

# Legal Issues Arising from Online Investing

by [Robert C. Port](#)

It seems as though we are bombarded daily with ads touting the virtues of on-line investing. TV ads show taxicab drivers pulling their yacht behind their cabs, and truck drivers have pictures of the Caribbean Island they own clipped to their rear-view mirrors. However, as the recent crash of the stock market has proven yet again, investing is not a game, and many who thought they could click their way to riches by trading on-line have quickly decimated years of savings.

In an environment like this, it is tempting to try to blame someone else for the losses suffered in the stock market. However, when the losses occur because of self-directed on-line activity, many of the traditional claims that could be asserted against a broker or brokerage firm -- such as churning,<sup>1</sup> unauthorized trading,<sup>2</sup> or unsuitable recommendations<sup>3</sup> -- may not apply. However, certain fact patterns and circumstances might provide an on-line investor with possible causes of action if brokerage firms do not properly execute their duties in offering such on-line capabilities.

Recent pronouncements by the National Association of Securities Dealers, Inc. ("NASD") are instructive as to some of the claims that might be available to an on-line investor. The NASD is a "self-regulatory organization" ("SRO") established under the authority of Sections 15A (15 U.S.C. §78o-3) and 19 (15 U.S.C. §78s) of the Securities Exchange Act of 1934. Congress directed the SRO's to promulgate rules which are "designed to prevent fraudulent and manipulative acts and practices, to promote just

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<sup>1</sup> Churning occurs when a broker buys and sells securities for a customer's account, "without regard to the customer's investment interests, for the purpose of generating commissions." Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983).

<sup>2</sup> Unauthorized trading occurs when a broker effects trades in a client's account without having either written or oral authority to do so. "No member, allied member or employee of a member organization shall exercise any discretionary power in any customer account . . . without obtaining written authorization of the customer." NYSE Rule 408(a); NASD Conduct Rule 2510; Gochnauer v. A.G. Edwards-&-Sons, 810 F. 2d 1042, 1049 (11th Cir. 1987) (describing the broker's "duty to transact business only after receiving approval from the customer").

<sup>3</sup> "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." NASD Conduct Rule 2310(a).

and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. . . ." 15 U.S.C. §78o-3(b)(6).

## **Brokers Duties to Customers**

Among the most fundamental of the rules promulgated by the NASD are the "Know Your Customer Rule" and the "Suitability Rule". The "Know Your Customer Rule", NASD Conduct Rule 2310(b), places a duty upon brokers to have an understanding of their customer's financial needs, investment objectives, and other pertinent information before making a recommendation to that customer to buy or sell a security.<sup>4</sup> The New York Stock Exchange ("NYSE") and American Stock Exchange ("AMEX") have similar rules. NYSE Rule 405(1); AMEX Rule 411.

Working hand-in-hand with the "Know Your Customer Rule", the "Suitability Rule", NASD Conduct Rule 2310(a), requires that the broker have a reasonable basis for believing that a securities transaction recommended to a customer is suitable for the customer, in light of the customer's own financial and other circumstances.<sup>5</sup> The NASD has made clear that a "recommendation", and hence the applicability of suitability requirements, is a fact specific inquiry. In particular, in NASD Notice To Members 96-60 (Sept. 1996), the NASD advised that "a transaction will be considered recommended when the member or its associated person brings a specific security to the attention of the customer through any means including, but not limited to, direct telephone communications, the delivery of promotional material through the mail, or the transmission of electronic

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<sup>4</sup> The Rule provides in full as follows:

Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

<sup>5</sup> The Rule provides in full as follows:

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

messages." (Emphasis Added). The NYSE has adopted a similar approach. "For purposes of these standards, the term 'recommendation' includes any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a security." NYSE Supplementary Material to Rule 472, Communications With The Public, No. 90-5.

In addition to the rules and guidance issued by the SRO's, state and federal statutory and common law, as well as state and federal regulatory pronouncements, address the obligations a broker and brokerage firm owe to a customer. Under Georgia law, a confidential, fiduciary relationship exists between a broker and his client. See, e.g., E. F. Hutton & Co. v. Weeks, 166 Ga. App. 443, 445, 304 S.E.2d 420, 422 (1982) ("[T]he broker's duty to account to its customer is fiduciary in nature, resulting in an obligation to exercise the utmost good faith."). In addition to the causes of action provided by common law fraud claims, both state and federal law and regulation prohibit false, misleading, or manipulative practices with regard to securities transactions. See, e.g., Section 10 of the Securities Exchange Act, 15 U.S.C. § 78j(b) (prohibiting manipulative and deceptive practices); 17 C.F.R. 240.10b-5 ("Rule 10b-5"; same); O.C.G.A. §10-5-14(a)(2) (same).

### **On-Line Trading Issues**

How do these statutes, rules and administrative pronouncement apply to on-line trading? The NASD has identified at least three areas of concern: (i) the ability of brokerage firms to handle the trading volume that on-line investors can generate; (ii) full disclosure of, and the accuracy of, the information presented on-line; and (iii) the possibility that on-line information might be deemed a "recommendation" to purchase a security, thus triggering the suitability rule. These concerns were addressed in two recent "Notices to Members" issued by the NASD.

In Notice to Members 99-11, entitled "*NASD Regulation Issues Guidance Regarding Stock Volatility*" (February 1999) the NASD reminded firms "first and foremost" of their obligation to ensure that they have adequate systems capacity to handle high volume or high volatility trading days. The NASD also provided specific guidance for brokerage firms on the following issues:

- Disclosure of Possible Delays: The NASD suggested that firms consider disclosing that high volumes of trading may cause delays in the transaction, and the transaction might be at prices

significantly different from what was shown on the web site at the time the order was placed.

- Lack of Access May Cause Delays. The NASD suggested that firms consider alerting customers that they may suffer losses during periods of volatility when systems problems result in inability to place buy or sell orders.
- Truthful Advertisements as to On-line Capabilities. The NASD advised that firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services, but these claims must not exaggerate the capabilities of the web site.

Further, in Notice to Members 01-23 entitled "*Suitability Rule And Online Communications*" (April 2001), the NASD concluded that suitability requirements applied to on-line trading, if it can reasonably be found that a broker "recommended" a security. "[T]he test for determining whether any communication (electronic or traditional) constitutes a 'recommendation' remains a 'facts and circumstances' inquiry to be conducted on a case-by-case basis." Notice to Members 01-23, p. 2.

The Notice provided examples of on-line communications that might be viewed as "recommendations", triggering the suitability rule:

- Emails urging the purchase of a security.
- Emails suggesting investments should be made in certain sectors, and urging purchase of securities from list of "buy" recommendations of the firm.
- Providing research tools for the customer, which the firm then uses to provide a list of securities that should be purchased in light of the information provided by the customer's use of such tools.
- Analyzing a customer's on-line activity, and then using such information to suggest that the customer purchase certain securities.

In contrast, the NASD gave examples of on-line activity that would not constitute a recommendation:

- Providing research reports, news, quotes, or charts through a Web site, which are not restricted to securities recommended by the firm.
- Providing research tools and screens that enable a customer to evaluate securities of their choosing.¶
- Providing “watch lists” or other email subscription services for investment information as selected by the customer.

### **Conclusion**

It seems as though everyone has heard of the ‘friend of a friend’ who has made a ‘killing’ in the stock market. Until recently, the market has been especially good to investors, with double digit returns seemingly the norm. Financial news and magazines offering investment advice are everywhere, and Internet bulletin boards and chat rooms are filled with people claiming to have identified the next Microsoft, Yahoo, or Cisco.

In this environment, investors can easily develop a false sense of security, and be enticed to engage in on-line trading. Because such activity is self-directed, many of the usual legal claims that might be available to a customer who deals directly with a broker are not available to those trading on-line. However, even though such trading is self directed, brokerage firms must provide adequate systems to handle such on-line trading, and must honor their “suitability” and “know the customer” obligations if the web site or on-line activity might be viewed as a recommendation to buy or sell securities.

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