diligence burden of experienced investors may be higher than that of insiders who lack such expertise."). See generally Note, *Due Diligence: A Post-Sale of Business Doctrine Method of Avoiding Rule 10b-5 Liability*, 64 WASH. U.L.Q. 589 (1986) (suggesting that sellers of corporate stock can avoid Rule 10b-5 liability by using due diligence or justifiable reliance defenses, both almost always available because of typical purchasers' sophistication).

As one commentator has pointed out, a subjective due diligence requirement can cause problems for a plaintiff seeking to represent a class in a class action, since a sophisticated plaintiff may have trouble satisfying this element of the Rule 10b-5 action. See Marcus, *Fraudulent Concealment in Federal Court: Toward a More Disparate Standard?*, 71 GEO. L.J. 829, 881 (1983). Typicality problems for the sophisticated investor in class actions are discussed *infra* notes 182-210 and accompanying text.

54. See, e.g., *In re Olympic Brewing Co. Sec. Litig.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461, at 92,819 (N.D. Ill. Nov. 13, 1985) (plaintiff's sophistication irrelevant in securities fraud cases; no graduated scale of duty depending upon sophistication); *Long v. Abbott Mortgage Corp.*, 459 F. Supp. 108, 116-17 (D. Conn. 1978) (refusing to apply higher standard of diligence to plaintiff, even though plaintiff a sophisticated investor).

55. See, e.g., *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977); *Holdsworth v. Strong*, 545 F.2d 687, 692 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); *Colvin v. Dempsey-Tegeler & Co.*, 477 F.2d 1283, 1287-88 (5th Cir. 1973); *McAlpine*, 434 F.2d at 103-04; *Bourdages v. Metals Ref. Ltd.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,828, at 90,169 n.3 (S.D.N.Y. Oct.

Lean v. Alexander,⁵⁶ the court addressed due diligence in these terms:

Whereas the test of materiality requires that the information be objectively important to a reasonable person, the duty of due care mandates that the plaintiff assess the information as would a person similarly possessed of his degree of business expertise. Thus, the duty to investigate the facts surrounding a securities transaction which attaches to the sophisticated investor is greater than the corresponding duty of a novice.⁵⁷

Accordingly, sophisticated investors may not simply close their eyes to facts relevant and obvious to them, only to claim later that ordinary investors would not have discovered those facts at all.⁵⁸ If, by virtue of his sophistication, a plaintiff has access to material information but fails to examine it, then his Rule 10b-5 claim must fail under a subjective due diligence test.⁵⁹ The court's admonition in *Caan v. Kane-Miller Corp.* applies in this context as well: "the securities laws are not to be used as an insurance policy for investors who choose voluntarily to disregard facts which would have been uncovered by any reasonable person in their

31, 1984); *McLean*, 420 F. Supp. at 1078; *Caan v. Kane-Miller Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,446, at 99,242-43 (S.D.N.Y. Feb. 5, 1976); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823, 830 (S.D. Cal. 1975); see also *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 472 F. Supp. 402, 408-09 (D. Colo. 1979) (using high level of due diligence for statute of limitations purposes in 10b-5 case), *aff'd*, 651 F.2d 687 (10th Cir.), *cert. denied*, 454 U.S. 895 (1981); Comment, *supra* note 42, at 842 ("In this way recovery would be denied to those who, because of their 'business sophistication,' acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings."); Note, *Due Diligence Requirement*, *supra* note 53, at 768 ("[T]he due diligence burden of experienced investors may be higher than that of insiders who lack such expertise."). See generally Marcus, *supra* note 53, at 879-80 (arguing in favor of individualized standard of due diligence in statute-of-limitations cases).

56. 420 F. Supp. 1057 (D. Del. 1976).

57. *Id.* at 1078.

58. See, e.g., *Buder v. Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 690, 692 (8th Cir. 1981) (plaintiff may not deliberately close eyes to information that would demonstrate to any reasonable person that representations could not have been true); *Hirsch*, 553 F.2d at 763 ("The securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment."); see also *duPont v. Brady*, 646 F. Supp. 1067, 1072 (S.D.N.Y. 1986) ("sophisticated investors may not intentionally refuse to investigate the information available to them"), *rev'd*, 828 F.2d 75 (2d Cir. 1987); cf. *North Am. Fin. Group v. S.M.R. Enters.*, 583 F. Supp. 691, 698 (N.D. Ill. 1984) (same holding in common law fraud case).

59. See, e.g., *Holdsworth*, 545 F.2d at 692 (insider must fulfill duty of due care in ascertaining information before claiming reliance on material misrepresentation); *NBI Mortgage Inv. Corp. v. Chemical Bank*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066, at 91,801 (S.D.N.Y. May 24, 1977) (plaintiff cannot claim reliance if he failed to exercise due diligence); *Eichen*, 402 F. Supp. at 830 ("investor who casually makes investments, and who blindly rides bubbles until they burst, does so at his own risk, and cannot later invoke [section] 10(b)" (quoting *McGraw v. Matthaei*, 388 F. Supp. 84, 92 (E.D. Mich. 1972))); *Nexus Indus. v. Smith*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,379, at 98,891 (S.D.N.Y. Dec. 5, 1975) (available information should have led reasonable and sophisticated investor to conclusion that company was in severe financial trouble).

position.”⁶⁰

A minority of courts, however, have rejected this subjective approach and its distinction between sophisticated and unsophisticated investors. In *Long v. Abbott Mortgage Corp.*, the court applied an objective standard to a sophisticated investor's claim.⁶¹ In *In re Olympic Brewing Co. Securities Litigation*,⁶² the court rejected a defendant's argument that plaintiffs, sophisticated investors who had full access to all relevant information, caused their own injury through a lack of diligence:

The sophistication of the investor is immaterial when it comes to plaintiffs' claims based upon misrepresentations and omissions. . . . 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.⁶³

Thus, in due diligence analysis, as in reliance analysis, courts fail to agree on the relevance of investor sophistication, and this leads to inconsistent results.

3. *Sophisticated Investors and Reckless Reliance.* One line of Rule 10b-5 cases demonstrates judicial ambivalence about the role of investor sophistication in causation inquiries and illustrates the connections between due diligence and reasonable reliance. The line follows from *Ernst & Ernst v. Hochfelder*, in which the Supreme Court held that Rule 10b-5 requires that plaintiffs prove scienter.⁶⁴ After *Hochfelder*, some courts began to reconsider whether plaintiffs should have to prove their due diligence as well as the defendant's scienter.⁶⁵ For example, in *Holdsworth v. Strong*, the Tenth Circuit held that plaintiffs must prove both due diligence and scienter only for negligent misrepresentation

60. [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,446, at 99,242 (S.D.N.Y. Feb. 5, 1976). The court had already determined that the plaintiff was a sophisticated investor who should have exercised a higher level of diligence than that of other investors. Of course, even a sophisticated plaintiff can establish due diligence, notwithstanding the higher level of care required. See, e.g., *Verace v. New York Stock Exch.*, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,575, at 98,043 (S.D.N.Y. July 10, 1980) (notwithstanding plaintiff's sophistication, he did not lack "due diligence" in relying on representation).

61. 459 F. Supp. 108, 116-17 (D. Conn. 1978). The court, however, found that the plaintiff had not met even that lower standard. See *id.* at 117.

62. [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461 (N.D. Ill. Nov. 13, 1985).

63. *Id.* at 92,819 (citations omitted).

64. 425 U.S. 185, 193 (1976).

65. See generally Marcus, *supra* note 53, at 875 n.290 (noting that courts disagree whether due diligence defense exists after *Hochfelder*); Note, *Plaintiff's Duty of Care After Ernst & Ernst v. Hochfelder*, 73 Nw. U.L. REV. 158, 159 (1978) (reporting and discussing circuit split regarding *Hochfelder's* effect on due diligence requirement).

claims.⁶⁶ According to the court, for claims under Rule 10b-5 or theories of fraudulent misrepresentation, if the plaintiff proves scienter, the defendant should not prevail simply by showing the plaintiff's lack of due diligence: "If contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be *gross conduct* somewhat comparable to that of defendant."⁶⁷

Other courts have decided that *Hochfelder* mandates no change in the due diligence requirement.⁶⁸ One interesting set of cases, however, holds that *Hochfelder* shifts the causation burden of proof to defendants. These cases suggest that a plaintiff need not prove due diligence to establish a prima facie Rule 10b-5 claim; rather, the defendant may allege the plaintiff's reckless reliance as an affirmative defense.⁶⁹ The cases define reckless reliance as action in disregard of a known and obvious risk.⁷⁰ By also allowing defendants to show reckless reliance, this approach opens up the possibility that courts would hold sophisticated plaintiffs to a higher standard than unsophisticated plaintiffs.

Thus, even if *Hochfelder* has merged reliance and due diligence, investor sophistication remains of central concern in the majority of cases. No matter how Rule 10b-5's causation element is expressed, a majority of courts consider investor sophistication relevant to their analysis of causation.⁷¹ Despite this agreement, however, they have articulated no theory that will clarify and justify the role of sophistication and will produce consistent results.

4. *Sophisticated Investors and the In Pari Delicto Defense.* Under the in pari delicto doctrine, a plaintiff cannot recover damages if his own conduct is the primary cause of his alleged injury.⁷² Some judges have argued that sophisticated plaintiffs make particularly appropriate targets

66. 545 F.2d 687, 692 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

67. *Id.* at 692. *But see* McLean v. Alexander, 420 F. Supp. 1057, 1078 (D. Del. 1976) (*Hochfelder* did not destroy due diligence requirement, since even under that case, a showing of knowledge or recklessness may support a 10b-5 action).

68. *See, e.g.*, Hirsch v. du Pont, 553 F.2d 750, 762 (2d Cir. 1977).

69. *See* Dupuy v. Dupuy, 551 F.2d 1005, 1018-20 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977); Straub v. Vaisman & Co., 540 F.2d 591, 597-98 (2d Cir. 1976); Stern & Stern Textiles, Inc. v. LBY Holding Corp., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,122, at 95,521 (S.D.N.Y. Feb. 3, 1987).

70. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 34, at 185 (5th ed. 1984); Mallis v. Bankers Trust Co., 615 F.2d 68, 78 (2d Cir. 1980); Dupuy, 551 F.2d at 1020 (citing Prosser); Stern & Stern, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,521 (citing Dupuy).

71. *See, e.g.*, Stern & Stern, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 95,521 & n.5 (noting that investor sophistication relevant to some issues in securities fraud cases, but not relying on sophistication in case at hand); McLean, 420 F. Supp. at 1078 (permitting defendant to establish sophisticated plaintiff's lack of due diligence).

72. *See generally* Gabaldon, *supra* note 20, at 343-61.

for an in pari delicto defense,⁷³ a view consistent with the caselaw's general tendency to hold sophisticated investors to a high level of scrutiny. The Supreme Court, however, in *Bateman Eichler, Hill Richards, Inc. v. Berner*, recently limited the defense's availability.⁷⁴ The *Bateman* Court held that a tipper cannot assert an in pari delicto defense against a tippee who sues under Rule 10b-5 for a misleading tip unless: (1) the tippee-plaintiff bears substantially equal responsibility for the alleged violation, and (2) preclusion of the plaintiff's suit would not interfere with effective enforcement of the securities laws.⁷⁵ *Bateman's* second requirement will make the defense unavailable to many tipper-defendants, who will have difficulty showing that their exoneration would comport with effective enforcement of the securities laws. Sophistication may still be important even under this rule, however, since sophisticated plaintiffs will more likely bear "substantially equal responsibility" for the violations they seek to redress.

Thus, investor sophistication plays a prominent role in all four approaches to Rule 10b-5 causation, but the nature of this role remains unclear. In order to alleviate this confusion, we must establish uniform guidelines for the proper treatment of investor sophistication in cases involving causation issues under Rule 10b-5. Part II of this Article takes up that task.

B. *Investor Sophistication and Other Elements of Rule 10b-5.*

A plaintiff's sophistication also affects other elements of a Rule 10b-5 claim. As the Rule prescribes: "It shall be unlawful for any person . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading"⁷⁶ Whether a defendant has misrepresented "facts," as the Rule requires, may depend on the sophistication of the investor hear-

73. See *Rothberg v. Rosenbloom*, 808 F.2d 252, 263-64 (3d Cir. 1986) (Sloviter, J., dissenting), cert. denied, 481 U.S. 1017 (1987); see also *Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Brooks*, 548 F.2d 615, 615-16 (5th Cir.) (rejecting argument that "sophisticated commodities futures investor who at all times possessed knowledge of his deficient margin account status . . . should not be required to pay back any indebtedness because the extension of credit violated a rule or regulation of the Chicago Board of Trade"), cert. denied, 434 U.S. 855 (1977); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74, 87-90 (S.D.N.Y. 1968) (holding for defendant where plaintiff, a sophisticated investor, knowingly and intentionally induced defendant to violate Regulation U), aff'd, 409 F.2d 1360 (2d Cir.), cert. denied, 396 U.S. 904 (1969). But see *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1141 (2d Cir. 1970) (permitting investor in pari delicto to assert claim despite his windfall), cert. denied, 401 U.S. 1013 (1971); *Courtland v. Walston & Co.*, 340 F. Supp. 1076, 1085 (S.D.N.Y. 1972) (same).

74. 472 U.S. 299 (1985).

75. *Id.* at 310-11.

76. 17 C.F.R. § 240.10b-5(b) (1988).

ing the alleged misrepresentations.⁷⁷ Similarly, an investor's sophistication may influence a court's decision about the materiality of facts allegedly misstated or omitted.⁷⁸ Some courts also find investor sophistication relevant in deciding whether facts were "misleading," or "deceptive."⁷⁹ Finally, many courts find sophistication relevant in omissions cases when they consider the adequacy of a defendant's disclosure.⁸⁰

1. *"Facts" and the Sophisticated Investor.* Occasionally, a defendant asserts that an alleged misstatement was nonfactual and therefore provides no basis for a Rule 10b-5 action.⁸¹ In such circumstances, the plaintiff's sophistication becomes relevant. In *Elkind v. Liggett & Myers, Inc.*, for example, the Second Circuit held that corporate officers' misrepresentations that "1972 was expected to be a good year," when communicated to a sophisticated investor, were not "facts" under Rule 10b-5.⁸² Presumably, the court left open the possibility that the statements at issue could be "facts" if communicated to a less sophisticated investor. In *Hughes v. Dempsey-Tegeler & Co.*,⁸³ the Ninth Circuit hinted at the same conclusion in deciding that the generality of the defendant's representations blocked any Rule 10b-5 violation. The plaintiff's sophistication had an influence on this decision: as the court remarked, the plaintiff was not a "gullible, defenseless investor unable to protect himself from the machinations of a vastly superior opposite party."⁸⁴

Both *Elkind* and *Hughes* are troubling, though, not because they suggest that a plaintiff's sophistication alters the analysis of "facts" under Rule 10b-5, but because they fail to present any reason for distinguishing sophisticated investors from "gullible, defenseless" investors. Why is sophistication relevant to courts? In particular, how does it affect whether representations are facts under Rule 10b-5?

In *Smith v. Sade & Co.*,⁸⁵ the court indicated a possible answer to these questions by demonstrating a connection between this "fact" re-

77. See *infra* notes 81-88 and accompanying text.

78. See *infra* notes 89-104 and accompanying text.

79. See *infra* notes 106-08 and accompanying text.

80. See *infra* notes 109-22 and accompanying text.

81. Of course, Rule 10b-5(b)'s proscription against misstatements and omissions is not the only aspect of the Rule that can serve as the basis for a claim. A plaintiff can also allege that a defendant employed a "device, scheme, or artifice to defraud" or has engaged in an "act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. § 240.10b-5(a), (c).

82. 635 F.2d 156, 164 (2d Cir. 1980).

83. 534 F.2d 156 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976).

84. *Id.* at 177.

85. [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,846 (D.D.C. Oct. 27, 1982).

quirement and the reliance inquiry. The *Sade & Co.* plaintiffs were quintessential "highly sophisticated investors"⁸⁶ who had suffered heavy losses in options markets and then sued their broker for Rule 10b-5 violations and common law fraud. They complained that the broker had made positive performance claims that constituted fraudulent misrepresentations of fact. The court, however, rejected this argument, reasoning in part that the plaintiffs could not reasonably have relied on such a performance claim: "While defendants may have expressed optimism as to their ability to perform . . . , reliance by a sophisticated investor such as [the plaintiff] on such expressed optimism, which may be characterized as 'puffing,' is insufficient to sustain an action for fraud."⁸⁷

As this holding indicates, investor sophistication decreases the probability that courts will view defendants' claims as misrepresentations of *fact*, rather than mere "puffing."⁸⁸ Yet, courts tend to make this characterization partly because a sophisticated plaintiff would not reasonably rely on such statements. Thus, in Rule 10b-5 cases involving sophisticated investors, courts entangle the fact requirement with reasonable reliance analysis. This approach results in unsatisfying, unprincipled, and almost incoherent caselaw. A general theory that justifies disparate judicial treatment of sophisticated and unsophisticated investors is necessary to clarify these cases as well.

2. *Materiality and the Sophisticated Investor.* In both misrepresentation and omission cases, a Rule 10b-5 claim requires a plaintiff to prove the materiality of misstated or omitted facts.⁸⁹ At first blush, the relation between investor sophistication and materiality should allow for no controversy, given the Supreme Court's classic definition of materiality in *TSC Industries v. Northway, Inc.*⁹⁰ The *Northway* standard for materiality requires

a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of *the reasonable shareholder*. Put another way, there must be a substantial

86. *Id.* at 94,338. One was a former United States Ambassador with substantial business experience and degrees from Harvard and Yale; the other, a self-employed business consultant and former government official. Both subscribed to the *Washington Post* and *Barron's* and met regularly with an account executive to discuss their financial planning. As the court found, they understood the securities markets generally and the specific principle that risk and return go together. *Id.* at 94,361-62.

87. *Id.* at 94,365.

88. That courts will characterize brokers' performance claims as "puffing," however, remains only probable. See, e.g., *Lukovich v. E.F. Hutton & Co.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,701, at 93,413-14 (D. Or. Apr. 21, 1986) (broker's assurances not "mere puffery" in light of investor's interest).

89. See 17 C.F.R. § 240.10b-5(b) (1988).

90. 426 U.S. 438 (1976).

likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.⁹¹

This language seems to envision an objective standard, and some courts agree.⁹² Indeed, at least one court has held investor sophistication irrelevant precisely because of the inquiry's objectivity.⁹³ Nonetheless, other courts have suggested that sophistication may have some bearing on the issue of materiality. In *SEC v. Shapiro*,⁹⁴ the defendants, accused of illegal insider trading under Rule 10b-5, claimed in defense that they were trading on immaterial information. The court, however, suggested that the proof was in the pudding: the fact that the financially sophisticated defendants invested soon after receiving the information showed its materiality.⁹⁵

In addition, recent cases decided under the antifraud provisions of the Commodities Exchange Act⁹⁶—a statute whose antifraud provisions are analogous to Rule 10b-5⁹⁷—suggest the importance of investor sophistication in materiality analysis. In *Herman v. T & S Commodities, Inc.*, a commodities fraud action, the court considered a commodities investor's sophistication in deciding the materiality issue.⁹⁸ The court characterized the materiality test as "partly subjective," but apparently confused materiality with causation, since it asked whether the plaintiff would have acted any differently had the defendant not acted wrongfully.⁹⁹ Although it remains unclear how this confusion colored the court's interpretation of the materiality requirement, the court did also note that the plaintiff's sophistication made him a difficult mark for an unscrupulous broker.¹⁰⁰

Although *Herman* raises more questions than it answers, it provides support for a subjective interpretation of the materiality requirement, which would open the door to considerations of investor sophistication.

91. *Id.* at 449 (emphasis added).

92. *See, e.g.,* McLean v. Alexander, 420 F. Supp. 1057, 1078 (D. Del. 1976).

93. *See* Wheat v. Hall, 535 F.2d 874, 876 (5th Cir. 1976) ("Under Rule 10b-5, the test of materiality is 'whether a reasonable man would attach importance to the fact misrepresented' Even sophisticated investors are entitled to the protections of this rule." (quoting John R. Lewis, Inc. v. Newman, 446 F.2d 800, 804 (5th Cir. 1971) (citations omitted))).

94. 494 F.2d 1301 (2d Cir. 1974).

95. *Id.* at 1307.

96. 7 U.S.C. §§ 1-26 (1982).

97. Section 4b of the Commodities Exchange Act (CEA), 7 U.S.C. § 6b (1982), proscribes fraud and imposes liability for misleading statements and omissions by commodities market makers. A private right of action for these violations exists. *Id.* § 25; *see also* Merrill Lynch v. Curran, 456 U.S. 353, 381-82 (1982) (recognizing implied private right of action under CEA).

98. 592 F. Supp. 1406, 1416 (S.D.N.Y. 1984).

99. *Id.*

100. *Id.* at 1410-11.

In addition, the *Northway* definition of materiality does not preclude a subjective test in Rule 10b-5 cases. *Northway* defined materiality as an objective inquiry in the context of the *proxy fraud rules*, not Rule 10b-5.¹⁰¹ Even in the context of the proxy fraud rules, the *Northway* standard is not necessarily a purely objective one. In speaking of the “responsible shareholder,” the Court left open the possibility that the reasonable investor should have the *plaintiff's* characteristics. Although this definition ordinarily applies in Rule 10b-5 cases as well,¹⁰² proxy fraud cases present a stronger justification for an objective standard than do Rule 10b-5 cases. In proxy fraud cases, a plaintiff need not prove that the fraudulent statement or omission was actually significant to her, but only that the voters *as a whole* would have found the statement or omission significant.¹⁰³ A 10b-5 plaintiff, however, must show that the statement or omission misled *him personally*.¹⁰⁴ Thus, even if proxy fraud cases require a purely objective inquiry,¹⁰⁵ Rule 10b-5 cases do not.

In short, the relevance of investor sophistication to materiality remains unclear, and this area of Rule 10b-5 jurisprudence, like the others, cries out for clarifying principles.

3. *Deceptiveness and the Sophisticated Investor.* Except in cases of manipulation, each of Rule 10b-5's three subsections requires some sort of deception.¹⁰⁶ Whatever the requirement, deception cannot occur in a void; it presupposes an object of deception, an investor who is misled. Because the nature of that object changes from case to case (some investors are less gullible than others), we should not be surprised to find that courts construe the requirement differently depending on the sophistication of the investor—or, if you will, the object—involved. Thus, in *Pierre J. LeLandais & Co. v. MDS-Atron, Inc.*, a case arising under Rule 10b-5 and the proxy rules, the court held that the plaintiffs' sophistication made it impossible to characterize a proxy statement as deceptive.¹⁰⁷ The *LeLandais* court did not, however, address the sophistication of other investors who received the proxy materials. If these investors were not sophisticated, the court could have characterized the materials as

101. See *Northway*, 426 U.S. at 449.

102. See, e.g., *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1976).

103. See, e.g., *Clayton v. Skelly Oil Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,269 (S.D.N.Y. Dec. 30, 1977).

104. On the requirement of actual reliance, see *supra* notes 21-47 and accompanying text. A fraud on the market theory eliminates this requirement, however. See *supra* note 24 and accompanying text; *infra* notes 205-10 and accompanying text.

105. See *supra* note 101 and accompanying text.

106. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-74 (1977).

107. 387 F. Supp. 1310, 1319 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 543 F.2d 421 (2d Cir. 1976), *cert. denied*, 429 U.S. 1062 (1977).

"deceptive" with respect to them. Or, perhaps the court meant to require that the plaintiffs prove their own subjective deception, which begins to sound like the subjective reliance test discussed above.¹⁰⁸ In summary, the *LeLandais* court expressly considered investor sophistication but failed to elaborate a theory that would explain the relevance of investor sophistication to the deceptiveness requirement. The case's treatment of the sophisticated investor issue is, unfortunately, typical.

4. *Adequacy of Disclosure and the Sophisticated Investor.* In securities transactions, Rule 10b-5 prohibits omission of material facts necessary to make a statement not misleading.¹⁰⁹ Less than total disclosure can still be adequate, though, as long as complete disclosure would not have altered the plaintiff's conduct.¹¹⁰ In many cases, adequacy of disclosure may turn on the sophistication of the party to whom disclosure is made; as the Eighth Circuit has stated, "there is no duty to disclose information to one who reasonably should already be aware of it."¹¹¹ Thus, the purpose of the disclosure requirement defines the contours of the requirement: Rule 10b-5 requires "nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions."¹¹²

Reasoning that sophisticated investors can draw upon "their own evaluative expertise" more easily than can others, many courts consider investor sophistication in determining a disclosure's adequacy.¹¹³ For example, in *Quintel Corp. v. Citibank, N.A.*, the court stated: "Sophisticated investors are entitled to the protection of section 10(b) of the Securities Exchange Act of 1934 . . . and Rule 10b-5. However, the

108. See *supra* notes 35-47 and accompanying text.

109. 17 C.F.R. § 240.10b-5(b); see *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Little v. First Cal. Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,745, at 96,466 (D. Ariz. July 11, 1974).

110. See, e.g., *duPont v. Brady*, 828 F.2d 75, 78 (2d Cir. 1987) (no 10b-5 liability if defendant proves "by a preponderance of the evidence that disclosure of [the material information at issue] would not have altered the plaintiff's investment decision").

111. *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), *quoted with approval in* *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978).

112. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); see also *Shappirio v. Goldberg*, 192 U.S. 232, 241-42 (1904) (stating, in land fraud case, that "[w]hen the means of knowledge are open and at hand or furnished to the purchaser or his agent . . . he will not be heard to say that he has been deceived to his injury by the misrepresentations of the vendor").

113. See, e.g., *Pittsburgh Coke & Chemical Co. v. Bollo*, 560 F.2d 1089, 1091-92 (2d Cir. 1977); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 891 (S.D.N.Y. 1986); *Quintel Corp. v. Citibank, N.A.*, 596 F. Supp. 797, 801-02 (S.D.N.Y. 1984); *Caan v. Kane-Miller Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,446, at 99,242 (S.D.N.Y. Feb. 5, 1976). *But see* *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973) (dictum) (sophistication irrelevant to question of adequacy of disclosure).

sophistication of [the plaintiff] is relevant to the adequacy of disclosure, and the extent of the reliance of [the plaintiff] on any alleged misrepresentation”¹¹⁴ Other courts have held disclosure to sophisticated investors adequate as a matter of law. In *Pittsburgh Coke & Chemical Co. v. Bollo*, the court rejected the plaintiff’s complaint that the defendant failed to alert him to certain provisions in the corporation’s supply contracts, reasoning that the plaintiff was a sophisticated investor and had full access to all of the corporation’s relevant books and records.¹¹⁵

Another case, *Martin v. Steubner*, typifies a slightly different, but consistent, line of cases. In *Martin*, the plaintiff had represented himself as sophisticated when signing a subscription agreement;¹¹⁶ as a result, the court held that the defendant lacked scienter because he had assumed the plaintiff was sophisticated.¹¹⁷ That holding necessarily implies that the disclosure would have been adequate if the plaintiff had actually been sophisticated.

Not all courts, however, find investor sophistication relevant to the adequacy issue. In the oft-cited case *Stier v. Smith*, the plaintiff had purchased \$50,000 worth of stock as part of an initial offering in Mickey Mantle’s Country Cookin’, Inc., which became worthless not long after the purchase.¹¹⁸ The plaintiff sued the corporation’s founder under Rule 10b-5, alleging numerous omissions of material fact. The trial court found fourteen undisclosed facts, but held the disclosure adequate for four reasons: the plaintiff was financially sophisticated; he knew that the corporation had filed a registration statement; a prospectus was available upon request; and he had failed to conduct any investigation.¹¹⁹ The Fifth Circuit reversed, however, issuing the much-repeated epigram that “sophisticated investors, like all others, are entitled to the truth.”¹²⁰ The court decided, without performing any meaningful analysis, that the defendant had a duty to disclose the omitted facts and that the plaintiff’s sophistication like the plaintiff’s failure to ask for any information or

114. 596 F. Supp. at 797, 801-02 (citations omitted).

115. 560 F.2d at 1091-92. This is not to say, of course, that a seller discharges a disclosure obligation merely by making all records, no matter how voluminous, available without any assistance. See *Caan*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,242 (obligations imposed by Rule 10b-5 not discharged by simply making company records available and requiring other party to sift out material facts).

116. 485 F. Supp. 88, 92-93 (S.D. Ohio 1979), *aff’d*, 652 F.2d 652 (6th Cir. 1981), *cert. denied*, 454 U.S. 1148 (1982). The plaintiff flew in unannounced, wore a conservative gray suit, said that he was in the oil business, knowledgeably discussed partnerships and tax shelters, and indicated that his income was three times his investment. *Id.* at 91-92, 97.

117. *Id.* at 97.

118. 473 F.2d 1205, 1207 (5th Cir. 1973). As baseball fans will be pleased to learn, Mickey Mantle merely lent his name to the enterprise; he was not named as a defendant.

119. See *id.*

120. *Id.*

examine the available prospectus, was irrelevant to that duty.¹²¹ Interestingly, although the court claimed to agree with the trial court's factual finding that the plaintiff was sophisticated, it did recite the weak evidence of sophistication that appeared in the record; the weakness of this evidence may well have influenced the court's decision.¹²² Thus, its pronouncement aside, the Fifth Circuit may implicitly recognize the relevance of investor sophistication to the issue of adequate disclosure.

The caselaw in this area illustrates the courts' inconsistent approaches in dealing with sophisticated investors. Without guiding principles, courts are simply unable to determine the relevance of investor sophistication in Rule 10b-5 actions.

C. *Churning and the Sophisticated Investor.*

Churning involves brokers' excessive trading in customers' accounts for the purpose of generating brokerage commissions.¹²³ As the Fourth Circuit describes: "Churning occurs when a broker, exercising control over the volume and frequency of trading, abuses his customer's confidence for personal gain by initiating transactions that are excessive in view of the character of the account. Its hallmarks are disproportionate turnover, frequent in and out trading, and large brokerage commissions."¹²⁴ The caselaw holds that churning violates Rule 10b-5.¹²⁵ To raise a churning claim under the Rule, a plaintiff must prove that a broker: (1) traded excessively in light of the plaintiff's investment objectives; (2) had control over that trading; and (3) had scienter, defined as either an intent to defraud or willful and reckless disregard of the plaintiff's investment interests.¹²⁶

121. *Id.* at 1208-09.

122. *See id.* at 1207 & n.2.

123. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 705 (2d ed. 1988); Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 869 (1967).

124. *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975).

125. *See, e.g., Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 (7th Cir. 1983); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1416 n.3 (11th Cir. 1983); *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676 (9th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 n.4 (5th Cir. Unit A 1981).

126. *See, e.g., Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1501 (11th Cir. 1985); *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 2 (1st Cir. 1983); *Follansbee*, 681 F.2d at 676; *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1392 (D. Md. 1986); *Smith v. Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,846, at 94,363 (D.D.C. Oct. 27, 1982). Some courts, however, have formulated the elements of churning slightly differently. In *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377 (N.D. Okla. 1975), for example, the court listed three general ideas relevant to an evaluation of a churning claim: (1) whether excessive trading had occurred in the account at issue; (2) whether the defendant intended to advance his own interests by generating commissions; and (3) whether the plaintiff was relatively uninformed and therefore relied on the broker's competence. *Id.* at 379; *see also Costello*, 711 F.2d at 1368 n.8 (courts have suggested that customer must also be unsophisticated). For an extensive

It has been said that churning is an evil that only a sophisticated investor would recognize;¹²⁷ not surprisingly, investor sophistication is a recurring theme in churning cases. Sophisticated investors' churning claims almost always fail.¹²⁸

Courts have found investor sophistication relevant to the second element of a churning claim, broker control. If a broker has actual discretion to trade in an account, that clearly satisfies the control element.¹²⁹ But a broker's de facto control also suffices: if the investor relies on the broker in making trading decisions, that reliance will establish control.¹³⁰

As the court in *Lieb v. Merrill Lynch, Pierce, Fenner & Smith*¹³¹ discussed, a number of factors—including investor sophistication—indicate de facto control:

In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly young, old, or naive with regard to financial matters, the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction,

introduction to the law of churning and the role that plaintiffs' sophistication plays in it, see Note, *Customer Sophistication and a Plaintiff's Duty of Due Diligence: A Proposed Framework for Churning Actions in Nondiscretionary Accounts Under SEC Rule 10b-5*, 54 FORDHAM L. REV. 1101 (1986).

127. *Roberts v. Magnetic Metals Co.*, 463 F. Supp. 934, 947 (D.N.J.), *rev'd*, 611 F.2d 450 (3d Cir. 1979).

128. See, e.g., *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373 n.10 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973); see also Note, *Due Diligence Requirement*, *supra* note 53, at 768 (sophisticated investors are often charged with knowledge of information; in case of churning, monthly statements should put even minimally sophisticated plaintiffs on notice of fraud). Courts may also deny recovery when a plaintiff's agent or advisor is sophisticated, even if the plaintiff is not. See, e.g., *Ocrant v. Dean Witter & Co.*, 502 F.2d 854, 858 (10th Cir. 1974) (churning claim where plaintiff's agent (and husband) was active trader and licensed broker); *Marshak*, 413 F. Supp. at 381 (sophistication of plaintiff's agent bars churning claim). Sophistication does not, however, always disable an investor from recovering. See *infra* note 133 and accompanying text.

129. See, e.g., *Tiernan*, 719 F.2d at 4 n.2 ("Indeed, even a sophisticated investor who blindly relinquishes all decisions to a broker may not be in control of his account."); *Follansbee*, 681 F.2d at 676 ("If a broker is formally given discretionary authority to buy and sell for the account of his customer, he clearly controls it.")

130. See, e.g., *Tiernan*, 719 F.2d at 3; *Follansbee*, 681 F.2d at 676-77.

131. 461 F. Supp. 951 (E.D. Mich. 1978).

the courts will usually find that the customer, by maintaining such an active interest in the account, thereby maintained control over it.¹³²

Since even a sophisticated investor can allow a broker to make all the decisions in an account, sophistication alone does not preclude a finding of actual broker control.¹³³ Except in exceptional circumstances, however, an investor's sophistication generally prevents a finding that a broker had de facto control of an account.

As the Ninth Circuit stated in *Follansbee v. Davis, Skaggs & Co.*, "[t]he touchstone [of de facto control] is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable."¹³⁴ The court thus examined the indicia of the plaintiff's sophistication: he had a college degree in economics and had taken an accounting course; he regularly read and understood financial reports and investment newsletters; he participated actively in investment seminars and kept meticulous records of his trades. These characteristics distinguished the *Follansbee* plaintiff from the stereotypical churning victim, such as a widow with no business experience or financial acumen.¹³⁵ In the court's assessment, the plaintiff's background marked him as "a person in complete control of his account."¹³⁶

The *Follansbee* opinion also limited an earlier Ninth Circuit case to its facts. In *Mihara v. Dean Witter & Co.*, the court had written that "the requisite degree of control is met when the client routinely follows

132. *Id.* at 954-55 (citations omitted); see *Costello*, 711 F.2d at 1368 n.8; S. JAFFE, *BROKER-DEALERS AND SECURITIES MARKETS* 308 (1977); see also *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1394 (D. Md. 1986) (quoting *Lieb*).

133. See, e.g., *Tiernan*, 719 F.2d at 3; *Costello*, 711 F.2d at 1368 n.8.

134. 681 F.2d at 677; see also Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3, 25 (1980) (gist of inquiry into customer sophistication in churning cases is whether customer understood what broker was doing); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975) ("[T]he Court must determine whether the investor is so informed that the stock broker is in a position to manipulate the account and perpetrate fraud on the unwary investor or whether, on the other hand, the investor is knowledgeable enough to warrant holding him responsible for the maintenance of his own affairs.").

135. *Follansbee*, 681 F.2d at 677.

136. *Id.* at 678. In *Marshak*, 413 F. Supp. at 381, the court found the following indicia of sophistication and concluded that the customer in that case retained control over his account:

- (1) he began trading in 1958, thirteen years prior to the conduct complained of;
- (2) he had maintained several brokerage accounts over the years;
- (3) he was a member of a stock investor's club;
- (4) he subscribed to the *Wall Street Journal*;
- (5) he kept track of his investments with his broker almost daily by phone and went to the broker's office three to five times per month; and
- (6) he received confirmation slips and monthly statements.

the recommendations of the broker."¹³⁷ Such a test would allow many more sophisticated investors to recover on churning claims, since even many sophisticated investors in full control of their financial affairs follow their brokers' advice. In response, *Follansbee* cautioned against construing *Mihara* to mean "that the most sophisticated investor is not in control of his account simply because he usually follows the recommendations of his broker."¹³⁸

In other cases involving the issue of broker's control, courts have held that sophisticated investors who have received confirmation slips from their brokers are estopped to complain about activity in their accounts. In *Landry v. Hemphill, Noyes & Co.*,¹³⁹ for example, the court barred a churning claim in the following terms:

Given plaintiff's obvious experience in the stock market, we hold as a matter of law that he must have realized the inconsistency between his alleged investment intent and what was actually occurring in his account; he is therefore estopped from arguing, for purposes of his churning claim, that he was an investor rather than a trader.¹⁴⁰

In considering the control element of churning claims, then, courts have found investor sophistication relevant. Like the cases in other contexts, however, the churning cases lack a cogent explanation of the criteria that should guide the analysis of control questions. Many courts seem to compensate for the absence of such an explanation by developing long lists of attributes of sophistication, but these courts have failed to explain convincingly or comprehensively the legal principles that make the listed attributes relevant.¹⁴¹ This lack of a firm theoretical basis for what seem like reasonable rules of law compromises the legitimacy of those rules.

137. 619 F.2d 814, 821 (9th Cir. 1980) (considering whether evidence would support jury finding of control).

138. *Follansbee*, 681 F.2d at 677; see also *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 n.2 (1st Cir. 1983) (limiting *Mihara* to its facts).

139. 473 F.2d 365 (1st Cir.), cert. denied, 414 U.S. 1002 (1973).

140. *Id.* at 373-74; see also *Ocrant v. Dean Witter & Co.*, 502 F.2d 854, 858-59 (10th Cir. 1974) (holding that action by sophisticated investor who regularly receives information about account and fails to object seasonably may be barred under doctrines of waiver, estoppel, laches, or ratification); cf. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F. Supp. 373, 376-77 (S.D. Tex. 1965) (investor who received confirmations of trades and did not object for 11 months barred from asserting fraud and negligence claims); *Ellwood v. Mid States Commodities, Inc.*, 404 N.W.2d 174, 182 (Iowa 1987) (holding that knowledgeable investor ratified unauthorized commodities trades by failing to object to confirmation slips).

141. See, e.g., *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373-74 & n.10 (1st Cir. 1973) (accepting, without explanation, trial court's finding of control, but providing long explanation why account not overtraded); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 956 (E.D. Mich. 1978) (listing plaintiff's personal characteristics that supported finding of no usurpation of control); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975) (denying churning claim because of plaintiff's background and control of account).

D. *Sophisticated Investors and Non-Rule 10b-5 Suits Against Broker-Dealers.*

Claims by disappointed and allegedly defrauded customers account for a sizable percentage of lawsuits filed against brokerage firms.¹⁴² We have already seen some of these, such as Rule 10b-5 actions for misrepresentations¹⁴³ and for churning,¹⁴⁴ but there are others, and investor sophistication affects the outcomes in many of them as well. Specifically, courts find sophistication relevant in actions alleging violations of margin rules and so-called "suitability" rules.

1. *Margin Rules Violations and the Sophisticated Investor.* Section 7 of the 1934 Act creates a complex system for regulating extensions of credit, or margin use, in securities transactions.¹⁴⁵ Most importantly, section 7(a) delegates to the Federal Reserve Board the authority to regulate "the amount of credit that may be initially extended and subsequently maintained on any security."¹⁴⁶ For brokers and their customers, the most important of these regulations is Regulation T, which prohibits the extension of credit on marginable securities beyond a certain percentage of those securities' value.¹⁴⁷ Violations of these limits often return to haunt a broker in the course of litigation. Customers may point to margin violations offensively, after losing a large sum of money on a highly leveraged position created on borrowed money,¹⁴⁸ or defensively, against a collection action by a broker whom a customer has failed to pay following such a loss.¹⁴⁹

In analyzing a margin violation claim, courts often examine a customer's sophistication. In fact, in *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Fourth Circuit held that a sophisticated investor had no private right of action for Regulation T violations.¹⁵⁰ Although the court rejected a private right of action for *any* plaintiff, it also stated that the plaintiff at bar, who was neither "small" nor "inexperienced,"¹⁵⁰

142. See *supra* notes 12-122 and accompanying text.

143. See *supra* notes 123-41 and accompanying text.

144. 15 U.S.C. § 78g(a) (1982).

145. *Id.*

146. 12 C.F.R. §§ 220.1-220.130 (1988). For a concise description of the Board's entire regulatory scheme, see T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 10.11, at 287-89 (1985).

147. See, e.g., *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073 (4th Cir. 1979); *Pearlstein v. Scudder & German*, 527 F.2d 1141 (2d Cir. 1975); *McCormick v. Esposito*, 500 F.2d 620, 621-22 (5th Cir. 1974), *cert. denied*, 420 U.S. 912 (1975).

148. See, e.g., *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,498 (S.D. Cal. June 13, 1974) (simultaneous actions by brokerage firm for deficiency and by customer for losses).

149. 603 F.2d at 1088-93.

150. *Id.* at 1093. The court noted the following indicia of the plaintiff's sophistication: he was a doctor with a very large practice of his own; his wife had a Ph.D.; he also owned a family corpora-

could not have recovered even if a private right of action *did* exist.¹⁵¹ The court derived this conclusion from the same reasoning that other courts had used to permit private rights of action in prior cases. This rationale focused on a tort doctrine that allows recovery for violations of a statutory duty if and only if the plaintiff falls within the class whose interests the relevant statute seeks to protect.¹⁵² The *Stern* court assumed, without support, that the margin requirements exist solely to protect unsophisticated investors from becoming overextended.¹⁵³ In fact, Congress also originally authorized such requirements to protect securities markets from the instability of highly leveraged positions and the economy from too great a diversion of its credit resources.¹⁵⁴ Although the court deserves commendation for its effort to justify a distinction between sophisticated and unsophisticated investors, its rationale rests on a faulty premise.¹⁵⁵

Margin violation claims by sophisticated plaintiffs have failed in most other cases as well.¹⁵⁶ Indeed, one commentator has even recommended that margin rules should not apply to sophisticated investors, presumably because such investors can protect themselves against the risks of excess leverage.¹⁵⁷ Margin violation cases, however, consistently

tion with extensive real estate holdings; his salary was very high; and he had been a stock and options trader for nearly 20 years, had traded hundreds of thousands of dollars worth of options, and had made all his own investment decisions. *Id.* at 1093-97.

151. *Id.* at 1097.

152. *Id.* at 1075-76 (discussing *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014 (D. Mass. 1949), a case that ultimately allowed recovery for a plaintiff outside the class that Congress intended that margin requirements protect); see also RESTATEMENT (SECOND) OF TORTS § 286 (1965) (the tort doctrine at issue).

153. *Stern*, 603 F.2d at 1076.

154. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934), reprinted in 1 SECURITIES LAW COMM., FED. BAR ASS'N, FEDERAL SECURITIES LAW: LEGISLATIVE HISTORY, 1933-1982, at 794, 801 (1983); S. REP. NO. 792, 73d Cong., 2d Sess. 3 (1934), reprinted in, 1 SECURITIES LAW COMM., FED. BAR ASS'N, *supra*, at 708-10.

155. For more defensible justifications, see *infra* notes 315-84 and accompanying text.

156. See, e.g., *McCormick v. Esposito*, 500 F.2d 620, 628 (5th Cir. 1974) (recovery for margin violations denied where plaintiff, a lawyer and long-time investor, knew or should have known of violations), *cert. denied*, 420 U.S. 912 (1975); *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,500-01 (S.D. Cal. June 13, 1974) (plaintiff denied recovery on margin violation claim where husband/agent was Harvard Business School graduate and professional speculator); see also *Pearlstein v. Scudder & German*, 527 F.2d 1141, 1147 (2d Cir. 1975) (reversing award of prejudgment interest against broker who had violated Regulation T; violation not in nature of fraud, given that plaintiff was experienced and sophisticated investor and was not inveigled into purchase or retention of his securities); Comment, *SEC Rule 10b-16: Should the Federal Courts Allow Sophisticated Investors to Recover?*, 18 PAC. L.J. 171 (1986) (analyzing split among courts over whether there exists a private right of action for violations of Rule 10b-16, which requires securities dealers to disclose credit terms in margin agreements; arguing that such a right of action should exist, except in favor of sophisticated investors).

157. Dennis, *Risk Arbitrageurs and the Market for Corporate Control* (Book Review), 37 HASTINGS L.J. 409, 423-24 (1985) (reviewing I. BOESKY, *MERGER MANIA—ARBITRAGE: WALL*

lack a justification for treating sophisticated and unsophisticated investors differently.

2. *Suitability Actions and the Sophisticated Investor.* Courts have said that investment brokers are fiduciaries of their customers.¹⁵⁸ As Justice Frankfurter has pointed out, however, such a statement only begins the inquiry: the real question concerns the nature of that fiduciary relationship.¹⁵⁹ In cases involving sophisticated customers, courts are more likely to hold that no fiduciary relationship exists at all¹⁶⁰ or that a broker's fiduciary duty is easily met.¹⁶¹

Under the so-called "suitability" rules of various securities exchanges, a broker has a duty to ensure a transaction's suitability for a customer in view of that customer's risk-bearing ability and investment objectives.¹⁶² When an investment goes awry, a customer may seek to recover his losses from his broker by asserting that he breached his fiduciary duty by recommending and executing an "unsuitable" investment.¹⁶³ A sophisticated customer, however, will likely lose such a suitability action. In *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith*,

STREET'S BEST KEPT MONEY MAKING SECRET (1985)). This view ignores the primary reason for margin requirements: the systemic danger and volatility of highly leveraged markets. See *supra* note 154 and accompanying text. The commentator mistakenly assumes that margin requirements exist solely to protect investors.

158. See, e.g., *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir. 1987), *cert. denied*, 108 S. Ct. 2846 (1988); *Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 920 (11th Cir. 1987).

159. *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943).

160. See, e.g., *Platts v. E.F. Hutton & Co.*, 642 F. Supp. 1277, 1308 (W.D. Mich. 1986) ("Upon the evidence presented, I have serious doubt that a fiduciary duty was owed by Hutton to plaintiff. Plaintiff was . . . an intelligent, inquisitive, and self-reliant man, inherently disinclined to relinquish his trust to anyone."), *aff'd*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 108 S. Ct. 1227 (1988).

161. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978) (if customer comprehends nature of market or personally knows about a security, broker's explanation of risks involved in transaction "may be merely perfunctory"); see also *Platts*, 642 F. Supp. at 1308:

The manner in which the broker is to perform these duties will depend to some degree upon the intelligence and personality of his customer. If the customer is uneducated or generally unsophisticated with regard to financial matters or incapable of understanding the transaction, the broker must define the particulars of the transaction more carefully and cautiously. However, if the customer fully understands the dynamics of the market or is personally familiar with the security or insists on making his own decisions . . . the broker's explanation of the risks may be merely perfunctory.

162. See, e.g., New York Stock Exchange Rule 405, 2 NYSE Guide (CCH) ¶ 2405, at 3697, 3701 (1984); NASD Rules of Fair Practice art. III, § 2, NASD Manual (CCH) ¶ 2152, at 2051 (1988). See generally Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445 (discussing suitability rules generally).

163. The customer might sue under a private right of action for violation of the suitability rule itself, although most courts do not recognize such a private right of action. See, e.g., *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1419 (11th Cir. 1983); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679-81 (9th Cir. 1980).

for example, the court held that a broker cannot be held liable to a highly sophisticated plaintiff for making an unsuitable investment.¹⁶⁴ Nor could a plaintiff recover for a broker's alleged failure to disclose risks when the plaintiff had signed a margin agreement that itself provided full disclosure.¹⁶⁵

Although the cases suggest that brokers will generally win suitability actions brought by sophisticated customers,¹⁶⁶ courts in suitability cases apparently see no relationship between these cases and other types of cases involving sophisticated investors, despite the common characteristics of the plaintiffs involved. Nor do these suitability cases articulate any coherent theory to justify such different treatment of sophisticated and unsophisticated customers.

E. *Enforcement of Arbitration and Forum Selection Clauses Against Sophisticated Investors.*

The enforcement of arbitration clauses in securities transactions has repeatedly attracted the Supreme Court's attention.¹⁶⁷ The Court's interest traces back to 1953, when it held in *Wilko v. Swan* that a customer's agreement to arbitrate claims under section 12(2) of the 1933 Act was unenforceable under section 14 of the same act.¹⁶⁸ Then, in a 1974 case, *Scherk v. Alberto-Culver Co.*, the Court decided that the so-called "*Wilko* doctrine" did not apply to arbitration agreements in international disputes under section 10(b) of the 1934 Act.¹⁶⁹ Eleven years later, in *Dean Witter Reynolds Inc. v. Byrd*, the Court rejected a rule that allowed litigation of clearly arbitrable claims in federal court if such claims were factually intertwined with claims subject to the *Wilko* doctrine.¹⁷⁰ Two years ago, in *Shearson/American Express, Inc. v. McMahon*,¹⁷¹ the Court limited the *Wilko* doctrine still further by holding that *Wilko* does not

164. 632 F. Supp. 471, 481-83 (D. Me. 1986). The court noted numerous indicia of the plaintiff's sophistication, but did not meaningfully discuss the relevance of these data to the case.

165. *Id.* at 482.

166. See cases cited *supra* notes 158-65.

167. See, e.g., Fletcher, *Learning to Live With the Federal Arbitration Act—Securities Litigation in a Post-McMahon World*, 37 EMORY L.J. 99 (1988) [hereinafter *Federal Arbitration Act*]; Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 72 MINN. L. REV. 393, 404-20 (1987) [hereinafter *Privatizing Disputes*]; Malcolm & Segall, *The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?*, 50 ALB. L. REV. 725 (1986); Note, *The Arbitrability of Claims Under the Federal Securities Laws*, 12 J. CORP. L. 535 (1987); Note, *Shearson/American Express, Inc. v. McMahon: What's Left for the Courts in Securities Litigation?*, 62 TULANE L. REV. 284 (1987); Note, *The Arbitrability of Federal Securities Claims: Wilko's Swan Song*, 42 U. MIAMI L. REV. 203 (1987).

168. 346 U.S. 427, 438 (1953).

169. 417 U.S. 506, 517 (1974).

170. 470 U.S. 213, 220-21 (1985).

171. 107 S. Ct. 2332 (1987).

apply to agreements to arbitrate claims under the 1934 Act¹⁷² or the Racketeering Influenced and Corrupt Organizations Act.¹⁷³ This Term the Court will decide whether to overrule *Wilko*.¹⁷⁴

Wilko, *Scherk*, *Byrd*, and *McMahon* have, however, left undecided the question of immediate importance here: should the *Wilko* doctrine apply to sophisticated investors' agreements to arbitrate?¹⁷⁵ Some courts say "no," thus adopting a sophisticated-investor exception to the doctrine¹⁷⁶—a position that the weight of scholarly commentary favors.¹⁷⁷ Other courts seem sympathetic to such an exception but have not explicitly adopted it,¹⁷⁸ and a large number of courts have referred to the exception in holding sophisticated investors to forum selection agreements.¹⁷⁹ Other courts, however, have explicitly rejected the idea of

172. *Id.* at 2337-41.

173. *Id.* at 2345-46. These three cases—*Scherk*, *Byrd*, and *McMahon*—have thus gradually eroded the *Wilko* doctrine and given effect to the mandate of the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1982), that arbitration agreements can be enforced. See *Federal Arbitration Act*, *supra* note 167; *Privatizing Disputes*, *supra* note 167, at 404-20.

174. See *Rodriguez de Quijas v. Shearson/Lehman Bros.*, 845 F.2d 1296 (5th Cir.), *cert. granted*, 109 S. Ct. 389 (1988) (No. 88-385).

175. The Court in *Scherk* mentioned but did not reach the issue, since it decided the case on other grounds. See *Scherk*, 417 U.S. at 512 n.6. Justice Douglas's dissent argued for rejection of the sophisticated investor exception to the *Wilko* doctrine. See *id.* at 526 (Douglas, J., dissenting).

176. See, e.g., *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 634 n.4 (5th Cir. 1977) (refusing to apply *Wilko* doctrine to sophisticated businessmen); *Alco Standard Corp. v. Benalal*, 345 F. Supp. 14, 24 (E.D. Pa. 1972) (suggesting sophisticated investor exception to *Wilko* doctrine); *GCA Corp. v. Coler*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,339, at 91,815 (S.D.N.Y. Jan. 13, 1972) (same); see also Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 295 (1984) ("Courts generally will not apply the *Wilko* restraint, however, when it is clear that the parties are knowledgeable persons—for example, a sophisticated investor and a broker-dealer—and that the arbitration agreement was the result of an arm's length transaction."); Peloso, *Agreements to Arbitrate*, 13 REV. SEC. REG. 943, 946-47 (1980) (same).

177. See, e.g., 2 FEDERAL SEC. CODE § 1725(b)(3)(C) (1980) (recommending rule that would codify *Wilko* doctrine but provide for exception in cases involving sophisticated investors); *Privatizing Disputes*, *supra* note 167, at 427-31.

178. See, e.g., *Goldberg v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 650 F. Supp. 222, 226 (N.D. Ga. 1986) (holding that, pursuant to their agreement, exchange members must arbitrate not only disputes arising out of professional activities but all others as well, since exchange members are "sophisticated investors, not inexperienced investors"); *McMahon v. Shearson/American Express, Inc.*, 618 F. Supp. 384, 386 (S.D.N.Y. 1985) ("Arbitration clauses are routinely upheld by the courts, and, given plaintiffs' sizeable investment, there is nothing to indicate that they were without bargaining power."), *aff'd in part and rev'd in part on other grounds*, 788 F.2d 94 (2d Cir. 1986), *rev'd*, 482 U.S. 220 (1987); *Mullis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 492 F. Supp. 1345, 1359 (D. Nev. 1980) (finding "patently frivolous" a claim by sophisticated investor that arbitration agreement procured by fraud); see also *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 835 (7th Cir. 1977) (applying *Wilko* doctrine because plaintiff was small individual investor, unlike the one in *Scherk*, and noting influence of plaintiff's sophistication in both *Wilko* and *Scherk*).

179. See, e.g., *Luce v. Edelstein*, 802 F.2d 49, 57 (2d Cir. 1986) ("Plaintiffs, sophisticated investors who warranted their familiarity with the agreement, have failed to offer any reason for us not to enforce the forum-selection clause in this case."); *Friedman v. World Trans. Inc.*, 636 F. Supp. 685,

such an exception to the *Wilko* doctrine.¹⁸⁰

I have argued elsewhere in favor of this exception and have attempted to draw up guidelines for its practical application.¹⁸¹ The point here, in contrast, is that some courts have distinguished between sophisticated and unsophisticated investors in applying the *Wilko* doctrine, while others have explicitly avoided doing so. Yet again, a set of unifying principles would clarify the situation.

F. *Sophisticated Investors in Class Actions.*

Federal Rule of Civil Procedure 23(a) lists the prerequisites to class certification:

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.¹⁸²

Having a sophisticated investor as a class representative raises an issue under the Rule's third requirement, typicality. Courts have not agreed whether sophistication makes a representative more typical, less typical, or has no bearing on the question of typicality.

The typicality requirement protects a litigant class as a whole by ensuring that the class's representative is neither distracted by legal and factual issues not common to the class nor uniquely vulnerable to defenses that do not apply to other class members.¹⁸³ Class certification

690 (N.D. Ill. 1986) (rejecting argument by plaintiff, "plainly a wealthy and sophisticated investor," that forum selection clause resulted from overwhelming bargaining power); *Adelson v. World Trans. Inc.*, 631 F. Supp. 504, 507-08 (S.D. Fla. 1986) (rejecting sophisticated businessmen's argument that forum selection agreement not enforceable).

180. See, e.g., *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974). As the *Newman* court stated, "[t]he federal securities laws do not distinguish between sophisticated and unsophisticated investors, and the protection afforded by their antifraud and registration provisions are designed for all investors, whether sophisticated or unsophisticated." Both points, however, can be disputed. First, the securities laws do explicitly distinguish between sophisticated and unsophisticated investors under certain circumstances. See, e.g., 15 U.S.C. § 77d(6) (1982) (registration exemption only for those securities sold to accredited investors). Second, Congress designed the securities laws primarily to protect investors incapable of protecting themselves. See *Weissbuch*, 558 F.2d at 834 (securities acts passed to protect small investors); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 772 (S.D.N.Y. 1968) (primary purpose of securities laws is to protect those investors unable to protect themselves); Neville, *The Enforcement of Arbitration Clauses in Investor-Broker Agreements*, ARB. J., Mar. 1979, at 5, 9; see also *infra* notes 315-29 and accompanying text (discussing policies behind securities laws).

181. See *Privatizing Disputes*, *supra* note 167, at 427, 429-31.

182. FED. R. CIV. P. 23(a).

183. *Fisher v. Plessey Co.*, 103 F.R.D. 150, 159 (S.D.N.Y. 1984); *McNichols v. Loeb Rhoades & Co.*, 97 F.R.D. 331, 334-35 (N.D. Ill. 1982).

will not be refused merely because the proposed class representative stands in a different factual position from other segments of the class. For a class representative to fail the typicality test, the difference of position must significantly *jeopardize* the interests of the class as a whole.¹⁸⁴

Sophistication becomes an issue because of courts' approach to the typicality requirement, which focuses on the plaintiff and holds it "well-settled . . . that where the representative party is subject to unique defenses his claim is not typical of the class."¹⁸⁵ Under this approach, to negate typicality and prevent class certification, the defendant need only point out some defense that is "unique, arguable and likely to usurp a significant portion of the litigant's time and energy."¹⁸⁶ All questions of class certification involve trial courts' discretion, and appellate courts will not reverse such decisions on appeal unless these decisions reflect abuses of discretion.¹⁸⁷ Using this discretion, trial courts have reached wildly disparate results in the treatment of sophisticated investors.

Many courts refuse to permit sophisticated plaintiffs to represent a class because defendants can raise certain unique defenses against them.¹⁸⁸ The Fifth Circuit, for example, has repeatedly held that a representative's sophistication destroys typicality in a Rule 10b-5 class action because the representative has a weaker due diligence case than does the rest of the class.¹⁸⁹ Other courts reach the same result under the heading of justifiable reliance.¹⁹⁰ Thus, in *Model Associates v. United States Steel Corp.*,¹⁹¹ the court held that the plaintiff, a corporate in-and-out trader controlled by sophisticated individuals, could not represent a class. The

184. See, e.g., *Peil v. Speiser*, 97 F.R.D. 657, 659 (E.D. Pa. 1983).

185. *McNichols*, 97 F.R.D. at 334.

186. *Id.*

187. See, e.g., *Garonzik v. Shearson Hayden Stone, Inc.*, 574 F.2d 1220, 1221 (5th Cir. 1978) (trial court did not abuse discretion in denying class certification for lack of typicality where plaintiff was sophisticated investor), *cert. denied*, 439 U.S. 1072 (1979).

188. See, e.g., *Masri v. Wakefield*, 106 F.R.D. 322, 324-25 (D. Colo. 1984); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1, 7 (N.D. Ill. 1977).

189. See *Warren v. Reserve Fund, Inc.*, 728 F.2d 741, 747 (5th Cir. 1984); *Garonzik*, 574 F.2d at 1221. As one commentator has pointed out, the typicality problem results from the individualized due diligence standard generally applied in Rule 10b-5 cases. See Marcus, *supra* note 53, at 881. But see *Dekro v. Stern Bros. & Co.*, 540 F. Supp. 406, 416 (W.D. Mo. 1982) (since it is "abundantly clear" that due diligence requirement applies class-wide rather than on an individual basis, it is not necessary to evaluate each class member's individual mental state) (citing *In re Commonwealth Oil/Tesoro Petroleum Sec. Litig.*, 484 F. Supp. 253, 258 (W.D. Tex. 1979)).

190. See, e.g., *Zandman v. Joseph*, 102 F.R.D. 924, 931-32 (N.D. Ind. 1984); *Model Asocs. v. United States Steel Corp.*, 88 F.R.D. 338, 340-41 (S.D. Ohio 1980); see also *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 609 (E.D. Mich. 1985) (refusing to certify class on state fraud claims because "less sophisticated investors may be entitled to rely on statements that would not fool more sophisticated investors"); *Weintraub v. Texasgulf, Inc.*, 564 F. Supp. 1466, 1471 (S.D.N.Y. 1983) (sophisticated investor status may give rise to unique defenses).

191. 88 F.R.D. at 338.

court reasoned that such a sophisticated plaintiff was less likely to have relied on any alleged misrepresentations than were unsophisticated members of the class.¹⁹²

In contrast, some courts have concluded that investor sophistication does not affect typicality and is no bar to class representation.¹⁹³ Courts so conclude because they find that defendants cannot actually assert the defenses in question against the representative,¹⁹⁴ or because those defenses turn out not to be unique.¹⁹⁵

Still other courts acknowledge that sophisticated representatives may indeed face unique defenses, but find that such defenses do not obstruct the representation.¹⁹⁶ Thus, in *O'Connor & Associates v. Dean Witter Reynolds, Inc.*,¹⁹⁷ the defendants sought to prevent a plaintiff's appointment as class representative by claiming that his sophistication would raise a unique defense: as a sophisticated investor, the plaintiff should have known that increased volume indicated insider trading. The court rejected the argument, reasoning that even if the defense were valid, it was still unlikely to "become the focus of the litigation and . . .

192. *Id.* at 340-41; see also *Carr v. New York Stock Exch.*, 414 F. Supp. 1292, 1305 (N.D. Cal. 1976) (class action not a superior form of litigation where all class members are sophisticated investors who can bring individual claims).

193. See, e.g., *Darvin v. International Harvester Co.*, 610 F. Supp. 255, 258 n.6 (S.D.N.Y. 1985); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,931, at 94,549 (S.D.N.Y. Sept. 23, 1986) (sophistication does not "render these plaintiffs' claims atypical"); *Westlake v. Abrams*, 565 F. Supp. 1330, 1334 (N.D. Ga. 1983) ("furthermore, the plaintiff's general legal background enhances, rather than detracts, from his adequacy as a class representative in this complicated action"); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 149-50 (N.D. Tex. 1980) (would-be class representative not disqualified because of active stock trading); *Feder v. Harrington*, 52 F.R.D. 178, 183 (S.D.N.Y. 1970) (difference in class representative's degree of reliance and quantum of damages does not bar typicality).

194. See, e.g., *Westlake*, 565 F. Supp. at 1334 (rejecting defendants' suggestion that court examine representative's individual claims of reliance); *Wilson v. Great Am. Indus.*, 94 F.R.D. 570, 575-76 (N.D.N.Y. 1982) (after *Affiliated Ute*, plaintiffs in Rule 10b-5 omissions cases need not prove individual reliance; thus, no reliance defense assertable against sophisticated plaintiff); *Dekro v. Stern Bros. & Co.*, 540 F. Supp. 406, 416 (W.D. Mo. 1982) (since clear that due diligence applies class-wide, individual mental state of each class member is irrelevant).

195. See, e.g., *Grossman v. Waste Mgmt., Inc.* 100 F.R.D. 781, 789 (N.D. Ill. 1984) (no unique defense against sophisticated investor, because any misrepresentations or omissions would have been made to or withheld from both sophisticated and unsophisticated members of class). See generally Note, *Class Actions, Typicality, and Rule 10b-5: Will the Typical Representative Please Stand Up?*, 36 EMORY L.J. 649, 676-83 (1987) (discussing typicality requirement and recommending that sophistication not count against adequacy as class representative).

196. See, e.g., *A & J Deutscher Family Fund v. Bullard*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,938, at 94,584 (C.D. Cal. Sept. 22, 1986) (fact that sophistication of named class representative subjected him to materiality defense did not impede representation); *Fisher v. Plessey Co.*, 103 F.R.D. 150, 160 (S.D.N.Y. 1984) (named class representative, who was subject to unique "sophisticated investor" defense, still suitable class representative).

197. 559 F. Supp. 800 (S.D.N.Y. 1983).

divert attention from the substance of the basic claim."¹⁹⁸

Some cases have proposed other possible solutions to this unique defenses problem. In both *Ridings v. Canadian Imperial Bank of Commerce Trust Co. (Bahamas)*¹⁹⁹ and *McFarland v. Memorex Corp.*,²⁰⁰ the courts suggested that the availability of defenses against sophisticated class members should not bar class certification, since courts could conduct individualized hearings on those unique defenses. Similarly, in *Greenwald v. Integrated Energy, Inc.*, the court held that the possibility of defenses unique to a sophisticated representative should not bar his appointment; the class could replace him if such defenses actually arose.²⁰¹

In considering the effect of a representative's sophistication on class certification, courts have also focused on Rule 23(a)'s fourth requirement, adequacy.²⁰² For example, in *Peil v. Speiser*, the court decided that the plaintiff's sophistication made him a more adequate representative than he would otherwise be; presumably his financial knowledge would improve his ability to pursue the class's interests.²⁰³ Moreover, although the judiciary has since repudiated the argument, defendants once commonly argued that *unsophisticated* plaintiffs make poor class representatives.²⁰⁴

As though not enough confusion and contention already surrounded the treatment of sophisticated investors in class actions, the emergence of the fraud on the market theory in Rule 10b-5 cases has added an additional point of dispute. The fraud on the market theory allows a plaintiff to allege a more attenuated version of reliance: instead of alleging direct reliance on a defendant's misrepresentations, the plaintiff claims that he relied on the general integrity of the market in pricing and deciding whether to buy or sell the security at issue, and that the defendant's mis-

198. *O'Connor*, 559 F. Supp. at 806 n.7 (citing *Kline v. Wolf*, 88 F.R.D. 696, 700 (S.D.N.Y. 1981)). Another interesting issue in *O'Connor* concerns the defendants' standing, as options traders, to assert insider trading violations. See *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1186-87 (S.D.N.Y. 1981) (holding, on motion to dismiss, that *O'Connor* had standing on misappropriation theory); see also Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959 (1987) (arguing in favor of standing, but noting split among courts).

199. 94 F.R.D. 147, 151-52 (N.D. Ill. 1982).

200. 96 F.R.D. 357, 363 (N.D. Cal. 1982).

201. 102 F.R.D. 65, 70 (S.D. Tex. 1984).

202. FED. R. CIV. P. 23(a); see *supra* text accompanying note 182 (quoting the Rule).

203. 97 F.R.D. 657, 661 (E.D. Pa. 1983); see also *Westlake v. Abrams*, 565 F. Supp. 1330, 1344 (N.D. Ga. 1983) (plaintiff's legal background enhances his adequacy as class representative); *Ridings*, 94 F.R.D. at 152 (sophisticated investors no less able to represent class and perhaps more able).

204. See *Fickinger v. C.I. Planning Corp.*, 103 F.R.D. 529, 533 n.5 (E.D. Pa. 1984) ("[A]ny suggestion that a would-be class representative need be a sophisticated investor versed in securities law has been rejected by the Supreme Court.").

representations resulted in a distorted market price.²⁰⁵ Thus, the plaintiff claims, as a result of the defendant's misrepresentation, he bought or sold the security at a falsely inflated or deflated price.²⁰⁶

This theory minimizes some of the problems that a sophisticated class representative faces. By obviating a plaintiff's need to prove reliance on a defendant's misrepresentations,²⁰⁷ the theory eliminates some of the most important unique defenses that defendants can assert against sophisticated plaintiffs. For this reason, most courts faced with the issue have (quite properly) decided that investor sophistication does not affect typicality in fraud on the market cases. As the court in *Leist v. Tamco Enterprises* stated:

Plaintiff, as a professional investor, the class members as amateurs, and indeed, those who choose stock by means of a ouija board or by throwing darts at the list, all believe as an article of faith that the market is an honest market. . . . Where the public market of a quoted security is polluted by false information, or where price, supply and demand are distorted as a result of misleading omissions, all types of investors are injured, experienced and inexperienced, smart and stupid.²⁰⁸

Courts are not unanimous on this point, however. For example, in *Zandman v. Joseph*,²⁰⁹ a fraud on the market case, the court found the plaintiff's sophistication relevant to his adequacy as a class representative. According to the court, notwithstanding the presence of a fraud on the market theory, the sophisticated plaintiff would still have a more difficult time showing justifiable reliance than would other class members.²¹⁰ The plaintiff arguably had not relied on the market, and would

205. The efficient-market hypothesis, some form of which is necessary to sustain the fraud on the market theory, is not universally accepted. Compare Morrissey, *Defensive Tactics in Tender Offers—Does Anything Go?*, 53 TENN. L. REV. 103, 103-09 (1986) (relying upon efficient-market hypothesis and citing to commentary and theoretical work on the hypothesis) with Gordon & Kornhauser, *supra* note 24, at 825-30 (questioning efficient-market hypothesis). See also Donnelly, *supra* note 24 (reporting debate among academics over efficient-market hypothesis' viability).

206. For good general discussions of the fraud on the market theory, see *Stoller v. Baldwin-United Corp.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,298, at 92,024-25 (S.D. Ohio June 4, 1985); Note, *supra* note 24. A plurality of the Supreme Court has accepted the theory. See *Basic Inc. v. Levinson*, 108 S. Ct. 978, 988-92 (1988) (Blackmun, J., joined by Brennan, Marshall & Stevens, JJ.).

207. See, e.g., *HSL, Inc. v. Daniels*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,557, at 97,197-99 (N.D. Ill. Aug. 25, 1983) (fraud on market theory creates rebuttable presumption of reliance on defendant's misrepresentations).

208. *Leist v. Tamco Enters.*, 34 Fed. R. Serv. 2d (Callaghan) 1424, 1427 (S.D.N.Y. 1982); see also *Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976) ("Differences in sophistication, etc., among purchasers have no bearing in the impersonal market fraud context, because dissemination of false information necessarily translates through market mechanisms into price inflation which harms each purchaser identically.").

209. 102 F.R.D. 924 (N.D. Ind. 1984).

210. *Id.* at 931-32. The plaintiff, however, relied not on the market, but on personal conversations with company officials.

therefore be subject to a defense not applicable to the rest of the class.

In this context as well, courts exhibit no unifying, or even coherent, theory for treating sophisticated investors. Part II of this Article will attempt to resolve this confusion.

G. *Statutes of Limitations and the Sophisticated Investor.*

Courts applying statutes of limitations to sophisticated investors show little more agreement than courts dealing with sophisticated investors in class actions. Many of the problems that arise with respect to statutes of limitations in Rule 10b-5 cases resemble those encountered with the Rule's due diligence requirement.²¹¹ Many statutes of limitations begin to run when a plaintiff actually discovers the wrongdoing at issue, or would have discovered it by exercising due diligence.²¹² In other words, a statute of limitations creates a window of time in which a plaintiff must file an action, but will permit the plaintiff to toll that period if he would not have discovered the alleged wrongdoing even by exercising reasonable diligence. As the Supreme Court has stated, "[t]his equitable doctrine [of tolling] is read into every federal statute of limitation[s]."²¹³

When a sophisticated investor seeks to toll a statute of limitations, the question arises whether a different standard of due diligence should apply. Although a majority of courts agree that sophistication is relevant to the tolling issue,²¹⁴ the caselaw reflects confusion. While some courts seem willing to treat sophisticated and unsophisticated investors differently, others refuse to do so. The various judicial approaches fall into roughly four categories.

The first category consists of cases that hold sophisticated plaintiffs to a higher due diligence standard. Under this higher standard, courts decline to excuse a sophisticated plaintiff's nondiscovery of a wrong or to

211. See *supra* notes 48-63 and accompanying text.

212. Decisions in fraud cases involving statutes of limitations have long required that plaintiffs exercise reasonable diligence to discover the fraud at issue. See, e.g., *Rosenberg v. Hano*, 121 F.2d 818, 821 (3d Cir. 1941). The 1933 Act contains its own statute of limitations. See 15 U.S.C. § 77(m) (1982). The statutes of limitations for express rights of action under the 1934 Act are contained in *id.* §§ 78i(e), 78r(c), 78ce(b). The limitations period for implied rights of action under the 1934 Act—including Rule 10b-5 actions—is the limitations period that the forum state applies in similar actions. *Roberts v. Magnetic Metals Co.*, 611 F.2d 450, 452 (3d Cir. 1979); *Klein v. Bower*, 421 F.2d 338, 343 (2d Cir. 1970).

213. *Holmberg v. Armbrrecht*, 327 U.S. 392, 397 (1946).

214. See, e.g., *Bengiovi v. Prudential-Bache Sec., Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,012, at 91,015 n.6 (D.D.C. Apr. 25, 1985) (sophistication labeled a "significant factor"); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 472 F. Supp. 402, 408 (D. Colo. 1979) (giving legal sophistication weight in assessment of due diligence), *aff'd*, 651 F.2d 687 (10th Cir. 1981).

toll the limitations period, thus generally upholding statute-of-limitations defenses to sophisticated plaintiffs' claims.²¹⁵ As the Eighth Circuit stated in *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, a sophisticated plaintiff "may not deliberately close his eyes to the information available to him which would demonstrate to any reasonable person . . . that the alleged representations of [defendant] as to the soundness and lack of risk . . . could not have been true."²¹⁶ Similarly, in *Ohio v. Peterson, Lowry, Rall, Barber & Ross*,²¹⁷ the court refused to toll the statute of limitations when the plaintiff was the State of Ohio:

In assessing the meaning of due diligence, this court gives some weight to the amount in controversy and the legal sophistication of the party involved. In this case, the state of Ohio is much more than a casual dabbler in the securities market. The size of the claim alone implies that a degree of care and diligence should be employed in its pursuit.²¹⁸

In the second type of case, courts apply the same standard of due diligence to sophisticated investors as to ordinary investors and, as a result, generally toll the statute at issue. For example, in *In re Commonwealth Oil/Tesoro Petroleum Securities Litigation*,²¹⁹ the court articulated an "objective" standard of due diligence, which asks "whether the facts available would have put a reasonably prudent investor on 'inquiry notice' of the possibility that the registration statement contained misstatements or omissions."²²⁰ Under that standard, the court found the plaintiff's sophistication irrelevant to whether the limitations period had run, since the court focused not on what the plaintiff himself knew, but on what a reasonable investor would have known.²²¹ Such a reading of the 1933 Act's statute of limitations seems to clash with the language of that section,²²² as well as the majority of cases.²²³

215. See, e.g., *Bender v. Rocky Mountain Drilling Assocs.*, 648 F. Supp. 330, 334-35 (D.D.C. 1986); *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 486 F. Supp. 56, 58-59 (E.D. Mo. 1980), *aff'd in part and rev'd in part on other grounds*, 644 F.2d 690 (8th Cir. 1981); *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,759, at 96,498-500 (S.D. Cal. June 13, 1974); *Maine v. Leonard*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,407, at 95,412-15 (W.D. Va. Oct. 17, 1973).

Since a plaintiff's sophistication is a question of fact, outright dismissal or summary judgment would be inappropriate if sophistication is contested in a given case. See, e.g., *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172-73 (10th Cir. 1974); *Bengiovi*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,015-16.

216. 644 F.2d 690, 692 (8th Cir. 1981) (quoting trial court).

217. 472 F. Supp. 402 (D. Colo. 1979).

218. *Id.* at 408.

219. 484 F. Supp. 253 (W.D. Tex. 1979).

220. *Id.* at 257.

221. *Id.* at 258.

222. The statute calls for an inquiry into what *each particular plaintiff*, if careful, should reasonably have discovered. 15 U.S.C. § 77m (1982) ("No action shall be maintained to enforce any liabil-

Courts in the third type of case more readily permit *unsophisticated* investors to toll statutes of limitations than they permit all other investors to do so. As the court in *Boyd v. Merrill Lynch, Pierce, Fenner & Smith* pointed out, "an unsophisticated investor who considers her broker to be a fiduciary should not be expected to make as diligent or comprehensive an inquiry as a sophisticated investor who is the victim of a flagrant and widely publicized fraud."²²⁴ Similarly, in *Weiser v. Shwartz*,²²⁵ a relatively unsophisticated investor brought a churning claim, but filed it after the statutory time period had elapsed. Because the plaintiff lacked financial sophistication, the court tolled the statute.²²⁶ In deciding whether the plaintiff had constructive notice, the court asked whether an exercise of reasonable diligence would have notified the plaintiff of the churning, and that inquiry required the court to examine his sophistication. Given the plaintiff's relative lack of sophistication, the court held that despite his receipt of confirmation slips and monthly statements, the plaintiff had no notice.²²⁷

In the fourth type of case, courts refuse to allow even unusually *unsophisticated* investors a longer limitations period than ordinary investors. These cases hold that unless a defendant affirmatively conceals alleged misconduct from a plaintiff, the statute of limitations will not toll.²²⁸ These cases sometimes produce harsh results.²²⁹ In *Koke v. Stifel, Nicolaus & Co.*,²³⁰ for example, an elderly widow in a nursing home and her daughter, neither of whom had any financial experience, sued their broker for numerous alleged violations. The court held that their

ity created under section 77k or section 77l(2) . . . unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . .").

223. See *supra* notes 214-18 and accompanying text.

224. 611 F. Supp. 218, 220 (S.D. Fla. 1985) (citing *Azalea Meats v. Muscat*, 386 F.2d 5, 9 (5th Cir. 1967)).

225. 286 F. Supp. 389 (E.D. La. 1968). Although the plaintiff was an insurance company executive, the court found him unsophisticated because he had only recently learned what churning was, and his investments had performed poorly.

226. *Id.* at 393.

227. *Id.*

228. See, e.g., *Koke v. Stifel, Nicolaus & Co.*, 620 F.2d 1340, 1343 (8th Cir. 1980) (statute of limitations begins to run from the date when fraud, upon reasonable inquiry, should have been discovered); *Militsky v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 540 F. Supp. 783, 787-88 (N.D. Ohio 1980) (statute began to run on date when reasonable person should have discovered alleged fraud); see also *Gec v. CBS*, 471 F. Supp. 600, 627 (E.D. Pa. 1979) (even singer Bessie Smith's lack of sophistication cannot toll statute of limitations for 40 years), *aff'd*, 612 F.2d 572 (3d Cir. 1979).

229. In *Militsky*, the court noted the rule's harshness when applied to a naive, unsophisticated investor, but nonetheless held that it could not toll the statute without evidence of affirmative concealment. See *Militsky*, 540 F. Supp. at 787-88.

230. 620 F.2d at 1340.

claims were time-barred, refusing to toll the statute of limitations notwithstanding the plaintiffs' lack of sophistication: the broker had attempted no concealment, and the plaintiffs had received accurate monthly statements.²³¹

Decisions that refuse to recognize an *unsophisticated* investor's special status are as much at odds with the purpose of the tolling doctrine as cases that refuse to recognize the relevance of a sophisticated investor's status.²³² The tolling doctrine calls upon a court to determine what a plaintiff would have known had she exercised due diligence,²³³ in this area, as in others involving questions of due diligence,²³⁴ most courts adopt a common-sense approach. They recognize that an unsophisticated elderly widow will not exercise the same degree of diligence that a sophisticated, professionally managed investment fund will apply.²³⁵

In short, courts disagree widely about the relevance of sophistication, or unsophistication, in statute-of-limitations cases. And again, the confusion stems from a complete lack of unifying principles for the judicial treatment of sophisticated investors.

H. *Registration Exemptions Under the 1933 Act and the Sophisticated Investor.*

The wide variety in investors' understanding and competence has led to a certain schizophrenia in disclosure philosophy. At whom should registration statements, prospectuses, and other disclosure requirements be aimed? Who should benefit from federally mandated disclosure? The SEC has long taken the position that registration statements should be simple enough for an average investor to understand, yet detailed enough to provide a sophisticated analyst with real information.²³⁶ Others have recognized that unsophisticated investors do not generally read registration statements or prospectuses and have suggested that aiming registra-

231. *Id.* at 1343.

232. *See supra* notes 219-21 and accompanying text.

233. *See supra* notes 211-13 and accompanying text.

234. *See supra* notes 47-63 and accompanying text (discussing due diligence requirement in connection with Rule 10b-5 claims).

235. One commentator has labeled this line of cases "unjust," while nonetheless considering it "ill-advised" to relax statutes of limitations except when a defendant has schemed to take advantage of a plaintiff's incapacity. *See* Marcus, *supra* note 53, at 879. Curiously, however, Marcus argues in favor of an individualized test for due diligence if an investor is *more* sophisticated than average. *Id.* at 880. Such a double standard seems unwarranted.

236. *See, e.g., In re Universal Camera Corp.*, 19 S.E.C. 648, 654 (1945); Panel Discussion, *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505, 527 (1973) (remarks of Harold Marsh) (prospectus must be addressed to both unsophisticated and knowledgeable investors). Courts, too, have suggested that registration statements and prospectuses should contain enough information for even the most sophisticated investor and still not slight the unsophisticated. *See, e.g., Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 566 (E.D.N.Y. 1971).

tion statements at sophisticated investors will also protect the unsophisticated by ensuring that market prices reflect any adverse disclosures.²³⁷ Still others have suggested that a registration statement should be directed only to those capable of understanding the transactions described.²³⁸

Congress and the SEC have responded to this confusion by exempting securities offered to wealthy or astute investors from the 1933 Act's registration requirements.²³⁹ These criteria of sophistication play a central role in three groups of exemptions,²⁴⁰ which the following subsections will discuss in turn.

1. *Private Offerings Under Section 4(2) and Rule 506.* Section 4(2) of the 1933 Act, itself a very short provision that makes no reference to investor sophistication, grants a registration exemption to "transactions by an issuer not involving any public offering."²⁴¹ As a substantial judicial gloss on the section clarifies, an offeree's sophistication plays an important role in determining whether a transaction involves a public offering.

In a 1953 case, *SEC v. Ralston Purina Co.*,²⁴² the Supreme Court established ground rules for applying section 4(2). In rejecting Ralston Purina's assertion that an employee stock sale plan was not a public offering, the Court emphasized that the public offering issue "should turn on whether the particular class of persons affected needs the protection of the [1933] Act."²⁴³ The Court also highlighted the primary importance of two criteria: sophistication and access.

An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

....

237. See, e.g., Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1351-52 (1966); Kripke, *The Myth of the Informed Layman*, 28 BUS. LAW. 631, 636-37 (1973); see also SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE 1933 AND 1934 ACTS 53 (1969) [hereinafter DISCLOSURE TO INVESTORS] (known as the "Wheat Report") (citing Douglas, *Protecting the Investor*, 23 YALE L.J. 508, 523-24 (1933) (although only sophisticated investors can understand disclosure materials, market price will reflect the materials' content, thereby protecting unsophisticated investors as well)); *Feit*, 332 F. Supp. at 565-66 (same).

238. See Panel Discussion, *supra* note 236, at 527.

239. As discussed *infra* notes 268-76 and accompanying text, these exemptions aim at securities offered to either "accredited" or "sophisticated" investors. The two categories describe different types of investors: the former may be wealthy, yet wholly unsophisticated, whereas the latter may be financially astute, yet unable to bear the burden of the risks they assume.

240. As pointed out *infra* note 277 and accompanying text, purchaser or offeree sophistication affects other exemptions at both the state and federal level.

241. 15 U.S.C. § 77d(2) (1982).

242. 346 U.S. 119 (1953).

243. *Id.* at 125.

The focus of the inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose.²⁴⁴

Courts applying the *Ralston Purina* standard have continued to emphasize the importance of offerees' sophistication.²⁴⁵ Some courts have repeatedly suggested that sophisticated offerees do not need the registration provision's protection.²⁴⁶ Other courts explicitly require offeree sophistication before granting exemptions.²⁴⁷ In fact, many courts have conditioned the exemption's availability on the involvement of sophisticated offerees.²⁴⁸ Under that approach, if any of the offerees are unsophisticated, the offering is a public one and the section 4(2) exemption becomes unavailable.²⁴⁹

244. *Id.* at 125, 127.

245. In *Ralston Purina*, the Court attempted to determine who needed the 1933 Act's protection and decided that if an investor had both access to information and the ability to fend for himself, the protections afforded by registration were unnecessary. See Note, *Revising the Private Placement Exemption*, 82 YALE L.J. 1512, 1514 (1973). As subsequent cases clarify, the ability to fend for oneself depends not on wealth, but on one's ability to evaluate information from an issuer. See, e.g., *Value Line Fund, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523, at 94,970 (S.D.N.Y. Mar. 31, 1965) (sophisticated offerees, as experienced institutional investors, had access to information that registration statement would have disclosed and were therefore able to fend for themselves).

One commentator, however, has argued that sophistication should be irrelevant in this area. See Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 874-76 (1981).

246. See, e.g., *Garfield v. Strain*, 320 F.2d 116, 119 (10th Cir. 1963); *Woodward v. Wright*, 266 F.2d 108, 115 (10th Cir. 1959); *Repass v. Rees*, 174 F. Supp. 898, 904 (D. Colo. 1959); *Collier v. Mikel Drilling Co.*, 183 F. Supp. 104, 112 (D. Minn. 1958).

247. See Section 4(2) and Statutory Law—*A Position Paper of the Federal Regulation of Securities Committee*, 31 BUS. LAW. 485, 489-95 (1975) [hereinafter *Position Paper*] (discussing four criteria, including "offeree qualification"); Soraghan, *supra* note 134, at 10-11, 20-27 (discussing three criteria, including "investment sophistication"). The Ninth Circuit has established a four-part test for applying the exemption, which includes:

- (1) the number of offerees;
- (2) the sophistication of the offerees;
- (3) the size and manner of the offering; and
- (4) the relationship of the offerees to the issuer.

See *SEC v. Murphy*, 626 F.2d 633, 644-47 (9th Cir. 1980); *McDaniel v. Compania Minera Mar de Cortes*, 528 F. Supp. 152, 162 (D. Ariz. 1981); see also *Barrett v. Triangle Mining Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,438, at 99,210-11 (S.D.N.Y. Feb. 2, 1976) (listing requirements for exemption, including access to information and offeree sophistication).

248. See, e.g., *Lively v. Hirschfeld*, 440 F.2d 631, 633 (10th Cir. 1971) (exemption applies only to offerees "of exceptional business experience"); *SEC v. International Scanning Devices, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,147, at 92,170 (W.D.N.Y. Apr. 6, 1977) (exemption available to offerees who do not need protection of 1933 Act registration provisions and who are knowledgeable concerning issuer's affairs).

249. See, e.g., *SEC v. Universal Major Indus. Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,229, at 98,210-12 (S.D.N.Y. July 14, 1975) (defendant failed to show that all purchasers of stock were sophisticated enough to protect their own interests; therefore, section 4(2) exemption did not apply), *aff'd*, 546 F.2d 1044 (2d Cir. 1976), *cert. denied*, 434 U.S. 834 (1977). This result occurs even if a plaintiff is himself sophisticated: he may assert that an offering is not

Although a plaintiff's sophistication often leads a court to rule for a defendant in section 4(2) cases,²⁵⁰ sophistication remains a necessary, but not a sufficient, condition for the exemption. As the Fifth Circuit remarked in *Doran v. Petroleum Management Corp.*, "evidence of a high degree of business or legal sophistication on the part of all offerees does not suffice to bring the offering within the private placement exemption."²⁵¹ Sophistication alone provides a poor substitute for the sort of information that registration discloses; as the *Doran* court realized, without access to information, the sophisticated investor cannot bring her sophistication to bear.²⁵² Indeed, courts have held that, without access to information, even sophistication of all the offerees in an offering will not satisfy the exemption's requirements.²⁵³ In *Andrews v. Blue*,²⁵⁴ the Tenth Circuit reinforced that point: "The statute is intended to promote full disclosure to every investor regardless of his particular business background. *Ralston Purina* rejects the idea that an exemption exists based only on the individual sophistication of the offeree and without regard to his actual knowledge concerning the issuer."²⁵⁵

In its current safe-harbor rules for the section 4(2) exemption, the SEC has incorporated the idea that offeree sophistication is necessary but not sufficient.²⁵⁶ The SEC's older version of these rules, Rule 146, imposed three requirements before an issuer could reach the safe harbor: First, an issuer needed reasonable grounds to believe that each offeree was a sophisticated investor. Either wealth or knowledge could demonstrate that sophistication.²⁵⁷ Second, before consummating a sale, an issuer had to have reasonable grounds to believe that a purchaser either

exempt because other offerees are unsophisticated. See, e.g., *McDaniel*, 528 F. Supp. at 164 (plaintiff's familiarity with industry not a bar to recovery if defendant fails to show that all offerees had adequate information).

250. See, e.g., *Barrett*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,211 (offerees sophisticated, but exemption granted); *Fuller v. Dilbert*, 244 F. Supp. 196, 212 (S.D.N.Y. 1965) (implying that section 4(2) exemption would be available on showing of access and sophistication), *aff'd sub nom.* *Righter v. Dilbert*, 358 F.2d 305 (2d Cir. 1966); see also *Bowers v. Columbia Gen. Corp.*, 336 F. Supp. 609, 622-24 (D. Del. 1971) (finding preliminary injunction inappropriate, since plaintiff's sophistication made success on merits of section 4(2) claim unlikely).

251. 545 F.2d 893, 902 (5th Cir. 1977) (quoting *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 690 (5th Cir. 1971)).

252. *Id.*

253. See, e.g., *Lawler v. Gilliam*, 569 F.2d 1283, 1289-90 (4th Cir. 1978); *Mason v. Marshall*, 412 F. Supp. 294, 300 (N.D. Tex. 1974), *aff'd*, 531 F.2d 1274 (5th Cir. 1976); see also *Henderson v. Hayden, Stone Inc.*, 461 F.2d 1069, 1070 (5th Cir. 1972) (even though plaintiff was sophisticated investor, defendant could not claim section 4(2) exemption, since it failed to establish other elements of exemption).

254. 489 F.2d 367 (10th Cir. 1973).

255. *Id.* at 373-74 (citation and footnote omitted).

256. 17 C.F.R. § 230.506 (1988).

257. *Id.* § 230.146(d)(1) (1976), *repealed and replaced by* 17 C.F.R. § 230.506 (1988).

could evaluate the investment's risks and merits himself, or had consulted a financial advisor *and* was able to bear the financial risks.²⁵⁸ Finally, each offeree had to have access to the same kind of information that a registration statement would have provided.²⁵⁹ Rule 146 thus required that all *offerees* be sophisticated or wealthy, but that actual *purchasers* be sophisticated or consult a financial advisor.

This entire scheme changed in 1982, when the SEC promulgated Regulation D and substituted Rule 506 for Rule 146.²⁶⁰ The new Rule replaces the old Rule's dual requirement of access *and* sophistication with a dual requirement of access and *either* sophistication *or* wealth. Rule 506 requires limited disclosure²⁶¹ and then permits sales to up to thirty-five sophisticated investors who "either alone or with [their] purchaser representative(s) [have] such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment."²⁶² The Rule also permits sales to an unlimited number of "accredited investors,"²⁶³ defined to include wealthy investors without regard to their sophistication.²⁶⁴ Neither category of sales—to accredited investors or to sophisticated investors—requires registration, presumably because neither group requires the protections that registration affords.²⁶⁵

Rule 506 thus departs from the *Ralston Purina* line of cases.²⁶⁶ Whereas before, private placement purchasers had to be smart, now they need only be rich. Such a departure raises an important, and unanswered, question: should the law presume that wealthy investors, who can bear investment risks, are sophisticated investors, and treat them as such, no matter how financially naive they may be? Conversely, should the law treat poor, but financially sophisticated investors, who cannot

258. *Id.* § 230.146(d)(2).

259. *Id.* § 230.146(e).

260. *See id.* § 230.501-.506 (1988). Regulation D, containing the Uniform Limited Offering Exemptions, contains the SEC's reformulation of several exemptions that had previously been treated separately. *See* *Riseman v. Orion Research, Inc.*, 749 F.2d 915, 916 n.2 (1st Cir. 1984).

261. 17 C.F.R. § 230.506(b); *see also id.* § 230.502(b)(2) (discussing type of disclosure required if issuer not subject to reporting requirements of section 13 or 15(d) of 1934 Act).

262. *Id.* § 230.506(b)(2)(ii).

263. *Id.* § 230.506(b)(2); *see also id.* § 230.501(e)(1)(iv) (excluding accredited investors from calculation of number of purchasers).

264. *Id.* § 230.501(a).

265. In fact, the SEC has recently proposed changes in Regulation D that would lower the thresholds for the "accredited investor" test. *See* 20 Sec. Reg. & L. Rep. (BNA) No. 9, at 323 (Mar. 4, 1988); 19 Sec. Reg. & L. Rep. (BNA) No. 3, at 85 (Jan. 16, 1987).

266. The most persuasive reading of *Ralston Purina* suggests that when the Court indicated that those who can fend for themselves do not need the 1933 Act's protections, it referred not to wealthy investors, but to financially sophisticated individuals capable of evaluating information provided by an issuer. *See* *Value Line Fund, Inc. v. Marcus*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523, at 94,970 (S.D.N.Y. Mar. 31, 1965); Note, *supra* note 245, at 1514-15.

bear investment risks, like other sophisticated investors? In short, what role should wealth and sophistication play in the determination whether an issuer must undertake 1933 Act registration? Neither the courts nor the SEC have adequately treated these questions.²⁶⁷ Part II of this Article will address them.

2. *Accredited Investor Exemptions Under Section 4(6).* These same questions arise in connection with section 4(6) of the 1933 Act, which establishes a registration exemption for offers and sales to accredited investors.²⁶⁸ Section 2(15) of that Act defines "accredited investor" to include whomever the SEC deems accredited in light of "such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management."²⁶⁹

While section 2(15)'s language clearly reflects a congressional intent that the SEC consider any relevant indicia of sophistication, the SEC has made true financial sophistication irrelevant. In promulgating Rule 215 to further define the term "accredited investor" under section 2(15), the SEC has made wealth rather than sophistication the sine qua non of accredited investor status.²⁷⁰ Like Regulation D,²⁷¹ Rule 215 includes within its definition certain institutions and persons affiliated with issuers, but it also includes individual investors whose net worth or income meets certain prescribed levels.²⁷²

As in the case of Rule 506, the SEC assumes either that wealthy investors are always sophisticated or that they, no matter how naive, do not need the protection of the 1933 Act's registration provisions. Here too, the relationship of wealth and sophistication to the need for such protection requires further study.

3. *Small Offerings Under Section 3(b) and Rule 505.* The SEC has repeated this pattern of registration exemptions for wealthy but unsophisticated investors in Rule 505,²⁷³ promulgated under section 3(b) of the 1933 Act.²⁷⁴ As a registration exemption provision, section 3(b) is an empty vessel with a lid. It contains no exemption of its own, but authorizes the SEC to add an exemption for small issues involving sales of up

267. One student commentator has proposed a test that would combine regular dealings in financial matters and previous investment experience, as determined by portfolio size, to determine availability of the private placement exemption. See Note, *supra* note 245, at 1529-30 & n.93.

268. 15 U.S.C. § 77(d)(6) (1982).

269. *Id.* § 77b(15).

270. 17 C.F.R. § 230.215 (1988).

271. *Id.* § 230.501(a).

272. *Id.* § 230.215(e)-(g).

273. *Id.* § 230.505.

274. 15 U.S.C. § 77c(b) (1982).

to \$5 million worth of securities if the SEC determines "that the enforcement of [the 1933 Act] with respect to such securities is not necessary in the public interest and for the protection of investors."²⁷⁵

Rules 504 and 505 exercise the authority granted in section 3(b). Rule 505 permits sales of securities to proceed without registration if made to no more than thirty-five investors, not including "accredited investors" (again, defined in Rule 501(a) as wealthy but not necessarily financially sophisticated investors);²⁷⁶ it thus allows unregulated sales to an unlimited number of "accredited investors."

Investor sophistication also affects other, less important, exemptions from registration,²⁷⁷ but the ones discussed here illustrate the fundamental policy problem that demands attention: determining the proper analysis of investor sophistication and investor wealth under the 1933 Act's requirements. We should applaud Congress and the SEC for their efforts to maximize efficiency in capital formation by eliminating costly registration requirements where the costs outweigh the marginal benefits of investor protection. Moreover, exempting securities offered and sold only to people who do not need federally mandated disclosure protection is a good idea, and might beneficially extend to other areas of securities law. Yet, this attempt to tie registration requirements to investors' needs for protection calls for further inquiry into what sorts of investors really need registration protection. Courts assume without justification that sophisticated investors do not require such protection, at least if they enjoy access to the types of information that registration provides; the SEC assumes that wealthy investors, simply because of their wealth, need no protection at all. Both of these assumptions require more scrutiny than they have received.

On a more fundamental level, the SEC's and Congress's attempts to exempt securities offered and sold to sophisticated investors have created a legal paradox: the scheme requires registration of securities offered to *unsophisticated* investors, thus ensuring that people who do not read pro-

275. *Id.*

276. 17 C.F.R. §§ 230.505(b)(2)(iii), 230.501(a) (1988); see *supra* note 264 and accompanying text.

277. See, e.g., Securities Act Release No. 33-4412, 26 Fed. Reg. 9158, 9159 (1961) (defining scope of 1933 Act section 3(a)(3) exemption question by whether instruments are of type not ordinarily purchased by general public, itself defined in terms of sophistication); *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1397-99 (S.D.N.Y. 1974) (interpreting section 3(a)(10) exemption in same terms). Some state exemptions also turn on investor sophistication. See, e.g., *McConnell v. Surak*, 774 F.2d 746, 750 (7th Cir. 1985) (Illinois exemption for sales to certain sophisticated institutional investors interpreted not to include sales to partnerships); *Rochambeau v. Brent Exploration, Inc.*, 79 F.R.D. 381, 385 (D. Colo. 1978) (interpreting state private placement exemption in COLO. REV. STAT. § 11-51-114(2)(i) (1973), amended by COLO. REV. STAT. § 11-41-113(a)(i) (1987), to turn on offeree's sophistication and access to information).

spectuses receive copies of them, but exempts securities offered to *sophisticated* investors who would read and benefit from prospectuses if they received them. A legal structure that creates such anomaly demands reconsideration.

I. *Proxy Fraud and the Sophisticated Investor.*

Section 14(a) of the 1934 Act prohibits any solicitation of proxies that violates SEC rules.²⁷⁸ Rule 14a-9 forbids the use of proxy materials that contain false or misleading statements, or misleading omissions, of material facts.²⁷⁹ Investor sophistication can become an issue in Rule 14a-9 cases in at least two ways.

The first involves the definition of an actionable falsehood. Courts are split over the relevance of plaintiffs' sophistication to the issue whether statements or omissions were actually false or misleading. The actual falsehood inquiry poses no problem: a listener's characteristics cannot alter the objective truth or falsity of a matter. Considering whether a statement or omission is "misleading," however, necessarily involves a listener's qualities: a statement cannot mislead unless a listener is capable of being misled. As a result, some courts apply a higher standard of deceptiveness for statements to sophisticated plaintiffs than for statements to unsophisticated ones. For example, in *Pierre J. Le-Landais & Co. v. MDS-Atron, Inc.*, statements contained in the proxy statement at issue were held not misleading because the sophisticated plaintiffs involved should not have been misled.²⁸⁰

278. 15 U.S.C. § 78n(a) (1982).

279. 17 C.F.R. § 240.14a-9 (1988):

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

A private right of action for Rule 14a-9 violations has long existed. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382-83 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426, 430-33 (1964).

280. 387 F. Supp. 1310, 1318-19 (S.D.N.Y. 1974), *aff'd in part and rev'd in part*, 543 F.2d 421 (2d Cir. 1976), *cert. denied*, 429 U.S. 1062 (1977); see also *Rosenfeld v. Black*, 445 F.2d 1337, 1349 (2d Cir. 1971) (statement that would mislead unsophisticated investors may not mislead sophisticated investors).

The same sort of rationale might apply to allegedly misleading omissions. As the Second Circuit pointed out in *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978) (citing *Myzel v. Fields*, 386 F.2d 718, 736 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968)), "there is no duty to disclose information to one who reasonably would already be aware of it." Cf. *Indiana Nat'l Bank v. Mobil Oil Corp.*, 578 F.2d 180, 184-85 (7th Cir. 1978) (language in tender offer statement not deceptive where all plaintiffs were sophisticated investors who should have understood challenged language).

A more convincing group of proxy fraud cases considers the sophistication of all the recipients of the proxy materials at issue, not just the individual plaintiff's sophistication. Thus, in *Clayton v. Skelly Oil Co.*,²⁸¹ the court noted that the plaintiffs were all sophisticated investors, none of whom had been duped. Nonetheless, the plaintiffs recovered because the same materials might have misled other, less sophisticated, recipients.²⁸² The *Clayton* result, is clearly correct. For a proxy statement to have the harm that Rule 14a-9 proscribes, it need only mislead *some* of its recipients. If the materials mislead a majority of voting shareholders, the majority's misguided action may harm the sophisticated plaintiffs even if they themselves were not misled.

Investor sophistication also presents an issue under Rule 14a-9's materiality requirement. As in the Rule 10b-5 context, the relevance of sophistication under Rule 14a-9 depends on whether the Rule creates a subjective standard of materiality or an objective one.

In *TSC Industries v. Northway, Inc.*,²⁸³ the Supreme Court held that a misstatement or omission qualifies as material under Rule 14a-9 when there is

a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.²⁸⁴

As discussed above,²⁸⁵ this passage fails to resolve the choice between a subjective and an objective standard; not surprisingly, courts have split in determining the relevance of investor sophistication under Rule 14a-9's materiality requirement.

As with the other areas in which issues of investor sophistication arise, a coherent theory for the treatment of sophistication under the federal securities laws would do much to alleviate judicial discord in the interpretation of Rule 14a-9.

J. *The Sophisticated Investor and the Definition of "Tender Offer."*

Judicial discord fades as courts determine whether, under the Williams Act,²⁸⁶ a stock purchase plan that is targeted at sophisticated investors involves a tender offer. The Williams Act and the SEC rules

281. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,269 (S.D.N.Y. Dec. 30, 1977).

282. *Id.* at 92,746-47.

283. 426 U.S. 438 (1976).

284. *Id.* at 449.

285. See *supra* notes 92-104 and accompanying text.

286. 15 U.S.C. §§ 78m, 78n (1982).

promulgated thereunder provide extensive regulation of tender offers. This complex regulatory scheme applies whenever a party makes a tender offer for a specified percentage of a 1934 Act registrant's equity securities.²⁸⁷ The Williams Act, however, refrains from defining the term "tender offer," reflecting the SEC's view that "the term is to be interpreted flexibly" in light of the "dynamic nature of these transactions."²⁸⁸

Courts have therefore defined the term themselves, often focusing on offeree sophistication in the process. In determining whether a transaction is a tender offer, courts use three main types of tests. The most common of these, enunciated in *Wellman v. Dickinson*, gives the first of many characteristics of a tender offer: "active and widespread solicitation of public shareholders for the shares of an issuer."²⁸⁹ In applying this test, courts have considered offerees' sophistication. As these decisions indicate, solicitation of a small number of sophisticated investors does not amount to a "widespread solicitation of public shareholders" and thus does not constitute a tender offer.²⁹⁰ In *Hanson Trust PLC v. SCM Corp.*, for example, the Second Circuit found no tender offer in open-market purchases by a former tender offeror only hours after an official tender offer was withdrawn.²⁹¹ The court based its decision on the fact that the buyer purchased his stocks privately from extremely sophisticated investors who did not need the Williams Act's protections.²⁹²

Similarly, in *Hoover Co. v. Fuqua Industries*,²⁹³ the court applied the *Wellman* test in a situation involving mainly unsophisticated offerees. Given the offerees' lack of sophistication, the court decided that the offerees did constitute "public shareholders" under the *Wellman* test's first part, and held that the case involved a tender offer.²⁹⁴

The second variety of tender offer test focuses on the motivation behind the Williams Act. The Act regulates tender offers in order to eliminate the unreasoned stampedes that such offers commonly engen-

287. For a concise description of the statutory and regulatory scheme, see L. LOSS, *supra* note 123, at 507-41.

288. Exchange Act Release No. 12,676, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,659, at 86,696 (Aug. 2, 1976).

289. 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

290. See, e.g., *Brascan Ltd. v. Edper Equities Ltd.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,882, at 95,633 (S.D.N.Y. May 25, 1979); *Financial Gen. Bankshares, Inc. v. Lance*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,403, at 93,429 (D.D.C. Apr. 27, 1978); see also *Beaumont v. American Can Co.*, 621 F. Supp. 484, 502 (S.D.N.Y. 1985) (no tender offer where solicitations made only to institutions, presumably sophisticated), *aff'd*, 797 F.2d 79 (2d Cir. 1986).

291. 774 F.2d 47, 58-60 (2d Cir. 1985).

292. See *id.* at 57.

293. [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,107 (N.D. Ohio June 11, 1979).

294. *Id.* at 96,149.

der, an effect particularly harsh to unsophisticated investors.²⁹⁵ In light of this motivation, the court in *Kennecott Copper Corp. v. Curtiss-Wright Corp.* defined a tender offer as "any offer to purchase securities likely to pressure shareholders into making uninformed, ill-considered decisions to sell."²⁹⁶ The *Kennecott* court, applying this definition, held that no tender offer existed because the offerees were

largely institutions who were unlikely to be forced into uninformed, ill-considered decisions. These sophisticated investors have at hand large reservoirs of financial knowledge and capable staffs able to evaluate the pros and cons of a particular sale. In short, they are hardly the uninformed security holder unable to fend for himself, who needs the protection of the Williams Act.²⁹⁷

The third definition of tender offer, properly understood, also depends on investor sophistication. In *S-G Securities Inc. v. Fuqua Investment Co.*, the court declared that a tender offer occurs whenever "there is: 1) a publicly announced intention by the purchaser to acquire a substantial block of the stock of the target company for purposes of acquiring control thereof, and 2) a subsequent rapid acquisition by the purchaser of large blocks of stock through open market and privately negotiated purchases."²⁹⁸ The court justified this test by noting that a public announcement creates a "risk of the pressure on sellers that the disclosure and remedial tender offer provisions of the Williams Act were designed to prevent."²⁹⁹ A court would be well advised to apply this test not mechanically, but by examining the sophistication of the offerees involved, since the risk of undue pressure to tender varies inversely with the sophistication of the offerees. Developed in light of the principles behind the Williams Act, the test should protect only those whom the Act seeks to protect.

No matter how a court defines the term "tender offer," offeree sophistication remains a crucial point of inquiry. Moreover, the interplay

295. See, e.g., Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1259, 1279 & n.133 (1973); Note, *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389, 409 (1982). Lucian Bebchuk has suggested that the Williams Act does not sufficiently protect unsophisticated investors during the tender offer process. Bebchuk argues that unsophisticated investors are less likely to be aware of bids and less able to deliver their shares in time. They are thus forced to accept the post-takeover value of their minority shares instead of the higher bid price. Because of better information and better means for delivering their share certificates, sophisticated investors are less likely to suffer this fate. See Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1706-07, 1735 n.100, 1781-88 (1985).

296. 449 F. Supp. 951, 961 (S.D.N.Y.) (quoting Note, *supra* note 295, at 1281), *aff'd in part and rev'd in part*, 584 F.2d 1195 (2d Cir. 1978).

297. *Id.*

298. 466 F. Supp. 1114, 1126-27 (D. Mass. 1978).

299. *Id.* at 1126.

between the Williams Act's policy concerns and offeree sophistication hints at a more effective general treatment of sophisticated investors under the securities laws.³⁰⁰

K. *The Definition of "Security" and the Sophisticated Investor.*

No topic has a greater impact on securities regulation than the definition of a "security." Sections 2(1) of the 1933 Act³⁰¹ and 3(a)(10) of the 1934 Act³⁰² both define the term. Each section contains a list of items that constitute securities and then licenses judicial development of these working definitions by including the prefatory phrase "unless the context otherwise requires."³⁰³ Investor sophistication often plays a role as courts apply these definitions to specific fact patterns.

300. See *infra* notes 315-84 and accompanying text.

301. 15 U.S.C. § 77b(1) (1982):

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

302. The 1934 Act's definition differs only slightly from the 1933 Act's:

The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or other participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to a foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation or, temporary interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Id. § 78c(a)(10) (1982).

303. 15 U.S.C. § 77b (1982); *id.* § 78c(a). Some have argued that the so-called "context clauses" do not in fact invite courts to limit the list of devices defined as securities in given factual contexts; instead, they suggest that the context clauses refer to *textual* contexts. See, e.g., Steinberg & Kaulbach, *The Supreme Court and the Definition of "Security": The "Context" Clause, "Investment Contract" Analysis, and Their Ramifications*, 40 VAND. L. REV. 489, 504-18 (1987). These arguments involve a meaningless distinction. Under the context clauses, an ordinary general partnership agreement, although a "profit sharing agreement," is not usually a security. See, e.g., *Rivanna Trawlers Unltd. v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 1383-85 (W.D. Va. 1986). This result occurs either because of the factual context in which such contracts arise or because the substantive statutory provision "otherwise requires" in the particular case. Either way, a court may legitimately hold that such a profit-sharing agreement is not a security under the context clauses.

One such pattern involves "investment contracts," an instrument that both the 1933 and 1934 Act definitions list as a security. In *SEC v. Howey*, the Supreme Court characterized investment contracts in terms that necessitate an inquiry into investor sophistication: "In other words, an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party" ³⁰⁴ Over time, courts have refined the *Howey* test into three elements: (1) an investment of money (2) in a common enterprise with (3) an expectation of profits that will be derived from others' efforts. ³⁰⁵ Investor sophistication affects the third part of the test, which requires a court to consider "the dependency of the investor on the entrepreneurial or managerial skills of a promoter or third party." ³⁰⁶ Where a case involves sophisticated purchasers or investors, courts are less likely to find an expectation to derive profits from the promoter's efforts. In *FBS Financial, Inc. v. CleveTrust Realty Investors*, for example, the court held a subparticipation in a loan not to be a security, since the plaintiff relied on its own sophistication, and not the managerial efforts of others, in structuring the participation. ³⁰⁷ The court reached a similar result in *Rivanna Trawlers Unlimited v. Thompson Trawlers Inc.*, ³⁰⁸ holding that a general partnership interest in a venture was not a security. Based on the sophistication of the general partner purchasers, the court noted that the plaintiffs were sophisticated enough to exercise control over the venture and held that they failed to satisfy the *Howey* test's third prong. ³⁰⁹

Although investor sophistication affects the definition of "security" primarily in investment contract cases, it comes into play in other contexts as well. For example, in *United California Bank v. THC Financial*

304. 328 U.S. 293, 298-99 (1946).

305. See, e.g., *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 477 (5th Cir. 1974).

306. *Westlake v. Abrams*, 565 F. Supp. 1330, 1340 (N.D. Ga. 1983).

307. [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,341, at 93,145, 93,159-60 (N.D. Ohio Dec. 23, 1977). In *Seattle-First Nat'l Bank v. Carlstedt*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,499, at 98,520-21 (W.D. Okla. May 17, 1984), the court held that a loan participation was not a security, and had strong words for sophisticated plaintiffs who try to convert their contract claims into federal securities claims: "Public policy dictates that sophisticated investors such as these . . . not be allowed to harass on fanciful bases financial institutions which are merely performing the functions that society and the law have created for them." *Id.* at 98,520.

308. 650 F. Supp. 1378 (W.D. Va. 1986), *aff'd*, 840 F.2d 236 (4th Cir. 1988).

309. *Id.* at 1385. Other courts have reached similar conclusions. See, e.g., *Williamson v. Tucker*, 645 F.2d 404, 424-25 (5th Cir.) (plaintiffs' ability to exercise control over enterprise is one factor demonstrating that their interest not a security), *cert. denied*, 454 U.S. 897 (1981); see also Note, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance Over Form*, 54 FORDHAM L. REV. 303, 324-26 (1985) (recommending that sophistication of purchasing general partner be considered in deciding whether partnership interest is a security).

Corp.,³¹⁰ the transaction at issue involved a sale of certain notes, together with a "put" letter. The Ninth Circuit held that the transaction did not involve a security, given the sale's commercial nature and the purchaser's sophistication. As the court stated, "[t]his is not the situation where an unsophisticated investor lacked access to inside financial information."³¹¹ The same court also recently held that interests in oil well leases do not constitute securities when the investors enjoy significant managerial powers and have "a high degree of business acumen."³¹²

Thus, whether a case concerns an investment contract or some other putative security, courts are likely to focus on investor sophistication in characterizing the investment at issue.³¹³ Despite this focus, however, courts make virtually no attempt to justify the relevance of investor sophistication to their analyses. In reading these cases, one develops an impression that judges have a feeling that purchaser sophistication somehow makes a case different from a typical securities case but are unable to articulate a principle that would legitimately make sophistication an issue.

L. *Judicial Treatment of Investor Sophistication and the Need for a Unifying Theory.*

So far this part has identified eleven major areas of securities law affected by investor sophistication: there are others as well.³¹⁴ Indeed, the wide-ranging impact of investor sophistication makes the absence of a unifying theory for the role of sophistication all the more remarkable. Courts that find sophistication relevant seem not to recognize that their *de facto* distinctions are part of a larger phenomenon; almost no cross-reference among these different types of cases seems to be occurring.

310. 557 F.2d 1351 (9th Cir. 1977).

311. *Id.* at 1358.

312. *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1570 (9th Cir. 1987); *see also* *South Carolina Nat'l Bank v. Darmstadter*, 622 F. Supp. 226, 231 (D.S.C. 1985) (boxcars not securities, in part because buyer "an educated, sophisticated businessperson well within her areas of business expertise"); *Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 645-46 (D. Colo. 1970) (restaurant franchise not security, in part because franchise purchasers usually sophisticated businesspeople), *aff'd*, 460 F.2d 666 (10th Cir. 1972).

313. *But cf.* *Securities Indus. Ass'n v. Board of Governors*, 468 U.S. 137, 159 (1984) (rejecting argument that commercial paper is not security for purposes of Glass-Steagall Act because it is purchased primarily by sophisticated investors: "In its prohibition on commercial-bank underwriting, the Act admits of no exception according to the particular investment expertise of the customer.").

314. For example, sophistication is relevant in criminal cases in which the government must allege willful misconduct. *See, e.g.,* *United States v. Massa*, 740 F.2d 629, 641 (8th Cir. 1984), *cert. denied*, 471 U.S. 1115 (1985); *United States v. Van de Carr*, 343 F. Supp. 993, 1009 (C.D. Cal. 1972); *see also* *SEC v. Cooper*, 402 F. Supp. 516, 521-22 (S.D.N.Y. 1975) (finding sophistication relevant in SEC enforcement action).

Moreover, even within the various categories of cases, confusion and sometimes outright disagreement over the relevance of sophistication characterize the courts' inquiries.

Despite this dissaray, it remains possible—and indeed necessary—to develop a coherent set of unifying principles that will justify this disparate treatment.

II. TOWARD A UNIFYING THEORY FOR THE TREATMENT OF SOPHISTICATED INVESTORS

Any theory justifying the distinction between sophisticated and unsophisticated investors must rest on the principles behind the securities laws. This part examines those principles and demonstrates how they can guide courts in applying the securities laws to sophisticated investors. To facilitate accurate application of these principles by courts, an appendix to this Article will present a set of criteria to help judges determine investors' level of sophistication.

A. *Whom Do the Securities Laws Protect?*

Underlying the confused judicial treatment of sophisticated investors is a fundamental disagreement about whom the securities laws protect. Courts not only disagree about the relevance of investor sophistication, they disagree whether the securities laws protect sophisticated investors in the first place.

1. *The Historical Motivation.* As a historical matter, Congress did not design the securities laws to protect investors capable of protecting themselves. The legislative history of the 1933 and 1934 Acts reflects three general concerns. First, Congress was concerned that the average investor was being fleeced in the financial markets by inadequate disclosure, misrepresentation, and manipulative schemes.³¹⁵

Second, Congress worried that predation on individual investors would lead to other, second-order, problems, including a generalized loss of confidence in our capital markets, our financial system, and even in our form of government. As Congressman Sam Rayburn (D-Tex.) put it:

When a people's faith is shaken in a business the business becomes halting and lame; when a people lose faith and confidence in the men who administer the government it follows as the night the day they lose faith in government. Only one thing can follow in the wake of this

315. See S. REP. NO. 792, 73d Cong., 2d Sess. 3-4 (1934), reprinted in 1 SECURITIES LAW COMM., FED. BAR ASS'N, *supra* note 154, at 710-11; S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933), reprinted in 1 SECURITIES LAW COMM., FED. BAR ASS'N, *supra* note 154, at 89; 77 CONG. REC. 937 (1933) (message from President Franklin D. Roosevelt, Mar. 29, 1933).

destroyed confidence, that is, lack of support; and in its wake must follow the evils that attend socialism, bolshevism, and communism.³¹⁶

In addition, some voiced concerns that "honest business" suffered from a competitive disadvantage in the capital markets when faced with unscrupulous sellers of inferior securities.³¹⁷ Others were concerned that industry's ability to sell securities to a guileless public was fueling an expansion of industry without regard to need.³¹⁸ We should not lose sight of the derivative nature of these concerns: Congress perceived a failure of confidence to be the *systemic* effect of multiple abuses of *individual* investors. Likewise, "honest" businesses' competitive disadvantage and unnecessary expansion of production capacity resulted from firms' ability to hawk unsound securities to an unwitting public.

Third, Congress was concerned about the extent to which excess margin was draining the nation's credit resources away from other areas of commerce,³¹⁹ and intended that the 1934 Act's margin provisions would stop that drain and would protect investors from their own excess leverage.³²⁰

Each provision in the 1933 and 1934 Acts reflects one or more of these concerns. Indeed, except for the 1934 Act's margin provisions, the Acts' legislative history shows that nearly every provision was motivated, either directly or indirectly, by concerns with predation on individual investors.

When legislatures enact a statute based on a desire to protect, they will design that statute to reach only those who are perceived to require protection. If the statute also draws others under its protective umbrella, that results only from the legislature's inability to tailor the statute's protection perfectly to the class in need of protection. Justice Stevens recognized this situation in his *Landreth Timber Co. v. Landreth* dissent.³²¹ In that case, the Court rejected the "sale of business" doctrine and held that ordinary common stock is always a security, even when a sale of a business simply uses a stock sale as a medium. Justice Stevens argued in

316. 77 CONG. REC. 2919 (1933) (remarks of Rep. Rayburn).

317. See 77 CONG. REC. 2983 (remarks of Sen. Fletcher) (one purpose of 1933 Act was to "protect honest enterprise . . . against the competition afforded by questionable securities offered to the public through crooked promotion"); *id.* at 2935 (remarks of Rep. Chapman) (one purpose of 1933 Act was to protect "honest corporate business" from "illegitimate competition of financial racketeers").

318. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933), reprinted in 1 SECURITIES LAW COMM., FED. BAR ASS'N, *supra* note 154, at 139.

319. See S. REP. NO. 792, 73d Cong., 2d Sess. 3-4 (1934), reprinted in 1 SECURITIES LAW COMM., FED. BAR ASS'N, *supra* note 154, at 710-11.

320. See 78 CONG. REC. 2264 (1934) (message from President Franklin D. Roosevelt, Feb. 9, 1934).

321. 471 U.S. 681, 698 (1985) (Stevens, J., dissenting).

dissent that "[a]t some level of analysis, the policy of Congress must provide the basis for placing limits on the coverage of the Securities Acts."³²² He then identified Congress's policy: "I believe that Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties."³²³ In light of that policy, Justice Stevens suggested that a business purchaser's sophistication provided enough protection.

Justice Stevens's statement of policy, moreover, expresses a proposition almost universally accepted by the judiciary: Congress enacted the securities laws, except the margin rules, in order to protect those who cannot protect themselves,³²⁴ and not to relieve sophisticated investors from the consequences of their bad investments.³²⁵ The systemic aims of the statutes are merely derivative of the congressional goal of protecting those who cannot protect themselves.³²⁶ As the Ninth Circuit has said: "The purpose of the [1934 Act] 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 Act."³²⁷

The operative question, though, remains: what practical consequences, if any, should follow from our understanding of Congress's motivations? On this point the courts are stuck. Many hold that since

322. *Id.*

323. *Id.*

324. See *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 834 (7th Cir. 1977); *Verace v. New York Stock Exch., Inc.*, 478 F. Supp. 1061, 1064 (S.D.N.Y. 1979); *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,501 (S.D. Cal. June 13, 1974); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 772 (S.D.N.Y. 1968); see also *Neville*, *supra* note 180, at 7 ("[I]t is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor." (quoting *Wilko v. Swan*, 346 U.S. 427, 435 (1953))). But see *Andrews v. Blue*, 489 F.2d 367, 373 (10th Cir. 1973) ("The statute is intended to promote full disclosure to every investor regardless of his particular business background."); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974) ("The federal securities laws do not distinguish between sophisticated and unsophisticated investors, and the protections afforded by [the] antifraud and registration provisions are designed for all investors, whether sophisticated or unsophisticated.").

325. See *Dahl v. Pinter*, 787 F.2d 985, 995 (5th Cir. 1986) (Brown, J., dissenting), *vacated*, 108 S. Ct. 2063 (1988); *Hirsch v. du Pont*, 553 F.2d 750, 763 (2d Cir. 1977); *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860, 860 (S.D.N.Y. 1986); *South Carolina Nat'l Bank v. Darmstadter*, 622 F. Supp. 226, 231 (D.S.C. 1985), *aff'd*, 813 F.2d 403 (1986); *Eriksson v. Galvin*, 484 F. Supp. 1108, 1126 (S.D.N.Y. 1980). Of course, even investors sophisticated for most purposes may become unsophisticated if they lack access to crucial information. See, e.g., *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1228 (S.D.N.Y. 1976) ("Both § 10(b) and Rule 10b-5 are designed to protect the unwary from the unscrupulous. In addition, they attempt to insure that even the most sophisticated investor is not duped simply because he is not privy to information available only to a favored few."), *aff'd*, 565 F.2d 8 (2d Cir. 1977).

326. See *supra* note 315-20.

327. *Royal Air Properties v. Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962).

Congress designed the securities laws to protect unsophisticated investors, the sophisticated are entitled to no protection.³²⁸ Others refuse to limit the securities laws in this way. Although the Fifth Circuit in *Henderson v. Hayden, Stone, Inc.* recognized that "one of the essential purposes of the [1933] Act is to protect innocent purchasers of securities,"³²⁹ and found that the defendant did not fall within that protected group, the court nonetheless permitted recovery under the 1933 Act.³³⁰ The five propositions developed in section B below provide a basis for alleviating this kind of confusion.

2. *The Textual Provisions.* In contrast to Congress's historical motivations for enacting securities statutes, the literal language of the securities laws rarely distinguishes between the sophisticated and the unsophisticated. As Justice Douglas's dissent in *Scherk v. Alberto-Culver Co.* correctly observed, the 1934 Act "does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing securities."³³¹ In fact, many courts have perceived that the securities laws' language is deliberately evenhanded on the issue of investor sophistication; these courts have made such declarations as "sophisticated investors, like all others, are entitled to the truth."³³² Other courts often advert to statutory language in concluding that "[l]arge as well as small investors are protected by the Securities Acts."³³³ Still others refer to specific statutory sections

328. See, e.g., *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073, 1075, 1093-97 (4th Cir. 1979) (refusing to recognize sophisticated investor's private right of action for Regulation T violations); *Hirsch*, 553 F.2d at 760 (refusing to permit sophisticated investor's recovery for alleged violations of New York Stock Exchange rules); *Verace*, 478 F. Supp. at 1064-65 (refusing to permit action by sophisticated investor under section 6 of 1934 Act).

329. 461 F.2d 1069, 1072 (5th Cir. 1972).

330. *Id.*

331. 417 U.S. 506, 526 (1974) (Douglas, J., dissenting).

332. *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973); see also *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973) (quoting *Stier*); *Quincy Co-op. Bank v. A.G. Edwards & Sons*, 655 F. Supp. 78, 84 (D. Mass. 1986) ("sophisticated investors no less than naive ones are entitled to receive correct, material information"), *cert. denied*, 415 U.S. 977 (1974); *In re Olympia Brewing Co. Sec. Litig.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,461, at 92,819 (N.D. Ill. Nov. 13, 1985) ("The sophistication of the investor is immaterial when it comes to plaintiffs' claims based upon misrepresentations and omissions."); *Stoller v. Baldwin-United Corp.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,298, at 92,031 n.12 (S.D. Ohio June 4, 1985) ("it is clear that 'sophisticated investors' are entitled to the protection of the securities laws"); *Spatz v. Borenstein*, 513 F. Supp. 571, 580 (N.D. Ill. 1981) ("securities laws entitle all investors, both the experienced and the novice, to the full and truthful disclosure of material information"); *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1399 (S.D.N.Y. 1974) (citing *Stier*); *Barthe v. Rizzo*, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974) (same).

333. *Welch Foods*, 398 F. Supp. at 1398-99; see also *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1976) ("even sophisticated investors are entitled to the protections of [Rule 10b-5]"); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) ("The speculators and chartists of Wall and Bay Streets are . . . entitled to the same legal protection afforded conservative traders."), *cert. denied*, 394 U.S. 976 (1969); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, [1986-1987 Transfer Binder] Fed.

and note the absence of any distinctions based on investor sophistication.³³⁴

As this discussion suggests, two general lines of cases exist. One emphasizes Congress's motivation, and the other the statutes themselves. Although the lines may appear to run in opposition, they are in fact entirely consistent with each another, and also correct in and of themselves.

B. *Five Propositions Justifying Disparate Treatment of Sophisticated and Unsophisticated Investors.*

The five interrelated points that follow will demonstrate how the historical motivation of the securities laws—protecting those in need of protection—relates to the undeniable evenhandedness of the statutory texts. The propositions will indicate how, in light of that relationship, courts should apply the securities laws to sophisticated investors.

1. *Proposition One: Using Principlist Models Correctly.* The first proposition concerns textual interpretation: there exists a proper relationship between a statute's motivating principles and its text; this relationship, if understood, can guide the statute's application.

In standard principlist modeling,³³⁵ all statutes consist of three elements: a rule, that rule's motivating principles, and the proper zone of application for that rule. The rule is the statutory text itself. The rule's principles consist most often (although not necessarily³³⁶) of the statute's historical motivation. The zone of application refers to the statute's boundaries as courts have applied it over time. A hypothetical statute will illustrate these elements and their proper relationship.

Consider a statute that declares that "no one may walk on the grass." The quoted language expresses the rule, and behind that rule,

Sec. L. Rep. (CCH) ¶ 92,931, at 94,549 (S.D.N.Y. Sept. 23, 1986) ("The securities laws afford protection to all investors, both sophisticated and unsophisticated."); *In re Scientific Control Corp. Sec. Litig.*, 71 F.R.D. 491, 512 (S.D.N.Y. 1976) ("As a general matter, the securities laws do not distinguish between sophisticated and unsophisticated investors . . ."); *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 450 (E.D.N.Y. 1969) (Securities regulations "are for the protection of the entire public, including a careless sophisticate, and not just for the ignorant."), *aff'd*, 422 F.2d 871 (2d Cir. 1970); *cf. Moe v. Coe*, 124 Or. 436, 438-39, 263 P. 925, 925-26 (1928) (sophisticated investors entitled to protection of state blue sky laws).

334. *See, e.g., Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1229 (7th Cir. 1980) ("Section 12(2) does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer."); *Hill York Corp. v. American Int'l Franchises*, 448 F.2d 680, 696 (5th Cir. 1971) (plaintiff's sophistication provides no defense to section 12(2) liability).

335. "Principlism" is the uncontroversial belief that we can use the principles behind a statutory text to improve our understanding of the text. For a more complete discussion of the use of principles in statutory application, see Fletcher, *Principlist Models in the Analysis of Constitutional and Statutory Texts*, 72 IOWA L. REV. 891, 894-99 (1987).

336. *See id.* at 899-900.

several possible principles may exist. Perhaps a relatively narrow principle such as "croquet ruins the grass" motivated the rule's adoption. Alternatively, a much broader principle may lie behind the rule, such as "grass is sacred." The rule's zone of application will include some, and exclude other, conduct; the statute will prohibit only the conduct named in the statute. Thus, walking across the grass would fall within the zone of application and be prohibited, whereas walking on the pavement immediately adjacent to the grass would neither fall within the zone nor be prohibited.

When applied correctly, a statute's three elements—rule, principle, and zone of application—stand in a certain relation to one another. Courts apply statutes erroneously by misunderstanding the nature of this relation among the elements. One common misconception involves what I call "conical principlism." Under this model, one allows a discovered principle, rather than the rule itself, to dictate the scope of the zone of application.³³⁷

Assume, for example, that historical investigation into our hypothetical statute leads to the conclusion that the principle that "grass is sacred" motivated the rule that "no one may walk on the grass." In light of this principle, would the *rule* apply if a person sat on the immediately adjacent pavement and pulled up a handful of grass? The answer is clearly no: this person has not *walked* on the grass. A conical principlist, however, would argue that the rule does apply and has been violated. In his view, the scope of the principle must determine the zone of application, and the conduct here impinges on the principle of sacredness. The conical principlist's mistake is to posit an illegitimate relation between rule, principle, and zone of application. This mistake occurs repeatedly in both statutory and constitutional interpretation, including interpretation of the securities laws.³³⁸

In the proper relation between these three elements, the rule itself, and not the principle, determines the zone of application.³³⁹ Thus, in our example, the grass-puller's conduct falls outside the zone of application because that zone can sweep no wider than the rule itself. Unless conduct involves *walking* on the grass, it is not within the rule's zone of application and therefore cannot violate the statute.³⁴⁰ The principle behind the rule might suggest that other conduct is morally reprehensible,

337. See *id.* at 902-19.

338. See *id.* at 910-13 (discussing mistakes made in *Wilko v. Swan*, 346 U.S. 427 (1953), and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).

339. I term this relation "reflexive principlism." See Fletcher, *supra* note 335, at 899.

340. Of course, difficult cases might allow debate over whether the person has in fact "walked" on the grass. Suppose, for example, that the person does a cartwheel across the grass or crawls across the grass. Is that conduct within the rule? Perhaps; perhaps not. In such cases we must use

but this may be said of many types of conduct that violates no legal rules. The legislature, then, faces the challenge of drafting rules that accurately reflect the principles behind them.

2. *Proposition Two: Taking Text Seriously.* Understanding the first proposition—that there exists a proper relation between a statute's rule, principles, and zone of application—provides a foundation for the second proposition: courts may not legitimately refuse to give sophisticated investors the benefit of rights of action expressly granted by the securities laws.

One cannot overstate the importance, in applying a statute, of understanding the proper relation between the statute's three elements; only such an understanding leads to a legitimate application. In the case of the securities laws, such an understanding tells us that where a statutory provision gives *all* investors a private right of action, courts may not narrow that rule's application by claiming that a narrow principle, such as protecting only unsophisticated investors, motivates the statute. Returning to our hypothetical statute, assume that the rule "no one may walk on the grass" is motivated by a narrow principle: "croquet ruins the grass." Just as non-croquet-players who trample the grass face penalties, so too must sophisticated investors enjoy private rights of action.

Under this proposition, we can reconcile those cases in which courts emphasize narrow principles behind the securities laws³⁴¹ with those in which courts point out that statutory texts themselves draw no distinction between investors based on sophistication.³⁴² True, Congress's enactment of the broad provisions of 1933 and 1934 Acts primarily reflects Congress's belief that those not capable of protecting themselves deserve protection, but that does not alter the fact that the texts of those provisions do not distinguish between the sophisticated and the unsophisticated. Thus, cases such as *Sanders v. John Nuveen & Co.*,³⁴³ which hold that sophisticated investors can raise claims under the express liability provisions of 1933 Act section 12(2), are clearly rightly decided.³⁴⁴ What Congress gives, the courts may not take away by the expedient of inter-

the tools of statutory construction. But the use of these tools does not alter the conclusion that the perceived principle behind a rule cannot dictate the scope of the rule's application. *See id.* at 934-39.

341. *See supra* notes 321-28 and accompanying text.

342. *See supra* notes 329-34 and accompanying text.

343. 619 F.2d 1222, 1229 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).

344. *See also* *Henderson v. Hayden, Stone Inc.*, 461 F.2d 1069, 1072 (5th Cir. 1972) (permitting sophisticated investor to recover under section 12(1) of 1933 Act even though "one of the essential purposes of the Act is to protect innocent purchasers of securities . . . and though [plaintiff] is certainly not the average innocent investor").

pretation in light of motivating principles.³⁴⁵

3. *Proposition Three: Treating Dissimilar Parties Differently.*

Proposition three holds that courts may legitimately treat sophisticated investors differently *even with respect to express rights of action*. This proposition accepts the second proposition's validity, but recognizes that *true evenhandedness* requires us to apply statutes differently in different circumstances. Only a false equality would call on us to apply a neutral principle of law to all actors in an identical fashion. True equality requires us to acknowledge that different circumstances dictate different results.

For that reason, courts that apply the securities laws' sophistication-neutral texts to sophisticated investors may, notwithstanding the texts' neutrality, continue to acknowledge differences in application of the law between sophisticated and unsophisticated investors. For example, given the proper facts, section 12(1) of the 1933 Act entitles any investor to sue for rescission after a sale of unregistered, nonexempt securities.³⁴⁶ Whether such securities are exempt, however, may legitimately depend on an offeree's sophistication.³⁴⁷

Similarly, section 12(2) of the 1933 Act provides an express right of action for an investor who purchases securities from a person who makes material misstatements or omissions in connection with the sale.³⁴⁸ Any purchaser, sophisticated or not, enjoys this right of action.³⁴⁹ However, by providing a defense if a purchaser knew of the untruth or omission at the time of his purchase,³⁵⁰ section 12(2) requires courts to examine sophisticated investors' claims under a brighter light. Because sophisticated investors are more likely to know of untruths or omissions, their section 12(2) claims fail more frequently than those of unsophisticated investors.

In addition, to take up the class action issue discussed above,³⁵¹ sophisticated investors can act as class representatives under Rule 23 of the Federal Rules of Civil Procedure;³⁵² courts cannot disqualify sophisticated investors from acting as class representatives solely because of their

345. *Accord* *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 493 (1985) (courts cannot impose prior criminal conviction requirement in civil RICO actions; such requirement is inconsistent with statute's language and legislative history and would frustrate congressional purpose).

346. 15 U.S.C. § 77f(1) (1982).

347. *See supra* notes 236-77 and accompanying text.

348. 15 U.S.C. § 77f(2).

349. *See, e.g., Sanders*, 619 F.2d at 1229.

350. *Id.*

351. *See supra* notes 182-210 and accompanying text.

352. FED. R. CIV. P. 23.

sophistication, since the rule provides for no such exclusion.³⁵³ But in certain types of class actions—those involving questions of due diligence or reliance—a sophisticated investor might face unique defenses that would prevent him from satisfying Rule 23's typicality requirement.³⁵⁴ Given Rule 23's wording, courts cannot deny *all* sophisticated investors eligibility to represent classes, but in individual cases, sophistication may make an investor an improper class representative.

Likewise, statutes of limitations make no sophistication-based distinctions; they impose the same time limits whether plaintiffs are sophisticated or not.³⁵⁵ In applying statutes of limitations, however, courts must treat sophisticated and unsophisticated investors differently. For example, section 13 of the 1933 Act³⁵⁶ requires a plaintiff to file suit within a certain period of time after a claim arises, and courts apply a due diligence test to determine when a plaintiff should have discovered his claim (which is when the claim is considered to have arisen). Of course, what a diligent sophisticated investor should discover will differ from what a diligent but unsophisticated investor should discover. Thus, although the 1933 Act's limitations provisions make no distinction based on sophistication, sophisticated investors will, as a practical matter, often face a shorter limitations period than will the unsophisticated.

In short, although courts must give sophisticated investors an opportunity to state a claim as long as the statute at issue does not expressly exclude sophisticated investors, courts may—and indeed must, if they are to decide cases justly—continue to treat sophisticated and unsophisticated investors differently. The rules and standards are the same for both types of investors, but these rules and standards differ as applied.

4. *Proposition Four: Applying Judicially Created Law.* Proposition four holds that courts may legitimately refuse to permit sophisticated investors to pursue *implied* causes of action under the federal securities laws. This proposition relates to the second proposition, which recognizes that statutory texts impose certain obligations on courts. As a corollary to that proposition, courts may legitimately treat sophisticated investors distinctively under judge-made law.

353. See, e.g., *Darvin v. International Harvester Co.*, 610 F. Supp. 255, 258 n.6 (S.D.N.Y. 1985) ("The Court rejects the suggestion that plaintiff's status as a sophisticated investor is, in and of itself, sufficient to warrant denial of his application to represent the class . . ."); *Fisher v. Plessey Co.*, 103 F.R.D. 150, 160 (S.D.N.Y. 1984) (sophisticated investors may represent classes in class actions); *In re LTV Sec. Litig.*, 88 F.R.D. 134, 150 (N.D. Tex. 1980) (class representative not disqualified merely because he was an active securities trader and vice president of corporation).

354. See *supra* notes 185-92 and accompanying text.

355. The treatment of sophisticated investors under statutes of limitations is discussed *supra* notes 211-35 and accompanying text.

356. 15 U.S.C. § 77m (1982).

Although a formalistic view of the federal government might portray Congress as lawmaker and the judiciary as law-interpreter, courts undoubtedly make law in at least three ways: (1) by implying rights of action under statutory provisions that grant no express rights of action; (2) by fleshing out vague statutory provisions whose substantive detail Congress has intentionally left to the judiciary; and (3) by developing legal doctrine outside any express statutory mandate. In developing judge-made law, courts attempt to tailor the application of such law in light of its motivating principles.³⁵⁷ Thus, courts can apply judicially created securities law in a manner that protects only those who need protection. In other words, courts can legitimately limit the reach of such law to unsophisticated investors. Exploring this proposition with respect to each type of judicially created law will prove fruitful.

Under the first category, judges may limit their grants of implied rights of action to those whom a statutory provision is intended to protect.³⁵⁸ For example, in *Kardon v. National Gypsum Co.*, a federal district court recognized an implied action for damages under Rule 10b-5 for the first time, limiting the action to certain categories of plaintiffs:

The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if: (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and (b) the interest invaded is one which the enactment is intended to protect.³⁵⁹

In other words, the court granted a private right of action under section 10(b) only to plaintiffs within a class that the statute was intended to protect.

More recent cases have recognized this principle of limitation in connection with the treatment of sophisticated investors. In *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Fourth Circuit held that even if an implied private right of action for Regulation T violations existed, sophisticated plaintiffs would be denied that right.³⁶⁰ The court

357. See, e.g., *Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976) ("The judiciary having created a private cause of action [under Rule 10b-5] soon sensed a need to limit and define it."); see also *Privatizing Disputes*, *supra* note 167, at 428 ("When investor protection is judicially created, the judiciary can and must limit that protection to those whose need prompted the enactment of the securities laws: individual investors not sophisticated enough to protect themselves adequately.").

358. Judges cannot, however, limit rights of action that Congress expressly provides. See *supra* notes 342-45 and accompanying text. For a discussion of the history of implied rights of action under the federal securities laws and the proper role of sophistication in a court's analysis of implied rights of action, see Comment, *supra* note 156.

359. 69 F. Supp. 512, 513 (E.D. Pa. 1946) (quoting RESTATEMENT OF TORTS § 286 (1934)); see *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (citing *Kardon* as first case recognizing private right of action under Rule 10b-5).

360. 603 F.2d 1073, 1093 (4th Cir. 1979); see *supra* notes 149-55 and accompanying text.

noted that the *Restatement (Second) of Torts* provides the most compelling basis for such a right of action under Regulation T. According to the *Restatement*, if a statutory violation causes an injury, a plaintiff may recover only if he falls within the class whose interests the statute seeks to protect.³⁶¹ The court reasoned that since the Federal Reserve Board enacted Regulation T³⁶² to protect unsophisticated investors, the plaintiff, as a sophisticated investor, fell outside the protected class and could claim no entitlement to the private right of action.³⁶³ The court in *Gammage v. Roberts, Scott & Co.* reached the same conclusion, noting that Regulation T was designed to protect "innocent lambs," a characterization that clearly did not apply to the plaintiff in that case.³⁶⁴ As a historical matter, these cases rest on the erroneous assumption that the margin rules exist solely to protect unsophisticated investors from excess leverage. In fact, Congress sought to restrict margin primarily to inhibit available credit from being diverted from what Congress saw as more productive uses.³⁶⁵ The point, however, is not that the above cases were rightly decided, but that they reflect sound methodology. A court may legitimately restrict a private right of action in light of perceived policy.³⁶⁶

As examples of the second type of judicially created law, Richard Danzig has argued that article 2 of the Uniform Commercial Code represents a call to judicial activism,³⁶⁷ "a renunciation of legislative responsibility and power."³⁶⁸ Michael Perry has argued that the Constitution is in many respects an empty vessel that leaves courts free to propound "general, fundamental ethical principles for the moral education and guidance of the political processes."³⁶⁹

The securities laws contain many empty vessels; those provisions give courts opportunities to exclude sophisticated investors from statutory protections. For example, Congress clearly intended the definitions

361. 603 F.2d at 1075.

362. Regulation T, 12 C.F.R. §§ 220.1-.130 (1988), promulgated under authority granted to the Federal Reserve Board in section 7 of the 1934 Act, 15 U.S.C. § 78g (1982), contains the Board's margin limitations.

363. 603 F.2d at 1075. The court's lengthy discussion of the plaintiff's sophistication is notable. See *id.* at 1093-97.

364. [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,501 (S.D. Cal. June 13, 1974).

365. See *supra* notes 319-20.

366. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748-49 (1975); *DMI Furniture, Inc. v. Brown, Kraft & Co.*, 644 F. Supp. 1517, 1528 (C.D. Cal. 1986).

367. Danzig, *A Comment on the Jurisprudence of the Uniform Commercial Code*, 27 STAN. L. REV. 621, 634-35 (1975).

368. *Id.* at 622.

369. Perry, *Abortion, The Public Morals, and the Police Power: The Ethical Function of Substantive Due Process*, 23 UCLA L. REV. 689, 716 (1976).

of "security" in the 1933 and 1934 Acts³⁷⁰ as empty vessels into which courts would pour content.³⁷¹ Those definitions contain long lists of instruments that are, *prima facie*, securities. But each definition also includes a clause that calls upon the judiciary to decide when the context requires exclusion of a listed instrument. The judiciary could conceivably decide that, when sold to sophisticated investors, *none* of the listed instruments are securities under the statute.³⁷² Indeed, the caselaw supports this view: when only sophisticated investors generally purchase a type of instrument, courts are more likely to consider that instrument not a "security."³⁷³

The cases reflect similar movement among courts forced to define the term "tender offer."³⁷⁴ When Congress began to regulate these transactions, it intentionally refused to define the term, leaving the task to the federal judiciary instead.³⁷⁵ Under the courts' definition, a tender offer will more likely exist when only sophisticated investors receive an offer to purchase.³⁷⁶ Faced with such open provisions, the courts have moved toward a scheme that might entirely exclude sophisticated investors from the Williams Act's protections.

370. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1982).

371. As discussed *supra* note 303, Marc Steinberg and William Kaulbach have argued unpersuasively that the definitions of "security" found in the 1933 and 1934 Acts are not empty vessels at all, because the definitions' "context clauses" were meant to refer to textual, not factual contexts.

372. Of course, before making such a sweeping pronouncement, any court would be guided by prudence, and by such Supreme Court cases as *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985), in which the Court held that stock having all the attributes of common stock is always a security. This Article merely suggests the *theoretical* legitimacy of such a judicial position.

373. See *supra* notes 301-13 and accompanying text; cf. *Marine Bank v. Weaver*, 455 U.S. 551 (1982). In *Weaver*, the Supreme Court held that a federally regulated bank's certificate of deposit is not a security for purposes of section 10(b) and Rule 10b-5, in part because the banking regulations' comprehensive scheme of protection make the protection of the securities laws unnecessary:

It is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposits are abundantly protected under the federal banking laws. We therefore hold that the certificate of deposit purchased by the Weavers is not a security.

Id. at 559. The *Weaver* Court applied a judicially implied private right of action and developed a definition of "security" under a clear congressional mandate that the judiciary make the law. For both of these reasons, the Court acted legitimately in circumscribing that law in light of the plaintiff's need for protection. See also *In re SSIW Corp.*, 7 Bankr. 735, 743 (S.D.N.Y. 1980) (in defining term "general public" for purposes of 11 U.S.C. § 101(39) (1982), court must determine whether "particular class of persons affected" needs statute's protection).

374. See *supra* notes 286-300 and accompanying text.

375. See T. HAZEN, *supra* note 146, § 11.13, at 348 ("The federal legislative pattern indicates a congressional intent to retain a flexible definition and to leave the resolution of the issue to the SEC and the federal judiciary."); *Full Disclosure of Corporate Equity Ownership and in Corporate Take-over Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 131 (1967).

376. See *supra* notes 289-300 and accompanying text.

Finally, the third category of judicially created law also limits the extent to which the securities laws protect sophisticated investors. Federal judges are in a sense common law judges, giving substance to the law, and shaping it in light of its purposes as they develop it against the background of statutes. One might even say that common law judges have an obligation to sculpt the law so that it yields no results inconsistent with policies behind a common law rule. Thus, even when the securities laws impose no textual constraints, courts must formulate judge-made securities law in a manner that reflects its motivating principles. As a result, courts may deny legal protection to sophisticated investors if a law is designed to protect only unsophisticated investors.

Of course, nontextual development in the securities field is not common law in the same sense as the law passed on by the English Lords. Reduced to its origins, federal securities law is statutory. Much of this law, however, has developed independently of the original statutes. For example, churning is illegal, purportedly under Rule 10b-5.³⁷⁷ But judicial development of anti-churning rules has long taken place outside of the Rule 10b-5 jurisprudence, and at an even further remove from 1934 Act section 10(b), the statutory basis for Rule 10b-5. Although churning may fit within the sweep of Rule 10b-5, and may involve a deceptive practice for purposes of section 10(b), the judiciary has developed the law on churning in the same way that it has developed constitutional equal protection doctrine: the doctrine has a formal anchor in the text of the rule, but is otherwise almost wholly judicially created, as though the statute has given rise to a body of common law. Given this judicial approach, courts may legitimately limit the application of churning laws in light of the purposes behind their development; because courts created the churning doctrine, they can limit it.

As the caselaw indicates, courts have done exactly that, limiting churning actions to protect only those in need of protection: unsophisticated investors. Churning occurs only where a broker exercises actual or de facto control over a customer's account. Except in those rare cases in which a sophisticated investor has given a broker *actual* control over an account,³⁷⁸ courts are much less likely to allow a sophisticated investor

377. See *supra* note 125 and accompanying text.

378. Courts recognize that if a sophisticated investor gives a broker actual control over trading in an account, the investor's sophistication loses its legal relevance: a sophisticated investor who has relinquished actual control of his account over to another is no different from the most unsophisticated investor. See *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (if investor follows broker's advice, that proves element of control under churning claim, but is not determinative); *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 n.8 (7th Cir. 1983) (plaintiff's lack of sophistication not an absolute requirement for churning claim); see also *supra* notes 129-41 and accompanying text. The importance of treating sophisticated investors no differently from unsophis-

to recover under a churning claim.

Similarly, courts have begun to recognize a "sophisticated investor exception" to the rule of *Wilko v. Swan*,³⁷⁹ another non-text-derived doctrine. Two Terms ago, in *Shearson/American Express, Inc. v. McMahon*, the Supreme Court undercut the *Wilko* doctrine, pointing out that its rationales no longer have vitality, if indeed they ever did.³⁸⁰ Nonetheless, the Court suggested that *Wilko* might remain good law, not because it was correctly decided, but because of strong notions of stare decisis—itsself a common law doctrine.³⁸¹ In this context, courts may freely limit *Wilko* to protect only those unsophisticated investors unable to protect themselves.

The common thread under this fourth proposition is the judicially created nature of much securities law. Even though such law assumes many forms, the principle remains the same: courts may limit judge-made law to protect only those whom courts deem in need of protection. Thus, courts may legitimately refuse to apply judicially created securities law for the protection of sophisticated investors. This is not to say, however, that judges should always refuse to apply such law to sophisticated investors, a point that proposition five takes up.

5. Proposition Five: Recognizing Similarity in Dissimilarity. Proposition five holds that in appropriate cases, courts may legitimately decline to limit application of judge-made securities law to unsophisticated investors. In some situations, permitting sophisticated investors the protection of judicially created law comports with the principles behind the securities laws. Since investor sophistication does not invariably matter, courts have no reason to limit the securities laws' application in all circumstances.

Courts would thus err in holding that sophisticated investors can never sue under Rule 10b-5, even though courts may restrict implied private rights of action under the Rule. For example, in Rule 10b-5 omissions cases, where a sophisticated plaintiff alleges intentional withholding of material information in the face of a duty to disclose, a court should not preclude the sophisticated investor from recovering under Rule 10b-5. Sophistication has no legal relevance unless an investor can put that sophistication to use. As the court pointed out in *McLean v. Alexander*:

ticated investors when sophistication ceases to be legally relevant is discussed *infra* notes 380-84 and accompanying text.

379. 346 U.S. 427 (1953); see *supra* note 176 and accompanying text.

380. See 107 S. Ct. 2332, 2341 (1987); see *supra* notes 357-64 and accompanying text.

381. 107 S. Ct. at 2338-43. But see *supra* note 174 (Supreme Court again reviewing *Wilko* this Term).

Sophisticated investors who possess either special expertise or the resources available to draw upon expertise, may be deemed to have knowledge of certain investments and their attendant risks, whether in fact they do or not and irrespective of whether material information was actually disclosed. Likewise, persons with vast business experience are similarly charged with a high degree of knowledge. *When, however, there is no access to the critical information nor opportunity to discover the fraud, even the sophisticated investor can be defrauded.*³⁸²

In fact, in the 1934 Act, Congress itself recognized sophisticated investors' vulnerability to fraud by concealment.³⁸³

Investor sophistication may also prove irrelevant in certain churning cases.³⁸⁴ As the First Circuit recognized in *Tiernan v. Blyth, Eastman, Dillon & Co.*, "even a sophisticated investor who blindly relinquishes all decisions to a broker may not be in actual control of his account."³⁸⁵ As these examples demonstrate, although courts may legitimately tailor judicially created law in light of its motivating principles, sophistication is not always a relevant distinction.

Collectively, the five propositions discussed above justify disparate treatment of sophisticated and unsophisticated investors. The propositions apply to each of the areas discussed in part I and can resolve the confusion and conflict that has pervaded the judicial treatment of sophisticated investors. As the propositions generally suggest, except where a statute limits the courts, courts should treat the sophisticated investor differently only to the extent that such treatment will bring the securities laws' application in line with their motivating principles.

CONCLUSION

This Article has addressed several issues. It has pointed out that, although the federal securities statutes make almost no distinction between sophisticated and unsophisticated investors, courts do treat them differently. The Article has shown the wide variety of securities cases that often turn on investor sophistication, and has demonstrated the confusion evident in the judicial treatment of these cases. That confusion

382. 420 F. Supp. 1057, 1078 (D. Del. 1976) (citations omitted) (emphasis added).

383. See DISCLOSURE TO INVESTORS, *supra* note 237, at 50 ("No investor, no speculator can safely buy and sell securities . . . without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." (quoting House report on 1934 Act)). Paradoxically, as some commentators have suggested, the truly sophisticated investor makes the most of disclosure; unsophisticated investors pay no attention to it. See Cohen, *supra* note 237, at 1351-55; see also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 565 (E.D.N.Y. 1971) (The unsophisticated investor "cannot by reading the prospectus discern the merit of the offering.").

384. See *supra* note 133 and accompanying text.

385. 719 F.2d 1, 4 n.2 (1st Cir. 1983).

results from two problems, both of which are remedied by the analytical approach suggested in this Article.

First, courts have failed to realize that the issue of investor sophistication arises repeatedly in many different circumstances, a failure that has prevented courts from drawing on important and helpful investor sophistication cases in other areas of securities law. Second, courts have articulated no unifying justification for their treatment of sophisticated investors. In light of its consideration of the various investor sophistication cases, this Article supplies five propositions to guide judicial treatment of sophisticated investors in securities cases. Finally, the appendix that follows presents a set of criteria to help both lawyers and judges effectively evaluate investor sophistication.

To paraphrase Ernest Hemingway, sophisticated investors are different from you and me: they are more sophisticated.³⁸⁶ Although this realization only begins the inquiry into the relevance of investor sophistication, it nevertheless turns out to be important. Sophisticated investors *are* different, and that difference can determine whether a court applies the federal securities laws or dismisses a complaint.

386. See E. HEMINGWAY, *The Snows of Kilimanjaro*, in *THE FIFTH COLUMN AND THE FIRST FORTY-NINE STORIES* (1938):

The rich were dull and they drank too much He remembered poor Julian and his romantic awe of them and how he had started a story once that began, "The very rich are different from you and me." And how someone had said to Julian, "Yes, they have more money."

Interestingly, in the original publication of the story, the line attributed to the character Julian in the passage was attributed to F. Scott Fitzgerald. See Hemingway, *The Snows of Kilimanjaro*, *ESQUIRE*, Aug., 1936, at 27,200. Recent evidence suggests that Hemingway borrowed this famous line from literary critic Mary Colum over lunch in 1936. See M. BRUCCOLI, *SCOTT AND ERNEST* 131 (1978).

APPENDIX: CRITERIA OF INVESTOR SOPHISTICATION

As an American Bar Association committee once observed, sophistication "is a shorthand way of expressing a rather complex thought."³⁸⁷ Although one might be tempted to suggest that the earmarks of sophistication should vary from situation to situation, it turns out that a set of criteria applies almost uniformly in all the types of cases that part I of this Article has discussed.

These criteria fall into three broad groups: (1) financial and business acumen, (2) individual characteristics of sophistication, and (3) investment-specific behavior. Each of these groups also contains a checklist of relevant considerations. It should be emphasized that these considerations are *merely relevant*, and none should determine the outcome of a sophistication inquiry. Rather, courts should review the criteria as a whole, shifting emphasis as appropriate from case to case.

A. *Financial and Business Acumen.*

As a general matter, the most important single criterion of investor sophistication is financial and business acumen, but this concept involves a multifaceted inquiry. The following criteria play a role:

1. *Investment Experience.* An investor with many years of investment experience is more sophisticated than one without such experience.³⁸⁸

2. *Professional Status.* Doctors, lawyers, dentists, and other professionals are more sophisticated than nonprofessionals.³⁸⁹ Of course,

387. *Position Paper*, *supra* note 247.

388. See *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073, 1093-96 (4th Cir. 1979); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373 & n.10 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973); *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1394 (D. Md. 1986); *Zandman v. Joseph*, 102 F.R.D. 924, 931-32 (N.D. Ind. 1984); *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981); *Scarfarotti v. Bache & Co.*, 438 F. Supp. 199, 203-05 (S.D.N.Y. 1977); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823, 825 (S.D. Cal. 1975); *Pollak v. Eastman Dillon*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,987, at 97,408 (S.D.N.Y. Feb. 18, 1975); *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,500 (S.D. Cal. June 13, 1974); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F. Supp. 373, 376-77 (S.D. Tex. 1965). For a detailed analysis of this criterion of sophistication in connection with the private offering exemption, see Soraghan, *supra* note 134, at 24-25.

389. See, e.g., *Stern*, 603 F.2d at 1093-96; *Rivanna Trawlers Unltd. v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 1385 (W.D. Va. 1986), *aff'd*, 840 F.2d 236 (4th Cir. 1988); *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F. Supp. 471, 481-82 (D. Me. 1986); *Smith v. Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,846, at 94,338-43 (D.D.C. Oct. 27, 1982); *Scarfarotti*, 438 F. Supp. at 203-05.

professional status alone does not reveal very much; rather, it signals an investor's education and income level.

3. *History of Speculative Investments.* Investors who have made speculative investments are more sophisticated than those who have in the past eschewed such risk.³⁹⁰

4. *Government or Business Experience.* Such experience leads to sophistication³⁹¹ by, for example, requiring investors to keep abreast of world and financial developments.³⁹²

5. *Professional Experience in the Securities Industry.* It hardly needs saying that an investor employed as a stockbroker or national securities exchange member is likely to be sophisticated.³⁹³

6. *General Familiarity with Securities Transactions.* An investor who has general familiarity with securities transactions is more sophisticated than one without that familiarity.

B. *Individual Characteristics of Sophistication.*

Some investors possess individual characteristics that indicate their sophistication:

1. *Understanding Trading in an Investment Account.* Where a complaint concerns activity in a brokerage account, a plaintiff's under-

390. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 53 & n.2 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Landry*, 473 F.2d at 373 n.10; *Scarfarotti*, 438 F. Supp. at 204.

391. *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1363 (7th Cir. 1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Brooks*, 548 F.2d 615, 616 (5th Cir. 1977); *Rivanna Trawlers*, 650 F. Supp. at 1381; *Xaphes*, 632 F. Supp. at 481; *South Carolina Nat'l Bank v. Darmstadter*, 622 F. Supp. 226, 231 (D.S.C. 1985), *aff'd*, 813 F.2d 403 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987); *Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,338-43; *Barrett v. Triangle Mining Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,438, at 99,211 (S.D.N.Y. Feb. 2, 1976).

392. See *Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,361.

393. See *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 635 (5th Cir. 1977); *Goldberg v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 650 F. Supp. 222, 226 (N.D. Ga. 1986); *Verace v. New York Stock Exch.*, 478 F. Supp. 1061, 1064 (S.D.N.Y. 1979); *Eichen v. E.F. Hutton & Co.*, 402 F. Supp. 823, 824-25 (S.D. Cal. 1975); *Pollak v. Eastman Dillon*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,987, at 97,408 (S.D.N.Y. Feb. 18, 1975); see also *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 486 F. Supp. 56, 58 (E.D. Mo. 1980) (investor's wife was broker); Note, *Due Diligence Requirement*, *supra* note 53, at 773:

If the plaintiff . . . is actually engaged in the securities business, it is proper to presume that the plaintiff has the expertise to understand the statements and recovery will be denied. If the plaintiff is not a broker or regular speculator, then generally more evidence is required before a court will hold that the plaintiff should have understood the confirmation slips.

standing of that activity indicates sophistication.³⁹⁴

2. *Education.* A highly educated investor is more sophisticated than a poorly educated one.³⁹⁵ Advanced degrees, particularly in business or other financially related fields, are especially relevant.³⁹⁶

3. *Special Access to Information.* In securities cases turning on access to information,³⁹⁷ an investor's special access to relevant information makes him more sophisticated.³⁹⁸

4. *Intelligence.* An investor with limited intellectual ability, unable to analyze available information, is less sophisticated than an intelligent investor.³⁹⁹

5. *Age.* The very old and the very young are particularly vulnerable to predation in securities transactions.⁴⁰⁰ Thus, extremities of age suggest a lack of sophistication.

6. *Wealth and Income.* In many cases, courts have suggested that high income levels or wealth indicate sophistication.⁴⁰¹ In fact, Congress and the SEC have taken the position that wealthy individuals do not need the protections offered by registration of securities under the

394. See *Brooks*, 548 F.2d at 616; *Landry*, 473 F.2d at 373 n.10; *Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,345-55; *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981).

395. See *Costello*, 711 F.2d at 1363; *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1393 (D. Md. 1986); *South Carolina Nat'l Bank*, 622 F. Supp. at 231; *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 956 (E.D. Mich. 1978); *Barrett v. Triangle Mining Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,438, at 99,211 (S.D.N.Y. 1976); *Pollak*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,408 n.2; *Gammage v. Roberts, Scott & Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,760, at 96,500 (S.D. Cal. June 13, 1974).

396. See *Barrett*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. at 99,211; *Pollak*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,408 n.2; *Gammage*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 96,500.

397. See, e.g., *supra* notes 241-67 and accompanying text (discussing private offering exemption under section 4(2) of 1933 Act).

398. See, e.g., *Rochambeau v. Brent Exploration, Inc.*, 79 F.R.D. 381, 385 (D. Colo. 1978) (interpreting exemption from Colorado filing requirement).

399. See *Nunes*, 635 F. Supp. at 1394 (citing *Follansbec v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982)); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocoock*, 247 F. Supp. 373, 376 (S.D. Tex. 1965).

400. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 954 (E.D. Mich. 1978); *Bocoock*, 247 F. Supp. at 376-77.

401. See, e.g., *Xaples v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F. Supp. 471, 481 (D. Me. 1986); see also *Position Paper*, *supra* note 247, at 491-95 (discussing relevance of wealth in private offering exemption); *Soraghan*, *supra* note 134, at 41 (same).

1933 Act.⁴⁰² Although courts should consider an investor's ability to bear economic risk, they should also be sensitive to the fact that rich investors can do stupid things.⁴⁰³ Indeed, the wealthy but naive investor is arguably the most vulnerable to securities fraud.⁴⁰⁴

C. *Investment-Specific Behavior.*

How an investor behaves with respect to her investments indicates her degree of sophistication. Relevant types of behavior follow:

1. *Regular Consultation with Investment Professionals.* Confer-ring regularly with a broker or other investment advisor indicates an investor's sophistication.⁴⁰⁵

2. *Number of Brokerage Accounts.* Maintaining several broker-age accounts over time indicates sophistication.⁴⁰⁶

3. *Stock Club Membership.* Membership in an investment pool suggests sophistication.⁴⁰⁷

4. *Amount of Money Invested.* Some investors put hundreds of thousands or even millions of dollars at risk in securities investments; such investments show sophistication,⁴⁰⁸ but subject to the above cau-tionary remarks about the criteria of wealth and income.⁴⁰⁹

5. *Scrutiny over Investment Accounts.* An investor who diligently monitors the trading in her investment account is sophisticated.⁴¹⁰

402. See 15 U.S.C. § 77d(6) (1982) (registration exemption for sales solely to "accredited investors," who are either wealthy or institutional); 17 C.F.R. § 230.505, .506 (1988) (registration exemption for sales to limited numbers of investors, with "accredited investors" not included in total).

403. See *Privatizing Disputes*, *supra* note 167, at 429-30.

404. See *id.* at 430.

405. See *Zandman v. Joseph*, 102 F.R.D. 924, 931-32 (N.D. Ind. 1984); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1, 7 (N.D. Ill. 1977); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975).

406. See *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 53 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Marshak*, 413 F. Supp. at 381.

407. See, e.g., *Marshak*, 413 F. Supp. at 381.

408. See *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073, 1093-97 (4th Cir. 1979) (hundreds of thousands of dollars worth of options trades); *Rolf*, 570 F.2d at 53 & n.2 (\$2,000,000 invested); *Zandman*, 102 F.R.D. at 931-32 (approximately \$3,000,000 invested).

409. See *supra* text accompanying notes 400-01.

410. See *Rolf*, 570 F.2d at 53 & n.2; *Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 632 F. Supp. 471, 481 (D. Me. 1986).

6. *Attending Investment Conferences.* At least one court has found investors' attendance of investment seminars and conferences relevant to their sophistication.⁴¹¹

7. *Subscribing to Financial or Investment Journals.* A staggering number of periodicals—such as—*The Wall Street Journal*, *Barron's*, *Investor's Daily*, *Forbes*, *Business Week*, *Financial World*, *Fortune*, as well as the many investment advisory services like *Value Line*—are targeted at investors. An investor who subscribes to, or regularly reads, such publications is sophisticated.⁴¹²

8. *Viewing Financial Television Programming.* Similarly, an investor who watches the Financial News Network, *The Nightly Business Report*, *Wall Street Week*, or similar programs is sophisticated.⁴¹³

9. *Reviewing Confirmation Slips or Monthly Statements.* Investors who review post-trade confirmation slips and read monthly statements are sophisticated.⁴¹⁴ Some courts have even found sophistication based solely on a plaintiff's receipt of confirmation slips or monthly statements.⁴¹⁵ Such a finding, however, goes too far. A court may consider receipt of such slips or statements to determine whether an investor should be estopped from complaining of transactions described in the slips or statements, but mere receipt of these materials has no relevance to sophistication.

D. *The Special Status of Institutional Investors.*

The appropriateness of presuming that all institutional investors are sophisticated deserves one final word. Such a presumption should exist, and it should be a conclusive presumption. As Dean Robert Clark has written: "Institutional investors are usually sophisticated and powerful enough to demand and get the information they need before committing their money. The legal system does not have to protect them with a

411. See *Zandman*, 102 F.R.D. at 931-32.

412. See *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373 n.10 (1st Cir.), cert. denied, 414 U.S. 1002 (1973); *Xaphes*, 632 F. Supp. at 481; *Smith v. Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,846, at 94,361 (D.D.C. Oct. 27, 1982); *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 486 F. Supp. 56, 58 (E.D. Mo. 1980); *Helfand v. Cenco, Inc.*, 80 F.R.D. 1, 7 (N.D. Ill. 1977); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975).

413. See, e.g., *Xaphes*, 632 F. Supp. at 481.

414. See *Landry*, 473 F.2d at 373 n.10; *Xaphes*, 632 F. Supp. at 481; *Sade & Co.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 94,345, 94,350; *Altschul v. Paine, Webber, Jackson & Curtis Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981).

415. See *Marshak*, 413 F. Supp. at 381; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F. Supp. 373, 376-78 (S.D. Tex. 1965).

superimposed mandatory disclosure system."⁴¹⁶

Indeed, courts seem inclined to consider institutional investors at least *prima facie* sophisticated.⁴¹⁷ Even Congress⁴¹⁸ and the SEC⁴¹⁹ have recently taken positions indicating their views that institutional investors are especially sophisticated. Although some institutions may lack sophistication in investment matters,⁴²⁰ the law should encourage them to have sophisticated parties invest on their behalf.

416. R. CLARK, CORPORATE LAW 730 (1986).

417. See, e.g., *J.H. Cohn & Co. v. American Appraisal Assocs.*, 628 F.2d 994, 998 (7th Cir. 1980); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 472 F. Supp. 402, 408 (D. Colo. 1979), *aff'd*, 651 F.2d 687 (10th Cir.), *cert. denied*, 454 U.S. 895 (1981); *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 449 F. Supp. 951, 961 (S.D.N.Y.), *aff'd in part and rev'd in part*, 584 F.2d 1195 (2d Cir. 1978); *Seiden v. Nicholson*, 72 F.R.D. 201, 205 (N.D. Ill. 1976); *Pierre J. LeLandais & Co. v. MDS-Atron, Inc.*, 387 F. Supp. 1310, 1314 (S.D.N.Y. 1974); see also *McConnell v. Surak*, 774 F.2d 746, 750 (7th Cir. 1985) (interpreting Illinois statute that provides for registration exemption in cases of sales to "sophisticated investors," a term that automatically includes certain institutions).

418. See 19 Sec. Reg. & L. Rep. (BNA) No. 11, at 386 (Mar. 13, 1987) (House subcommittee report questions relevance of traditional notions of shareholder protection where market dominated by sophisticated institutional investors).

419. See 19 Sec. Reg. & L. Rep. (BNA) No. 33, at 1245 (Aug. 14, 1987) (new Rule 144A would allow resales of unregistered securities to qualified institutional investors in recognition that such investors do not need protection of registration); 19 Sec. Reg. & L. Rep. (BNA) No. 3, at 85 (Jan. 16, 1987) (proposed Regulation D changes would provide for exempt sales to employee stock option plans); see also 20 Sec. Reg. & L. Rep. (BNA) No. 1, at 6 (Jan. 8, 1988) (American Stock Exchange requests SEC approval for SITUS (System for Institutional Trading of Unregistered Securities), which would permit domestic trading of unregistered foreign securities by institutional investors, who "do not require the protection of the registration and periodic reporting provisions of the U.S. securities laws.").

420. See, e.g., *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F. Supp. 1393, 1399 n.1 (S.D.N.Y. 1974).