Report of the Division of Securities and Retail Franchising of the Virginia State Corporation Commission on the Statutory and Regulatory Requirements Concerning Broker-Dealers Who Provide Discount Brokerage Services

STATE CORPORATION COMMISSION
DIVISION OF SECURITIES AND RETAIL FRANCHISING

STAFF

Ronald W. Thomas
Director

Garland H. Sharp III
Chief Broker - Dealer Examiner

Brian A. Calub
Legal Assistant

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EXECUTIVE SUMMARY

By letter dated March 10, 2000, Speaker of the House of Delegates, S. Vance Wilkins, Jr., asked the Virginia State Corporation Commission ("Commission") to conduct an in depth study of on-line and off-line discount brokerage firms to determine the feasibility and necessity of requiring disclosure and suitability interviews for high-risk securities accounts. Accordingly, the Commission agreed to conduct the study by providing staff and conducting the study by utilizing the Commission's numerous information resources.

Pursuant to a request from the Speaker of the House of Delegates, the Commission prepared this report to include discussion of:

(1) federal, Self Regulatory Organization ("SRO"), and state suitability requirements;

(2) recent developments in the brokerage industry and market place;

(3) recent regulatory agency actions;

(4) Virginia's current suitability requirements;

(5) a survey of a small sample of Virginia investors and an extensive survey of recent customer complaints against discount brokerage firms to examine customer concerns, interests; and

(6) the study's findings and recommendations for addressing the issue of on-line and off-line discount brokerage suitability and disclosure requirements.

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As a part of the continuing development of the highly successful off-line or "brick and mortar" discount brokerage industry, the on-line brokerage industry has enjoyed tremendous growth since 1998. For the most part there are three distinct types of firms that provide on-line brokerage services. The first type of firm is the "hybrid firm." Hybrid on-line brokerage firms are full-service brokerage firms that also offer their customer's investment advice along with the ability to place trades on-line.

The second type of firm is the on-line discount brokerage firm. Much like traditional "brick and mortar" discount brokerage firms, on-line discount brokerage firms are firms that offer their customers order placement services. Unlike hybrid firms or full-service brokerage firms, on-line and off-line discount brokerage firms provide their customers the ability to place trades to market without offering any investment advice. In general, trades placed with on-line and off-line discount brokerage firms are unsolicited trades placed at the sole discretion of the customer. Thus, the commission fees customers pay to on-line or off-line discount brokerage firms are usually less than the fees paid by customers of hybrid firms or full-service brokerage firms.

The third and final type of on-line brokerage firm is the day trading firm. Day trading firms offer their customers access to both software and information technology systems that allow the customer to view market-makers' bid and ask prices for stocks. Day trading firms' information technologies also provide customers with direct access to financial markets. Therefore, the trades placed with a day trading firm are immediately executed once the customer enters the trade on the day trading firm's system. Day trading firms are a separate class of on-line brokerage service provider that is not related to either on-line discount brokerage firms or hybrid firms. Promotion of numerous intra-day trades and momentum trading characterizes the practices of day trading firms.

During the course of the study the Commission made three significant findings that form the impetus for the Commission's recommendations. The findings are as follows:

(1) Virginia's current statutory requirements generally provide sufficient enforcement authority for the Commission to prevent and prosecute violations of widely accepted suitability rules.

(2) There is still a need for extensive disclosure and educational programs for on-line investors.

(3) There does not seem to be an overwhelming epidemic of problems with on-line brokerage accounts in the state of Virginia.

<u>Virginia's current statutory requirements provide sufficient enforcement authority for the Commission to prevent and prosecute violations of widely accepted suitability rules.</u>

The Virginia Securities Act ("Act"), under section 13.1-523, grants the Commission the authority to adopt such disclosure and suitability rules as are necessary to carry out the provisions under the Act. Any rules changes contemplated by this report can be accomplished through the Commission's rule making authority.

Presently, Virginia follows the majority of jurisdictions that have suitability rules. Virginia's suitability rules are substantially similar to the suitability language used by the North American Securities Administrators Association ("NASAA"). [1] 21 V.A.C. 5-20-280 A2 to 3 provides the Commission with the authority to investigate suitability complaints brought by investors. Furthermore, 21 V.A.C. 5-20-280A2 to 3 in conjunction with 21 V.A.C. 5-20-270A2 creates an affirmative duty for broker-dealers[2] to solicit financial suitability information from investors. Therefore, broker-dealers must

[1] The North American Securities Administrators Association or "NASAA" is a voluntary association whose membership consists of 66 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for investor protection and efficient capital formation. (More information about NASAA can be found at www.NASAA.org.)
[2] The term "broker-dealer" refers to "any person selling any type of security other than an interest in or unit in condominium . . . for the account of others or for his own account otherwise than through a broker or agent." (defined in the Virginia Securities Act, § 13.1-501).

learn of the financial capacity of an investor and must also use that information when considering the suitability or appropriateness of a securities recommendation, whether the broker-dealer operates on-line or off-line.

The current suitability scheme also affords investors the freedom to invest quickly and efficiently taking advantage of the efficiencies and savings delivered by discount brokerage services that only offer order execution services. Therefore, the Commission's current suitability rules allow self-directed investors to trade without the burden of having their trade placement and execution slowed by a manual suitability analysis. However, the suitability rule automatically becomes applicable in situations where self-directed investors receive some sort of recommendation or solicitation from their discount broker-dealer or broker-dealer agent. The need for further government intervention in the realm of self-directed trading is not pressing because investor problems in this area are not widespread throughout self-directed investors. In fact, the discovery that less than one percent of self-directed on-line trading account holders make complaints regarding problems shows that a large majority of self-directed investors do not need regulatory assistance to protect their financial interests. The enactment of more regulations requiring across the board suitability may significantly reduce the efficiencies of the order execution process to the detriment of competent self-directed investors who are more concerned with speed and efficiency than some form of government or institutional oversight.

On the other hand, there appears to be a need for the Commission to pursue adoption of rules addressing suitability, disclosure, and margin requirements regarding day traders. Possible rules are discussed in detail in this report.

<u>There is still a need for extensive disclosure and education programs for on-line investors.</u>

Most on-line broker-dealers provide the on-line investor with a wealth of market information. However, consumers do not receive a wealth of information that discloses all of the risks involved with on-line investing. Furthermore, if an on-line brokerage firm provides disclosure of the risks involved with on-line investing, then the information may not always be easily accessible nor conspicuously noticeable amid all the other information offered by the on-line firm. The level of complaints, as well as input from customers surveyed, indicates that novice investors feel that they want and need clearer investor education information and website operations disclosure.

<u>There does not seem to be an overwhelming epidemic of problems with online brokerage accounts in the Commonwealth of Virginia.</u>

Although the study documented over four hundred complaints of Virginians with on-line brokerage accounts during the first four months of the year 2000, the number of account holders that made complaints represent less that one percent of the total number of on-line account holders associated with the firms examined during the course of the study. Furthermore, although there were more complaints in the four-month period examined in the year 2000 than the number of complaints examined during the six-month period in 1999, the increase in complaints does not necessarily mean that on-line brokerage firms' suffered a deterioration in their service capacities. Numerous articles and reports noted a large increase in the number of on-line investors. The increase in complaints for the smaller time period is logical given the large growth in on-line investment accounts and does not necessarily indicate degrading service quality in the on-line brokerage industry. In fact, year 2000 access complaints were considerably reduced when compared to the access complaints documented during the 1999 survey of Virginia on-line brokerage complaints.

In light of the study's findings, the Commission makes the following recommendations:

(1) All firms should increase and improve their risk disclosure and investor education schemes.

(2) On-line brokerage firms should strive to make websites and on-line trading systems more user friendly.

(3) On-line brokerage firms should collect suitability information even if the firm does not make recommendations. Furthermore, if technically feasible, on-line firms should utilize the collected suitability information to provide an automated suitability warning service available at the option of the on-line investor.

(4) Virginia, NASAA, the Securities and Exchange Commission ("SEC"), and Self Regulatory Organizations ("SROs") should continue to monitor trends and practices within the on-line brokerage industry. The organizations should also aggressively prosecute irresponsible and misleading advertisers.

(5) Virginia, NASAA, the SEC, and SROs should consider other uniform measures of investor protection and education that may be applicable to both on-line firms and off-line firms. A good starting point would be the best practices noted in this report.

(6) In regards to day trading, the Commission should consider working through NASAA to adopt a uniform rule that recognizes and adopts rules similar to the National Association of Securities Dealers[3] ("NASD") Rules 2360 and 2361.[4]

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[3] The National Association of Securities Dealers, Inc. or NASD is a securities industry self-regulatory organization that, through its subsidiaries, NASD Regulation, Inc. and the NASD Stock Market, Inc., develops rules and regulations, conducts regulatory reviews of members' business activities, disciplines violators, and designs, operates, and regulates securities markets and services all for the ultimate benefit and protection of the investor. (For more information about the NASD, visit their website at www.NASD.com)

[4] New Rules 2360 and 2361 focus on disclosing the basic risks of engaging in a day-trading strategy and assessing the appropriateness of day trading strategies for individuals pursuant to suitability analysis. In particular, these two proposed rules would require a firm that is "promoting a day-trading strategy," directly or indirectly, to deliver a specified risk disclosure statement to a non-institutional customer prior to opening an account for the customer. In addition to the risk disclosure statement, the Rules 2360 and 2361

(7) In regards to margin trading, the Commission should consider coordinating with NASAA to adopt a uniform rule that captures the day trading margin rules stated in NASD 2520.

(8) By letter from the Commission, Virginia should recommend to NASAA that it conduct a nationwide survey of on-line and off-line discount brokerage account holders.

<u>All firms should increase and improve their risk disclosure and investor education schemes.</u>

All firms should endeavor to divulge more information that accurately and fully describes the risks of fast market trading because of difficulties associated with placing on-line orders and having them executed during such fast market conditions. Also, more information describing how firms route orders to market and how market makers execute orders is necessary to make on-line investors' expectations match on-line brokerage firms' current levels of performance. All disclosures and educational material should be readily available to the consumer and easy to access. Furthermore, the Commission should act swiftly to deter any attempts to revive the misleading advertising by on-line brokerage firms characteristic of 1998 and 1999.

On-line and off-line brokerage firms should also increase disclosure of the rights, obligations, and risks involved in margin trading. The margin information and risk disclosure should be in a conspicuous place and described in plain and simple language. Furthermore, on-line brokerage firms should improve teaching customers how to use and manipulate the on-line trading system to decrease user errors. Providing some sort of systems training manual in a conspicuous and easily understandable manner would greatly assist on-line brokerage firms' customers. If the firms fail to strengthen the disclosures in these areas, the Commission should consider working with NASAA to adopt uniform disclosure guidelines to compel on-line brokerage firms to provide plain English disclosures to Virginia citizens.

<u>The website and on-line trading system should be more user friendly.</u>

Many of the websites offered by on-line brokerage firms have a wealth of market and investment information that the on-line investor may review. However, there is very little information on most websites that addresses technical issues in regards to manipulation of the many features offered on the website. Thus, on-line firms appear to assume that most on-line investors have a high level of computer proficiency and that the on-line brokerage firms' systems are simple to use. However, the study's research

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would require a firm to either: (1) approve the customer's account for day trading; or (2) obtain a written agreement from the customer stating that the customer does not intend to use the account for day-trading activities. *See*, Order Approving Proposed Rule Changes Relating to the Opening of Day Trading Accounts, 65 Fed. Reg. 44,082 (approved July 10, 2000). Once receiving approval, the NASD made Rules 2360 and 2361 effective on October 16, 2000.

showed that a high level of computer proficiency is not always the case for on-line investors.

Unfortunately, this has led to many consumer errors because there is frequently no "owners manual" that an on-line investor can reference if he or she gets confused. Although almost all on-line brokerage firms offer technical assistance over the phone, such live help is neither always timely nor effective. It would be helpful if an operations manual of some kind augmented the live technical assistance.

<u>On-line and off-line brokerage firms should collect suitability information even if the firm does not make recommendations.</u>

On-line and off-line firms that do not make recommendations should gather suitability information to protect their financial interests and their customers' financial interests. On-line and off-line brokerage firms need the invested assets of investors to remain solvent. Suitability information can help on-line brokerage firms warn the investors of transactions that have a high risk of failure and are not consistent with their investment objectives. Furthermore, a pre-trade or post-trade transaction review, similar to systems in use at certain full-service firms and hybrid firms, may help on-line investment firms warn investors to preserve assets through long-term trading strategies. On-line and off-line brokerage firms may offer the pre-trade or post-trade review as a value-added service. On-line and off-line firms should be free to develop this technology without extraneous interference from regulatory agencies in situations where the firms clearly did not recommend particular securities transactions.

<u>Virginia, NASAA, the SEC, and SROs should continue to monitor trends and practices within the on-line brokerage industry.</u>

Since on-line brokerage services are becoming more and more of an integral part of the financial investments industry, Virginia, NASAA, the SEC, and SROs have an increasing responsibility to make sure that on-line brokerage firms do not abuse current rules. Regulatory agencies must also consistently evaluate on-line brokerage firms' business practices as well as current proposed rules to identify the best practices that maximize investor protection and the firms' financial solvency. The key issues here are that investor protection and firm solvency are necessary to maintain the overall efficiency and life of the market. Working through NASAA and other regulatory agencies allows the Commission to be consistent with other states.

<u>Virginia, NASAA, the SEC, and SROs should consider uniform measures of investor protections that are applicable to both on-line firms and off-line firms.</u>

The need for uniform rules is of paramount importance to both regulators and members of the on-line and off-line brokerage industries. Uniform rules allow firms to efficiently transact business in various jurisdictions, because they provide a consistent means of enforcement and a uniform set of standards applicable to both on-line and off-line firms. A uniform rule that is applicable to on-line and off-line firms ensures a level playing field between the two types of brokerage firms. Therefore, investors can expect similar services and should have similar treatment whether the investor uses an on-line or off-line firm. Working with NASAA and other regulatory agencies would allow the Commission to assist in the creation of uniform rules that would be consistent throughout the states and would also allow the Commission to make a significant contribution to the development of national investor protection policy. A good starting point to consider is the best practices noted in this report.

In regards to day trading, the Commission should consider adopting rules through NASAA that recognize and adopt rules similar to NASD Rules 2360 and 2361.

The Commission should consider adopting rules similar to the new day trading rules adopted by the NASD and approved by the SEC. NASD Rules 2360 and 2361 make suitability determination mandatory for day trading firms. A similar requirement by the Commission would show that the Commission also expects day trading firms registered in Virginia to make such suitability determinations. Recognizing and adopting rules similar to NASD Rules 2360 and 2361 would also mandate risk disclosures and give the Commission the ability to bring actions against day trading firms that allegedly failed to comply with the guidelines prescribed by the Commission and uniform NASD requirements. Working through NASAA and other regulatory agencies would allow the Commission to assist in the creation of uniform rules that would be consistent throughout the states and would also allow the Commission to make a significant contribution to the development of national investor protection policy. Adoption of rules similar to NASD Rules 2360 and 2361 would allow the Commission to remedy consumer complaints against firms that violate these rules instead of leaving customers to seek a remedy from the NASD.

In regards to margin trading, the Commission should consider coordinating with NASAA to adopt a rule that captures the day trading margin rules stated in NASD Rule 2520.

To prevent day traders from overextending their financial capacity, the NASD proposed changes to its margin rules to protect individuals that pursue day trading strategies. Virginia may benefit from a similar policy because the NASD's proposed margin amendments would make margin requirements more stringent for day traders. By adopting rules developed uniformly through NASAA, Virginia would enjoy having the authority to require day trading firms and on-line brokerages to meet the stringent margin requirements similar to the NASD's proposed amendments to Rule 2520. Working through NASAA would allow the Commission to assist in the creation of a uniform rule that would be consistent throughout the states and would also allow the Commission to make a significant contribution to the development of a national rule regarding day trading and margin. Again, these rules would allow the Commission to remedy consumer complaints against firms that violate these rules instead of leaving customers to seek a remedy from the NASD.

By letter from the Commission, Virginia should recommend to NASAA that it conduct a nationwide survey of on-line and off-line discount brokerage account holders.

The Commission should recommend by letter that NASAA conduct a nationwide survey of on-line and off-line discount brokerage account holders and their representatives to identify what information investors want disclosed. NASAA should try to identify investor's perceptions, preferences, concerns, and trends to help states determine how to effectively tailor uniform state regulations to meet investor needs in a consistent manner throughout the United States. If NASAA conducts such a study, and then proposes uniform policies or rules, the Commission should strongly consider adopting similar rules under its rule making authority.

I. Introduction

In late 1998 and early 1999, the Commission's Division of Securities and Retail Franchising ("Division") received a large number of complaints pertaining to on-line discount brokerage services. In response to the complaints received, the Division began to study the on-line discount brokerage industry. The Division studied the complaints and operations of 19 on-line discount brokerage firms that conducted business within the Commonwealth of Virginia. The Division requested and received documentation of complaints and settlements from the 19 on-line brokerage firms from the last quarter of 1998 to the end of the first quarter 1999. The documentation pertaining to the various complaints filed by Virginians described the nature of the complaint and any settlements reached with specificity. At the same time, both the New York Attorney General ("NYAG") and the Securities and Exchange Commission ("SEC") conducted separate studies of the on-line brokerage industry. One year later on January 24, 2000, the General Assembly considered House Joint Resolution No. 222, a bill related to the on-line brokerage industry. By letter dated March 10, 2000, Speaker of the House of Delegates, S. Vance Wilkins, Jr., asked the Commission to conduct an in depth study of brokerage firms to determine the feasibility and necessity of requiring disclosure and suitability interviews for high-risk securities accounts. The results of the study are to be reported to Speaker S. Vance Wilkins, Jr.

A. Scope and Purpose

This report investigates the following issues in response to the Speaker's request:

1. Whether current trends in the on-line and off-line investing industry have negative and damaging effects for investors from Virginia;

2. Whether on-line brokerage firms adequately disclose all the risks involved with on-line trading to create more informed and investment savvy consumers;

3. Whether Virginia on-line and off-line investors face the same or similar problems that other on-line and off-line investors throughout the United States face;

4. Whether Virginia's current rules dealing with suitability requirements adequately protect on-line and off-line investors;

5. Whether other jurisdictions use more stringent or effective regulatory schemes to impose suitability obligations for on-line and off-line investment firms; and

6. The best practices and methods on-line and off-line brokerage firms should follow to fully inform on-line and off-line investors, so investors may adequately protect their interests through more judicious investment decisions.

The following objectives define the scope of this study:

1. Identify and survey 19 on-line brokerage firms that conducted business in Virginia during the last three months of 1998 through the first three months of 1999 and also during the first four months of the year 2000.

2. Compare complaints made by Virginia on-line investors from the last three months of 1998 and the first three months of 1999 with complaints made during the first four months of the year 2000.

3. Identify the problems and trends that affected on-line and off-line discount investors throughout the United States and Virginia.

4. Survey and scrutinize the regulatory suitability schemes of other states, the federal government, and Self Regulatory Organizations ("SROs").

5. Determine the best practices among on-line and off-line brokerage firms.

6. Study the changes or lack of changes by on-line brokerage firms since January 1999 that have improved or failed to improve customer service capabilities and capacity.

7. Survey news periodicals, industry reports, state reports, National Association of Securities Dealers ("NASD") proposals, SEC policy statements, and other secondary sources to identify trends in the on-line brokerage industry and its regulatory environment.

8. Participate in North American Securities Administrators Association ("NASAA"), SEC, NASD, and industry conferences, meetings, and dialogues to identify and discuss issues concerning on-line and off-line brokerage firms and uniform methods to address those issues.

9. Survey a small sample of Virginia on-line customers to determine customer perceptions, needs, and preferences.

B. Approach and Methodology

The first stage of this study consisted of developing a study work plan, making staff assignments, defining the study's scope and purposes, and gathering general background information. Division staff compiled and organized information gathered from an earlier survey of on-line brokerage firms performed by the Chief Examiner of the Division. Division staff also gathered reports on the on-line brokerage industry written by the NYAG, NASAA, the SEC, and the Government Accounting Office ("GAO"). Furthermore, the Chief Examiner of the Division participated in various meetings and conferences to discuss on-line investing issues with other regulatory agencies and members of the on-line and off-line brokerage industry.

The second stage of this study consisted of developing a detailed questionnaire for on-line brokerage firms. After completion of the questionnaires, the staff sent the questionnaires to various on-line brokerage firms. Later, staff organized and compiled the various firms' responses into a database.

The third stage of this study consisted of developing a detailed follow-up questionnaire to the initial on-line brokerage questionnaire to clarify some of the points made in the on-line firms' responses to the initial questionnaire. The information from the responses to the follow-up questionnaire clearly identified the changes made to the firms' information system infrastructure. The information also offered a clearer perspective of the number of complaints made by on-line investors from Virginia. The on-line brokerage responses also helped the Commission identify the best practices currently in use by some firms.

The fourth stage of this study consisted of surveying a small sample of Virginia on-line customers to determine customer perceptions, needs, and preferences.

At the same time, staff also studied industry reports, state reports, and federal agency reports to gain a better understanding of the on-line and off-line industry's external environment. Furthermore, staff examined numerous periodicals and secondary information sources to identify new issues and trends for the study to address.

After staff compiled the responses to the various questionnaires, the information synthesized from the raw data was used to complete the report.

The fifth stage of this study consisted of developing a detailed questionnaire for Virginia to elicit information, from other states, that described the various states' suitability rules or lack thereof. Staff then compiled the responses of the participating states into a database.

The sixth stage of the study consisted of participating in NASAA, SEC, NASD, and industry conferences, meetings, and dialogues to identify and discuss issues concerning on-line brokerage firms and uniform methods to address those issues.

II. FEDERAL, SRO REQUIREMENTS, AND STATE SUITABILITY REQUIREMENTS

A. Present Statutes and Rules

The suitability doctrine has two requirements. The first suitability doctrine requirement is "customer-specific" suitability. "Customer-specific" suitability is a broker-dealer's duty to recommend to a customer only those securities that are suitable to the investment objectives and unique needs of that particular customer. Under the "customer-specific" requirement, the suitability doctrine matches the investment objectives, unique needs, and financial status of a particular customer with the characteristics of the recommended security. Therefore, "customer-specific" suitability fulfills the individual customer's needs.

The second suitability requirement is "reasonable basis" suitability. "Reasonable basis" suitability requires broker-dealers to have an "adequate and reasonable" basis for recommending a particular investment. "Reasonable basis" suitability relates to the suitability of a particular investment, instead of a particular investor. Under the "reasonable basis" suitability requirement, any particular investment recommendation must be "adequate and reasonable" so that the recommendation may be appropriate for some investor without considering each investors' particular characteristics. For example, if a broker-dealer knew that a particular investment recommendation was not plausible in light of current market conditions, then that particular broker-dealer has no "reasonable basis" for making such a recommendation to any investor.

Suitability rules come from regulatory developments under the SEC, common law developments under the Supreme Court and federal appellate court circuits, and SROs. States have also contributed to the development of the suitability doctrine. However, most of the developments for the suitability doctrine came from SROs. The advent and rise of arbitration proceedings to settle customer disputes is the main reason why SROs have heavily influenced the development of the suitability doctrine.

Furthermore, the SROs' emphasis on equitable principles based on fair dealing and good faith make the enforcement of suitability doctrine violations easier for the public to pursue through the SRO arbitration process. Conversely, actions for suitability violations brought under the federal regime place a factual burden of proof on the investor to affirmatively prove elements of well-settled statutory securities mandates. Therefore, enforcement proceedings of suitability violations are more difficult at the federal level than at arbitration proceedings under SROs.

Federal Enforcement

The SEC is the federal agency responsible for securities regulation at the national level. Federal suitability requirements originated from securities antifraud measures expressed in SEC rules and applicable federal statutes. Sections 10(b)[5] and 15(c)[6] of the

[5] 15 U.S.C. § 78j(b) (1999).
[6] 15 U.S.C. § 78o(c)(1) (1999).

Securities Exchange Act of 1934 ("Exchange Act") provide the SEC with authority to deal with suitability doctrine issues. Under the Exchange Act, the SEC promulgated regulatory Rules 10b-5[7] and 15c1-2[8] to enforce the standards established by the Exchange Act. Essentially, the SEC made the suitability doctrine's application a legal obligation for those who dispense financial recommendations. The SEC enforces the suitability doctrine under the premise that a violation of the suitability doctrine may constitute a violation of Rule 10b-5 based upon the shingle theory. The shingle theory holds that when a broker-dealer hangs a shingle, the broker-dealer implies that he or she will only recommend securities if there is a reasonable basis for believing that the securities suit a customer's financial circumstances.

There are two types of unsuitability claims recognized under Exchange Act Section 10(b) and Rule 10b-5. Under the Exchange Act, the SEC categorizes the first type of claim as a misrepresentation or failure to disclose a material fact. This type of claim is essentially a subset of ordinary fraud under Rule 10b-5. Fraud claims require proof of some sort of intent to perpetrate the fraud or hide material facts from another party. Under the Exchange Act, the SEC categorizes the second type of claim as fraud by conduct. These types of claims are very similar to a churning claim.[9] Overall, federal requirements and SEC requirements are fairly narrow and require proof of intent to violate the suitability doctrine. Also, the SEC rules that express suitability requirements have limited applications to the particular transactions those rules address. For example, Rule 15g-9[10] only applies suitability considerations to transactions involving penny stocks.

In *In re Olde Discount Corp.*[11], the SEC incorporated suitability concepts into Exchange Act Sections 10(b) and 15(c)(1) and Rules 10b-5 and 15c1-2 with legal reasoning that is similar to the shingle theory, but somewhat different.[12] In *In re Olde Discount Corp.*, the SEC argued that either a fiduciary relationship or a similar relationship of trust and confidence between customers and their registered representatives existed because the registered representatives strongly influenced their customers' accounts. The SEC further argued that the fiduciary relationship or similar relationship of trust and confidence gave rise to an affirmative duty to disclose the unsuitable nature of the recommendation. The SEC then reasoned that Olde acted with the requisite *scienter*[13] to violate the suitability doctrine by proffering evidence to show that Olde's compensation scheme and aggressive sales techniques encouraged its representatives to sell highly speculative "special venture stocks" to customers without

[7] 17 C.F.R. 240.10b-5 (1999).
[8] 17 C.F.R. 240.15c1-2 (1999).
[9] *Churning* is a term used to denote a registered representative's improper use of a discretionary authority. It implies that the registered representative who buys and sells securities for a customer is intent only upon the amount of commissions generated, while ignoring the customer's best interests and objectives.
[10] 17 C.F.R. 240.15g-9 (2000).
[11] *See*, Exchange Act Release No. 40,423, 67 SEC Docket 2045 (Sept. 10, 1998).
[12] *See*, Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW at 1557, 1581 (1999).
[13] *Scienter* is "[a] mental state consisting of an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 1345 (6th ed. 1990).

making an adequate assessment of suitability determinations. Two senior officials and the firm's chairman/founder agreed to pay $5 million and surrender to other sanctions to settle charges brought against the firm for irresponsible and reckless investment advisement without concern for suitability requirements.

In re Olde Discount Corp. shows that the SEC recognized an affirmative duty for registered representatives to adequately consider a customer's suitability requirements. The case also shows that the establishment of a fiduciary relationship or a similar relationship of trust and confidence is enough of a nexus to trigger suitability doctrine requirements.

SRO Rules

The advent of the suitability doctrine under SRO rules began with a concern for the ethical considerations involved with transacting business with customers. Thus, the development of the suitability doctrine under SROs emphasized issues of fair dealing and professional ethics instead of legal precedents and securities laws. Another consideration that encouraged the development of the suitability doctrine was the financial industry's desire to remain solvent. The desire for self-preservation made it imperative for financial institutions to have customers that remained solvent over time. Thus, in an effort to protect the interests of the financial industry, SROs formulated and adopted the suitability doctrine to maintain the integrity of the financial markets. The two primary SROs that made significant contributions to suitability doctrine development were the NASD and the New York Stock Exchange ("NYSE"). Although both organizations made significant contributions, the NASD and the NYSE used very distinct measures to adopt the suitability doctrine into their regulatory regimes.

The NASD adopted the suitability doctrine through Rule 2310. Rule 2310(a) states:

> 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 security holdings and as to his financial situation and needs.[14]

Under subsection (a) of Rule 2310, the NASD prohibits a registered representative from making an unsuitable recommendation. Furthermore, the express language of Rule 2310(a) limits the application of the rule to situations where an individual makes a recommendation by beginning the subsection with "[i]n recommending to a customer . . . a member shall . . ."[15] However, subsection (a) of Rule 2310 does not impose a duty on members to seek information regarding a customer's

[14] NASD Conduct Rule 2310, NASD Manual, 4261-4264 (July 1996) [hereinafter Rule 2310].
[15] *Id.*

suitability because the determination of suitability under subsection (a) is limited to "the basis of facts, if any, *disclosed by the customer*."[16]

The NASD addressed Rule 2310(a)'s deficiencies by adopting subsection (b) of Rule 2310. Therefore, Rule 2310 in its entirety also obligates the registered representative to make certain inquiries about the customer before making a recommendation. Under Rule 2310(b), a registered representative must make reasonable efforts to obtain information concerning a customer's suitability characteristics. Rule 2310(b) states:

> (b) 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;
> (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.[17]

Rule 2310(b) places a duty on the NASD member to collect information to allow the member to make an informed assessment of the various recommendations he or she may make to a customer. Therefore, Rule 2310(b) compliments 2310(a) by creating an affirmative duty of inquiry that 2310(a) failed to expressly impose.

The NYSE does not have an expressed suitability rule established. However, the NYSE has a "know your customer rule" or "due diligence" Rule 405[18] that was originally designed to protect member firms from irresponsible customers.[19] The NYSE appears to be expanding the application of Rule 405 to apply the suitability doctrine to the broker-customer relationship. Rule 405 states that every member must "[u]se diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization . . ."[20] Furthermore, persons who approve the opening of accounts must be personally informed "as to the essential facts relative to the customer and to the nature of the proposed account"[21] before approving the account.

Unlike NASD Rule 2310, Rule 405's language does not limit Rule 405 to recommendations. In fact, there is an absence of limiting language under Rule 405

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[16] *Id.*
[17] *See id.*
[18] NYSE Rule 405(1), 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994) [hereinafter NYSE Rule 405(1).
[19] *See*, Lowenfels & Bromberg, *supra* note 12, at 1571.
[20] *See*, NYSE Rule 405(1), *supra* note 18, at 3696.
[21] *Id.* at 3697.

because it states that members should " . . . learn essential facts relative to *every* customer, *every* order, *every* cash or margin account."[22] Furthermore, unlike NASD Rule 2310(b), Rule 405's language does not expressly define the *essential facts* Rule 405 requires its members to learn. Differences aside, both the NASD and NYSE provide suitability requirements that impose duties that appear to serve the best interests of the financial industry and its consumers.

There are also suitability doctrine requirements that are specifically applicable to transactions involving options, penny stocks, municipal securities, and IRAs. Most of these types of suitability rules ask the financial service provider to assess the financial capacity of the client. These suitability requirements also require firms to disclose all the pertinent risks that exist when dealing with the type of security identified in the rule. Since these specialized suitability rules target a narrow and particular form of securities or transactions, SROs that regulate the targeted securities may only require and enforce the suitability doctrine if the particular specialized suitability requirement covers the transaction. However, since the applicability of such a rule is dependent on the type of transaction involved, determining whether or not a firm provides customer-specific recommendations may be irrelevant since certain suitability requirements must be met to enter into the transaction covered by the narrowly applied suitability rule.

<u>State Rules</u>

NASAA develops uniform statements of policy that states can fully or partially adopt to maintain a uniform comprehensive regulatory regime. NASAA addresses suitability in its "Dishonest or Unethical Business Practices" portion of NASAA Statements of Policy. The language used by NASAA expresses its suitability rule by classifying unsuitable recommendations as a dishonest or unethical business practice. NASAA defined the recommendation of an unsuitable transaction as:

> Recommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such a recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.[23]

NASAA's language is similar to the language used in NASD Rule 2310(a) and (b). Therefore, NASAA's suitability rule mandates reasonable recommendations in light of the unique factors discovered through reasonable inquiry. The NASAA language stating "based upon reasonable inquiry" fulfills the role of NASD Rule 2310(b) by requiring a "reasonable inquiry" to learn the "financial situation and needs, and any other relevant information" that is necessary to determine the suitability of a recommendation.

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[22] *See id.* at 3696.
[23] Dishonest or Unethical Business Practices, NASAA Reports (CCH) ¶ 1402 (April 23, 1983).

Thirty-two states and Virginia use language that is the same or substantially similar to NASAA's suitability language. [24] The other remaining states follow variations of NASAA's rule, follow NASD rules, or have no rules at all.

Arkansas and Minnesota use language that is substantially similar to NASD Rule 2310(a). [25] However, the absence of language that is the same or similar to NASD Rule 2310(b) leaves in doubt the broker-dealer's duty to engage in "reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information." Unless there is other regulatory language that mandates the collection of suitability information, the lack of supplemental language that creates the duty of "reasonable inquiry" would limit the information that determines suitability to information that the customer voluntarily divulges.

Maryland and Nevada follow the NASD Rules that govern fair practices and ethical standards as their suitability rules. However, unlike Arkansas and Minnesota, Maryland and Nevada follow both 2310(a) and 2310(b). Therefore, Maryland's and Nevada's suitability rules impose a "duty of inquiry" to learn a customer's suitability characteristics. Maryland adopts NASD rules through *Brewster v. Maryland Sec. Comm'r*[26], an appellate court decision. Nevada adopts NASD Rules for fair practices and ethical standards by rule.[27] Nonetheless, both states appear to adopt NASD Rule 2310 in its entirety for suitability rule.

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[24] *See* Ala. Rule 830-X-3-.12, 1 Blue Sky L. Rep. (CCH) ¶ 7,433 (2000); Alaska § 45.55.025, 1 Blue Sky L. Rep. (CCH) ¶ 8,104 (May 18, 1999); Calif. Rule 260.218.2, 1A Blue Sky L. Rep. (CCH) ¶ 12,203 (2000); Colo. Rule 51-4.7, 1A Blue Sky L. Rep. (CCH) ¶ 13,437 (Jan. 1, 1992); Conn. Rule 36b-31-15a, 1A Blue Sky L. Rep (CCH) ¶ 14,464 (1995); Fla. Rule 3E-600.013, 1A Blue Sky L. Rep. (CCH) ¶ 17,463 (Aug. 1, 1991); Ga. Rule 590-4-2-.14, 1A Blue Sky L. Rep. (CCH) ¶ 18,420C (Mar. 16, 1987); Idaho Rule 118, 1A Blue Sky L. Rep. (CCH) ¶ 21,411H (Jul. 1, 1993); Ind. Reg. § 710 IAC 1-16-22, 2 Blue Sky L. Rep. (CCH) ¶ 24,613M (Jan. 1, 1992); Iowa Sec. 191—50.9(502), 2 Blue Sky L. Rep. (CCH) ¶ 25,409 (2000); Kan. Reg. § 81-3-1, 2 Blue Sky L. Rep. (CCH) ¶ 26,403 (Jan. 1, 1966); Ky. Rule 808 KAR 10:030, 2 Blue Sky L. Rep. (CCH) ¶ 27,403 (June 25, 1998); Mass. Reg. § 12.204 2 Blue Sky L. Rep. (CCH) ¶ 31,454 (Dec. 1, 1980); Mich. Code Sec. 451.604, 2 Blue Sky L. Rep. (CCH) ¶ 32,114 (1989); Miss. Rule 523, 2A Blue Sky L. Rep. (CCH) ¶ 34,495L (1998); Mo. Reg. § 30-51.170, 2A Blue Sky L. Rep. (CCH) ¶ 35,447 (1992); Mont. Reg. § 6.10.126, 2A Blue Sky L. Rep. (CCH) ¶ 36,467 (Jan. 1, 1989); Neb. Reg. Ch. 12.005.01 to .01C, 2A Blue Sky L. Rep. (CCH) ¶ 37,412 (1999); N.M. Rule 12 NMAC 11.2.11.1, 2A Blue Sky L. Rep. (CCH) ¶ 41,536 (1999); N.C. Rule .1414, 2A Blue Sky L. Rep. (CCH) ¶ 43,458 (January 1, 1984); N.D. Sec. 73-02-09-02, 3 Blue Sky L. Rep. (CCH) ¶ 44,462 (Sept. 9, 1990); Ohio Rule 1301:6-3-19, 3 Blue Sky L. Rep. (CCH) ¶ 45,540 (2000); Okla. Reg. § 660:10-5-42, 3 Blue Sky L. Rep. (CCH) ¶ 46,472 (1998); Or. Rule 441-205-140, 3 Blue Sky L. Rep. (CCH) ¶ 47,620 (2000); Pa. Sec. 403.010, 3 Blue Sky L. Rep. (CCH) ¶ 48,521 (Mar. 30, 1974); R.I. Rule 212(a)-1, 3 Blue Sky L. Rep. (CCH) ¶ 50,406(C) (Jan. 1, 1991); S.C. Rule 113-25, 3 Blue Sky L. Rep. (CCH) ¶ 51,125 (May 28, 1993); Tenn. Rule 0780-4-3-.02, 3 Blue Sky L. Rep. (CCH) ¶ 54,417 (1998); Utah R164-6-1g, 3A Blue Sky L. Rep. (CCH) ¶ 57,403 (2000); Vt. Reg. § S-91-1, 3A Blue Sky L. Rep. (CCH) ¶ 58,400 (Jan. 7, 1992); 21 V.A.C. 5-20-280A2 to 3; Wash. Reg. § 21.20.702, 3A Blue Sky L. Rep. (CCH) ¶ 61,164A (Apr. 1, 1994); Wis. DFI-Sec. 4.06(c), 3A Blue Sky L. Rep. (CCH) ¶ 64,566 (Jan. 1, 1978); Wyo. Reg. § 6(g), 3A Blue Sky L. Rep. (CCH) ¶ 66,431 (1998).

[25] *Compare* Ark. Rule 308.01, 1A Blue Sky L. Rep. (CCH) ¶ 10,427 (1998) *and* Minn. Rule Part 2875.0910, 2 Blue Sky L. Rep. (CCH) ¶ 33,426 (1989) *with* Rule 2310, *supra* note 14, at 4261.

[26] *See Brewster v. Maryland Sec. Comm'r*, 548 A.2d 157, 160 (Md. App. 1998).

[27] Nev. Reg. § 90.327(d), 2A Blue Sky L. Rep. (CCH) ¶ 38,436A (Oct. 16, 1989).

New Hampshire also has a suitability rule. However, the rule appears to have a limited application to investment advisors.[28] In general, New Hampshire prohibits fraudulent practices and contrivances used for the sale of securities. Under New Hampshire rules, inducing excessive trading in a customer's account or inducing trading beyond a customer's known financial resources is considered a fraudulent act prohibited by New Hampshire law. Therefore, broker-dealers cannot induce excessive trading if the trading is not suitable for the customer's financial resources. New Hampshire rules and statutes also prohibit salesmen and broker-dealers from promoting speculative securities through "boiler room" tactics that force prospective investors to make hasty decisions to invest, irrespective of the investor's investment needs and objectives.[29]

South Dakota has two separate suitability rules. One suitability rule is applicable to investment advisors[30] and the other suitability rule is applicable to broker-dealers.[31] The language in South Dakota's investment advisor suitability rule appears to mirror the language used by NASAA's suitability rule. However, South Dakota's suitability rule for broker-dealers appears to be more stringent than the suitability rule for investment advisors. The South Dakota rule lists failure to make a suitability determination as a prohibited broker-dealer business practice by stating:

> The following are practices which constitute "fraudulent transactions," "sale of securities by such licensee that would work a fraud on purchasers," or "bad business repute" by a broker-dealer under SDCL 47-31-43, without limiting those terms to practices specified in this section:
> (3) ***Effecting a transaction*** in the purchase, sale, or exchange of a security without reasonable grounds to believe that the transaction is suitable for the customer based upon an inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by the broker-dealer . . .

The language ***"effecting a transaction"*** appears to be more comprehensive than the "***making a recommendation"*** or "***recommending***" language used by other suitability rules. In this case, the word "***effecting***" appears to connote any actions that facilitate or "bring about" a securities transaction.[32] Therefore, in the absence of a recommendation from a broker-dealer, an individual may claim that the broker-dealer committed a prohibited act by "***effecting***" a securities transaction, if the broker-dealer knowingly made a securities transaction that is financially unsuitable for an investor.

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[28] *See* N.H. Regs. § 421-B:4, 2A Blue Sky L. Rep. (CCH) ¶ 39,157 (May 18, 1992); *see also* N.H. Regs. § 421-B:2(IX)(c), 2A Blue Sky L. Rep. (CCH) ¶ 39,152 (May 18, 1992) (excluding broker-dealer from the definition of investment advisor).
[29] *See* N.H. Atg. Regs. § 602.1, 2A Blue Sky L. Rep. (CCH) ¶ 39,474 (July 1, 1992).
[30] *See* S.D. Reg. § 20:08:05:13(1), 3 Blue Sky L. Rep. (CCH) ¶ 52,770 (Feb. 3, 2000).
[31] *See* S.D. Reg. § 20:08:03:22(3), 3 Blue Sky L. Rep. (CCH) ¶ 52,722 (Feb. 3, 2000).
[32] The word ***effect*** can mean "[t]o produce as a result; bring into existence" or "[t]o bring about." THE AMERICAN HERITAGE DICTIONARY 439 (1991), *see also* BLACK'S LAW DICTIONARY 514 (6th ed. 1990).

Hawaii and Louisiana have rules that mention suitability-like duties. Hawaii uses its suitability rule to determine whether an individual is worthy of recommending securities to others. The act of "inducing a customer to invest beyond the customer's means, or without regard to the nature and character of the account"[33] constitutes grounds to find any financial intermediary unworthy to dispense investing advice and in violation of Hawaii law.

Louisiana law states that its securities rules do not "relieve registered dealers or salesmen from due diligence, suitability or know-your-customer standards or any other requirements of law otherwise applicable to such registered persons."[34] However, the Louisiana rule does not specifically state what standards and laws define "due diligence, suitability or know-your-customer standards or any other requirements of law otherwise applicable." Therefore, determining whether the rules and standards mentioned in the rule include NASAA, NASD, SEC, or NYSE standards is not clear.

Finally, Arizona, Delaware, the District of Columbia, Illinois, Maine, New Jersey, New York, Texas, and West Virginia do not have suitability rules. However, each of the states' fraud rules and statutes address suitability type complaints that involve fraudulent activities.

Regulatory Gray Areas

Under present law, either a broker-dealer or investment advisor must recommend a transaction before the suitability doctrine is applicable to the transaction. The suitability doctrine exists as a somewhat vague rule that lacks definitive clarity in the definition of some of its terms.[35] Instead, a case-by-case analysis of the surrounding circumstances of each transaction determines whether actions are a "recommendation." Although "recommendation" may lack a standard definition, the current case-by-case analysis provides for a flexible interpretation of "recommendation" that can change with the times. The flexible definition may encourage equitable considerations when investors bring complaints. Organizations that enforce suitability requirements also have a better opportunity to conduct thorough investigations into the surrounding circumstances of the alleged "recommended" transaction because enforcement actions of suitability rules require a very fact intensive inquiry to determine whether a "recommendation" existed.

Another unclear issue regarding suitability is determining how to apply suitability analysis to unsolicited trades placed with either full-service firms or hybrid firms[36]. Although customers of full-service firms can expect recommended or solicited transactions to meet suitability requirements, does that fact necessarily mean that customers can or should expect a suitability analysis for unsolicited trades placed through a full-service or hybrid firm? There appears to be two conflicting but reasonable rationales to resolve the issue. On the one hand, customers that place an unsolicited trade

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[33] Hawaii Reg. § 16-38-7(c)(6), 1A Blue Sky L. Rep. (CCH) ¶ 20,431 (1988).
[34] La. Reg. § 701, 2 Blue Sky L. Rep. (CCH) ¶ 28,511 (1990).
[35] *See,* Lowenfels & Bromberg, *supra* note 12, at 1557.
[36] The term *hybrid firm* is discussed in detail on pages 20 and 29.

through a full-service or hybrid firm should not expect to receive suitability analysis from the firm because the trade was unsolicited. On the other hand, customers may expect suitability analysis for unsolicited trades because of the fiduciary relationship that exists between the customer and the broker-dealer agent charged with preserving the financial interests of the customer. Even though no transaction recommendations occurred, the advisor-advisee relationships that exist at either a full-service firm or a hybrid firm may result in a fiduciary responsibility or contract liability regarding any transaction placed with the firm.

In the on-line brokerage context, pull and push technologies cloud the definition of "recommendation" further. Both push and pull technologies are methods of personalizing a website's information to suit a particular user's needs. Pull technology allows on-line investors to set their preferences to describe the type of information they are requesting from a particular on-line merchant. After receiving the preferences, the on-line merchant sends information to meet a particular investor's preferences. Pull technology essentially allows the on-line investor to request specific information from an on-line merchant. On the other hand, push technology is not a proactive, investor activity. In the push technology concept, the on-line firm tracks the investor's preferences (possibly by monitoring the investor's Internet history and behavior on-line). The on-line merchant then takes advantage of its observations and begins to send notices, warnings, or advertisements that match the on-line investor's Internet preferences and behavior. Unlike pull technology, push technology involves no investor input.[37] Essentially, the on-line investor becomes the marketing target of the on-line merchant.

Although the SEC did not define what constitutes a recommendation, the SEC stated that a "recommendation may be found even where one has not been made expressly."[38] Furthermore, the NASD stated that "a transaction will be considered recommended when the member . . . brings a specific security to the attention of the investor through any means . . . including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or transmission of electronic messages."[39] Arguably, push technology can easily meet the definitions propounded by both the SEC and the NASD because push technology essentially sends information that the on-line investor did not solicit from the on-line broker. A regulatory agency may interpret the sending of information as a recommendation under such circumstances. Under the SEC's interpretation, the on-line broker may be making implied recommendations by sending information regarding various securities to a customer. It is conceivable that pull technology could result in an implied recommendation. If a firm guided an investor to particular securities through the use of suitability type personal information, then there may be grounds to find a recommendation. Under the NASD's definition, the on-line broker may be making a recommendation because the firm is

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[37] LAURA UNGER, SEC. & EXCHANGE COMM'N, ON-LINE BROKERAGE: KEEPING APACE IN CYBERSPACE at 33 (1999) (analyzing a hypothetical number 5) [hereinafter SEC Report].
[38] *See id.* at 24 n. 47 (quoting National Committee of Discount Brokers, SEC No-Action Letter (May 27, 1980)).
[39] *Id.* (quoting NASD Notice to Members 96-60, "Clarification of Members' Suitability Responsibilities under NASD Rules . . . " (Sept. 1996)).

bringing specific securities to the attention of the investor through an electronic medium (the Internet).

B. Full-service Firms and Hybrid Firms

Full-service firms and hybrid firms are firms that provide clients with asset management services and other financial services to meet client needs. Full-service firms offer clients investment advising and account management services. Hybrid firms provide services similar to the services offered by full-service firms. However, hybrid firms allow their clients to place trades via the Internet. The offering of investment advice to clients distinguishes both full-service firms and hybrid firms from discount firms and day trading firms. Furthermore, the representatives of both full-service firms and hybrid firms offer and synthesize a wide variety of financial data on behalf of their clients. Therefore, clients do not bear the burden of performing research and then synthesizing the data into useful investment information.

Both full-service firms and hybrid firms offer recommendations to clients to purchase, sell, and hold particular securities to meet their clients' financial needs and desires. Clients of full-service firms usually receive recommendations from a representative, and sometimes these representatives also pre-screen or post-screen self-placed trades for suitability. Hybrid firms offer the added convenience of self-placed trades on the Internet combined with the investment advice of a registered representative. However, a representative at a hybrid firm may not pre-screen self-placed trades over the Internet unless the self-placed trade leaves the Internet trading system for manual review or the account agreement requires a representative to assess the suitability of every transaction. Nonetheless, many hybrid firms perform post-transaction suitability checks to protect their clients' and the firms' interests. Therefore, full-service firms are similar to hybrid firms except for the hybrid firms' provision of self-placed Internet trades.

In the case of full-service firms and hybrid firms, the regulatory demands of the suitability doctrine square directly with the business activities of these particular firms. Since both full-service firms and hybrid firms advise clients to invest in particular securities, it is important for these organizations to consider the suitability requirements of their customers before making a recommendation. Furthermore, the express language of NASD Rule 2310 specifically applies to situations where a member institution's representatives "mak[e] recommendations."[40] Therefore, most suitability requirements are applicable to both full-service firms and hybrid firms because both types of firms offer investment recommendations and solicit trades from their respective clients.

Since there may be a strong relationship between the registered representative of either a full-service firm or the hybrid firm and a client, both the full-service firms and the hybrid firms may have a fiduciary duty to make suitable recommendations to their clients. Suitability is also appropriate because clients may rely on investment recommendations from the firms' representatives to maintain a successful investment portfolio. Thus, the fiduciary obligations of the full-service firm and hybrid firm create a

[40] Rule 2310, *supra* note 14, at 4261.

duty to identify and assess the financial capacity of clients before making any recommendations. The assessment of suitability is necessary for all other applicable suitability rules because both full-service firms and hybrid firms must also meet the demands of various "specialized" suitability rules that target particular security transactions. Another important aspect of this relationship is disclosure of material facts between the representative of either a full-service firm or the hybrid firm and a client since the client needs to know all material information to decide whether to adopt or reject a particular recommendation.

It is not clear whether suitability applies in the absence of a solicitation or recommendation in regards to unsolicited trades placed with either a full-service firm or a hybrid firm. The issue that may decide whether suitability rules are applicable to a particular transaction is the nature and existence of a fiduciary relationship between the financial firm and its client. The existence of the fiduciary relationship may depend upon the terms of the account service agreement and the customer's expectations. Therefore, there is no clear application of suitability or contract requirements to unsolicited trades placed through a full-service or hybrid firm.

C. On-line Discount Firms and Traditional Discount Firms

In general, both on-line discount firms and traditional discount firms offer their clients the ability to place trades for lower commission fees than those fees charged at either full-service firms or hybrid firms. Since both types of discount firms neither solicit specific securities nor recommend various investment strategies, the firms do not charge their clients for the time and expertise of a broker-dealer agent. Therefore, clients of discount firms only pay for the transaction costs of placing the trade. Many discount firms also provide their clients with a wide array of financial data and research materials. However, since the true discount firms do not make recommendations, the client of the firm is responsible for synthesizing all the data received into useful information. Discount firms may provide bulletins or news to clients, but must make sure that such data is not self-serving and targets a broad audience so as to avoid the act of either soliciting or recommending a security to a particular client.

NYSE Rule 405 applies to both on-line discount firms and traditional discount firms because Rule 405 imposes a broad obligation to "learn essential facts relative to *every* customer, *every* order, *every* cash or margin account"[41] Rule 405 does not define what constitutes an essential fact. Therefore, it is difficult to determine what facts discount firms must learn about "*every* customer, *every* order, *every* cash or margin account."[42]

Unlike full-service firms or hybrid firms, both true on-line discount firms and traditional discount firms do not offer either security solicitations or recommendations. Therefore in the absence of either securities solicitations or recommendations to clients, the suitability doctrine of NASD Rule 2310 does not apply to discount firms because the

[41] NYSE Rule 405(1), *supra* note 18, at ¶ 2405.
[42] *See id*.

language of Rule 2310 limits the rule's application to instances where a client receives a recommendation or solicitation. In the SEC's on-line trading report by Laura Unger, the SEC agreed with the view that when a discount broker provides only order execution services to its clients, then the discount firm need not perform a customer specific suitability review.

D. Day Trading Firms

Day trading firms are a unique class of financial service provider. Day trading firms "provide the means for customers to trade their own accounts, and promote and facilitate a particular type of trading."[43] A day trading firm furnishes its clients with equipment and software that allows the client to trade through the day trading firm's order placement system. The placement of orders is usually instantaneous and directed to market makers trading particular securities. Day trading firms promote numerous intra-day trades so their clients may profit on the small changes in the prices of stock throughout the day. Usually a day trading firm encourages its customers to close out all positions by the end of each day. As a result of the numerous orders that day trading firms handle throughout the day, day trading firms collect large amounts of commission fee income. Obviously, day trading firms have an interest in the amount of trading volume generated throughout the day by intra-day traders.

Day trading firms are not subject to the typical suitability requirements because these firms do not solicit specific securities to their clients. However, day trading firms advocate a particular trading strategy to customers. Arguably, the pursuit of intra-day trading may be considered a recommended investment strategy, but the day trading industry counters the argument by stating that the investment strategy is merely the broad presentation of investing information not targeted to a particular customer. Furthermore, once customers begin trading through a day trading firm, all trades placed by the customer are unsolicited and traded on the customer's own account. Thus, in the absence of a directed recommendation of a particular security, there is no trigger for the imposition of the suitability doctrine to day trading firms.

In response to growing concerns regarding day trading, the NASD proposed Rules 2360 and 2361. On July 10, 2000, the SEC approved both Rules 2360 and 2361. Rules 2360 and 2361 require a member firm that promotes a day trading strategy to furnish a risk disclosure statement to a non-institutional client before opening an account for the customer. The member firm may either approve the customer's account for day trading or have the customer sign an agreement stating that the customer has no intention of using the account for day trading purposes. Furthermore, the rules would require day trading firms to make a threshold determination that day trading is appropriate for the customer.

The SEC found that the risk disclosure statements and the appropriateness review mandated by the new NASD rules "are thoughtfully designed and tailored to address investor protection concerns raised by the increasingly popular trading strategy referred

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[43] DAY TRADING PROJECT GROUP, N. AM. SEC. ADMINISTRATORS ASS'N, NASAA DAY TRADING REPORT at 2 (1999) [hereinafter NASAA REP.].

to as day trading."[44] After receiving SEC approval, NASD Rules 2360 and 2361 went into effect on October 16, 2000 and are now fully enforceable by the NASD.

E. Automated Process of Checking and Determining Suitability

In terms of suitability, none of the on-line firms studied for this report used information technology systems or people to routinely perform systematic suitability determinations for orders placed by on-line investors. It appears that on-line brokerage firms feel that they had no obligation to perform such analysis. Nonetheless, many on-line firms gathered some suitability information. Hybrid firms, on the other hand, instituted information technology systems using suitability reports and personal reviews that allowed broker-dealer agents to perform a post-screening of trades placed. Some hybrid firms offered such a service as a value-added measure to show investors that hybrid firms committed their resources to provide investors with quality asset management services.

[44] Order Approving Proposed Rule Changes Relating to the Opening of Day Trading Accounts, 65 Fed. Reg. 44,082 (approved July 10, 2000).

III. TYPES OF COMPLAINTS

From January 1, 1999 through September 30, 1999, the SEC noted that its most frequently received complaint was difficulty accessing accounts.[45] The second most frequent complaint was order processing delays and failure to process orders. The third most frequent complaint identified in the SEC report was erroneous order processing. The SEC's findings show the on-line brokerage industry's inability to adequately service the large volume of customer orders. The inability of the consumer to access his or her account was usually the result of overloaded computer servers and the lack of personnel to adequately answer a high volume of customer phone calls. Furthermore, in order to catch-up with the high volume of orders placed, some on-line firms would shut down their order processing systems and manually process orders to alleviate high volume pressure. The large volume of work processed at a rapid pace via manual methods then caused the quality of order processing, placement and execution to decrease. An increase in order processing errors may have coincided with insufficient capacity because the automated quality assurance methods were not in use during periods of high volume. Usually, consumers complained that the on-line broker-dealer did not execute the order at the consumer's expected price because the order took too long to execute.

Other complaints identified by the SEC included:

1. "best execution" problems;
2. errors or omissions in account records and documents;
3. transfer of account problems;
4. margin position sellouts;
5. problems with IPO allocations;
6. problems with opening accounts;
7. inaccurate quotes and pricing information;
8. problems with deposits and withdrawals of funds;
9. use of false or misleading advertising material;
10. inadequate margin disclosures;
11. failure to honor limit orders.

Around the same time as the SEC study, the Commission also reviewed approximately 349 complaints from Virginians regarding 19 on-line brokerage firms. The Virginia complaints for the last three months of 1998 through the first three months of 1999 mirrored the complaints the SEC noted in its report. The most frequent Virginia complaint was difficulty accessing the brokerage account. Difficulty accessing account information or trading services appeared to be the result of system outages along with a lack of capacity to meet the large volume of phone calls that customers made since the on-line systems suffered from bottlenecks. The second most frequent complaint was poor web design and system problems. Administrative errors and poor customer service also comprised the second highest number of complaints. The third most frequent complaint was poor order executions. Much like the SEC complainants, Virginia complainants complained of errors in order placement, processing, and execution. Again,

[45] *See* SEC Report, *supra* note 37 app. 5.

a majority of these complainants claimed that they expected faster execution of their order at a better price.

The other types of 1999 Virginia complaints were:

1. duplicate trades, unauthorized trades, and the inability to place trades;
2. fee disputes;
3. consumer errors because of mistakes or unawareness;
4. no notice of execution;
5. account set-up or transfer problems;
6. margin liquidations and margin transactions without customer consent;
7. limited trading services provided by on-line firm;
8. Initial Public Offering ("IPO") unavailability.

The NYAG also identified similar types of complaints in its study completed in the same time frame. The complaints listed in the NYAG's report were the inability to access online trading services, delayed execution of orders, failure to provide best execution of a trade, inadequate staffing and training of telephone customer service, inaccurate entry of trade orders, and execution of orders beyond account buying power. For the most part, the complaints identified in the New York Report are consistent with the findings in the SEC report and Virginia study. However, the New York Report did not provide a numerical breakdown for the types of complaints.

A second survey of Virginia complaints made over the first four months of 2000 revealed that the consumers are still making the same types of complaints made in 1999. However, there has been a shift in the frequency of certain types of complaints made. For the 2000 period surveyed, administrative errors and poor customer service complaints surpassed account access complaints. Account access complaints are now second to administrative error complaints. Poor order execution complaints continue to exist and are now the third most frequent complaint made by Virginians. The next highest number of complaints made by Virginia investors is account set-up and transfer complaints. The top four complaints appear to be proof of the increased capacity of on-line brokerage firms and overall growth in the on-line brokerage industry. However, the rise in customer access and use of on-line brokerage services has given rise to an increase of customer service complaints. Thus, customers are able to access their accounts, but customer service personnel are not fulfilling the demands and service expectations of new on-line clients. The increase in administrative error and customer service complaints may also indicate that on-line brokerage clients have unrealistic expectations for on-line firms' services and do not comprehend the on-line brokerage firm's limits. It also seems that on-line brokerage clients failed to recognize the risks involved with on-line trading. Nonetheless, on-line brokerage firms should remain aware of their obligation to provide adequate and competent service to their customers.

The various complaints described in this section indicate a certain level of naiveté that investors have in regards to on-line investing. The complaints may even suggest that less computer literate investors are entering the on-line market place. Arguably, any forced suitability analysis may protect some of these investors from themselves at the expense of another investor's ability to freely choose to invest in any securities they see fit. It seems that an effective effort to protect the investor and prevent the complaints listed above would be to provide better education, disclosure, and customer service so investors can make their own investment decisions.

IV. RECENT DEVELOPMENTS IN THE BROKERAGE INDUSTRY AND MARKET PLACE

A. On-line Discount Firms

Over the last five years, on-line discount firms evolved into a major force in the brokerage industry by providing an electronic venue for the placement of securities orders. According to the on-line discount brokerage industry, on-line discount firms do not recommend either share purchases or investment strategies. Instead, on-line discount firms provide investors with access to a wide variety of financial data that the investor may analyze before the placement of an unsolicited order. By avoiding the added costs for an advisor's expertise, the on-line investor pays commissions at a lower rate. Thus, commissions associated with on-line transactions usually involve only the transaction costs associated with the placement and subsequent execution of the trade.

On-line discount firms operate two main systems to deliver their services to the investor. The two systems are the "front end" system and the "back end" system.[46] On-line discount firms operate a "front end" system that allows investors to interact with the on-line brokerage firm. The "front end" system serves as the first point of contact between an investor and the on-line discount firms. Thus, the front-end system provides the investor with the on-line access to the on-line discount firm. The "front end" system is usually in the form of a website provided by a server that serves as a conduit between the investor and the "back end" system. The investor will normally access an Internet Service Provider ("ISP") to gain access to the on-line discount firm's website. The "front end " system then provides the investor the ability to review his or her account activity, collect information on various companies and financial instruments, and manipulate website screens provided by the on-line discount firm to place an order.

Much like full-service firms, on-line brokerages also operate a "back end" system responsible for the placement of orders to market. Although investors may place orders with an on-line broker via the Internet, the executions of orders through the back end system are subject to the same constraints as off-line discount firms and full-service firms. For example, volatile price fluctuations for particular shares and the market makers' inability to execute a trade under heavy trading volume delays on-line brokerages in the same manner as traditional firms. The on-line investor does not have direct access to the market. Therefore, the on-line investor must rely on the on-line discount firm for execution of his or her order by a market maker or through an Electronic Communication Network ("ECN")[47]. Thus, delays in the execution of trades may occur, if the "back end" system cannot process the delivery of orders to market makers immediately or the market maker cannot execute the order in a timely fashion.

[46] *See* INVESTOR PROTECTION & SEC. BUREAU. & INTERNET BUREAU, N.Y. ATT'Y GEN., FROM WALL STREET TO WEB STREET: A REPORT ON THE PROBLEMS AND PROMISE OF THE ONLINE BROKERAGE INDUSTRY at 55 (1999) [hereinafter N.Y. ATT'Y GEN. REP.].

[47] Electronic Communication Networks or ECNs provide an automated method for matching buyers and sellers to make a market for the execution of trades.

On-line discount investing has enjoyed tremendous growth. By the end of 1999, discount brokerage firms gained 29% of the nation's investment accounts.[48] The on-line discount brokerage firm E-Trade exemplifies the rapid growth of the on-line discount brokerage industry. In the first three months of the year, E-Trade increased the number of accounts by 33%.[49] Furthermore, the number of customers doubled to 2.4 million in one year.[50] E-Trade is also expanding its services to nine more countries.[51] Overall, the on-line investing industry enjoyed a 25% increase in the first three months of 2000. On-line discount firms now account for one in six stock market trades.[52]

The lower commission fees charged by on-line discount brokerages made on-line investing an attractive alternative to traditional full-service investing. Furthermore, aggressive advertising spurred the immediate rise in the popularity of on-line brokerage services. The advertisements' themes emphasized consumer empowerment and characterized full-service firms as cost incurring middlemen who increased transaction costs to the detriment of investors.[53] Furthermore, on-line brokerage advertisements highlighted a get-rich-quick mantra fueled by the large increases in the price of Internet stocks and technology IPOs.[54] The claims and bravado associated with these advertisements received heavy criticism from both regulators and traditional full-service firms. In the spring of 1999 SEC Chairman, Arthur Levitt, likened some on-line brokerage ads to lottery commercials.[55] Full-service firms and critics of the advertisements argued that the advertisements made "exaggerated, unwarranted, [and] misleading" statements or claims.[56] Since Chairman Levitt's comment, the advertisements have toned down and now emphasize a "trust in yourself" theme.[57]

Recently, there appears to be a lull in the growth of the on-line brokerage industry.[58] The increased volatility in the markets coupled with inadequate customer service to meet increasing customer demands may be forcing some investors to seek the services of full-service or hybrid financial firms. Traditional full-service brokers have now captured 28% of total on-line assets traded and 11% of active on-line accounts.[59]

A 1999 survey by the Investment Company Institute ("ICI") and the Securities Industry Association ("SIA") discovered that on-line investors tend to be younger and

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[48] *See* Geoffrey Smith, *On the Web – But With a Broker on Standby: Wall Street's Full-service Firms Offer Advice Along With E-Trading*, BUS. WK., May 22, 2000, 150, 150.
[49] Ianthe Jeanne Dugan, *E-Trade's Growing Pains*, WASHINGTON POST, Jun. 18, 2000, at H01.
[50] *See id.*
[51] *See id.*
[52] *See id.*
[53] *See* Marcy Gordon, *Online Broker Ads Reviewed*, Feb.1, 2000.
[54] *See id.*
[55] *See id.*
[56] *Id.*
[57] *Id.*
[58] *See Boom in Online Trading Leveled Off, Study Says*, WALL ST. J., Jun. 15, 2000
[59] *See* Emily Thornton, *Take That, Cyber Boy: Real World Brokers Are Landing Some Body Blows*, BUS. WK., Jul. 10, 2000, at 58.

more affluent than investors who invest with traditional full-service firms.[60] On-line investors' median age is 41 with a median household income of $73,800 and median household financial assets $229,000.[61] More on-line investors have a college education than other investors.[62] The survey also noted that the typical on-line investor has equity investments of approximately $127,600.[63]

B. On-line Hybrids

Another developing financial service is the on-line hybrid financial service ("hybrid service"). The hybrid service format is basically a traditional full-service firm that offers services via the Internet. In the hybrid service format, the financial service institution provides the investor with the ability to invest on his or her own while still receiving some degree of advice and guidance from a broker-dealer agent.[64] In this relationship, the investor may ask the broker-dealer agent for investment advice and a broker-dealer agent may respond with a recommendation. However, since the broker-dealer agent actively recommends adoption of certain strategies and the purchase of certain securities the commission savings from on-line trades diminishes due to the value-added advice of the broker-dealer agent.[65]

Much like the on-line discount brokerages, hybrid services operate a "front end" system that allows investors to place trades via the Internet and a back end system that routes the trades to market for execution. The only significant difference between the hybrid service and on-line discount firm is that the hybrid service provides recommendations and guidance to the investor for a higher commission fee. As noted earlier, hybrid firms made inroads into an on-line market dominated by on-line discount firms by touting their value-added off-line service.

C. On-line Day Trading Firms

On-line day trading firms offer a different form of investment service; and their operations are totally unrelated to the types of operations used by on-line discount brokerages and hybrid services. On-line day trading involves the direct placement of orders to financial markets.[66] Therefore, unlike on-line discount brokerages and hybrid firms, day trade investors have their orders immediately executed because they place their trades directly to market makers. On-line day trading firms advocate multiple trades

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[60] *See* SEC Report, *supra* note 37, at 12 (noting statistical information compiled from ICI and SIA, *Equity Ownership in America*, Fall 1999 at 29).
[61] *See id*.
[62] *See id*.
[63] *See id*.
[64] Geoffrey Smith, *On the Web – But With a Broker on Standby: Wall Street's Full-service Firms Offer Advice Along With E-Trading*, BUS. WK., May 22, 2000, at 150 (noting the existence and popularity of such services).
[65] *See id*.
[66] *See* GREGORY J. MILLS, THE DAY TRADERS, at 119 (1999).

throughout the day to generate commission fees.[67] Many sources researching day trading determined that investors who participate in day trading risk losing their entire investment due to market risks and extremely high transaction fees created by the great volume of trading they pursue.[68]

On-line day trading firms usually operate a computer system at the site of the brokerage firm. The system tracks the movements of the market and allows for the direct placement of orders to the market. The information provided by the day-trading system promotes momentum trading. By following the movements of the market, day traders buy and sell securities in an effort to capture short lived market imbalances or arbitrage opportunities. The availability of NASDAQ Level II quotes also facilitates this style of trading because day traders can monitor the price movements of stocks among a group of market makers.[69]

Investors generally must invest a minimum amount to open an account. Once the minimum amount is invested, the prospective day trader may sit through a class that reviews the investment terminology, functions of the market, tutorials describing use of the computer system, and trade placement protocol.[70] Investing with a day trading firm requires a constant flow of capital through the day trading account because of numerous day trades plus the many commission fees that are charged for every transaction performed during the day. Numerous studies, enforcement actions, and high profile tragedies highlighted the risks and regulatory shortcomings associated with the day trading business. The NASD focused new rules and enforcement actions to deal with day trading firms. In particular, these actions addressed fraudulent advertising, illegal loans, and customer unsuitability. This trend in enforcement is likely to continue.

D. The Use of Margin and High Risk Investments

Margin

Buying on margin allows an investor to borrow money from a broker to purchase stocks. The use of margin allows the investor to leverage his or her position. The increased financial leverage means that the investor may magnify his or her return because the investor invests less personal funds by using margin as opposed to funding the transaction entirely with personal funds. However, the increased financial leverage also has a negative effect. If a particular investment incurs a loss, the financial leverage magnifies the loss in the same manner the financial leverage would magnify a gain.

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[67] *See* NASAA REP., *supra* note 43, at 2 (stating that a day trading firms' customers are known as day traders because they "make intra-day trades, i.e., they are taught to close out positions by the end of each trading day").
[68] RONALD L. JOHNSON, DAY TRADING: AN ANALYSIS OF PUBLIC DAY TRADING AT A RETAIL DAY TRADING FIRM, at 7 (1999) (concluding that the study shows that 70% of traders will not only lose, but will almost certainly lose every thing they invest).
[69] *See* MILLS, *supra* note 66, at 123.
[70] *See id.* at 113 (beginning discussion of the tutorial methods used by day trading firms).

For example, Joe has a margin account with Broker-Dealer X. The current account balance in Joe's margin account is $2,000 in cash, since $2,000 is the minimum balance needed to open a margin account under NASD and NYSE rules.[71] Federal law mandates a limitation on the amount of margin offered to any investor holding a margin account. Under Federal Regulation T[72], Broker-Dealer X may only offer margin equivalent to 50% of available assets within the margin account on typical common stock transactions. In this scenario, since Joe only has $2,000 in assets (in the form of cash), Broker-Dealer X may only offer a margin loan in the amount of $1,000. Therefore, Joe may purchase $3,000 worth of securities because he has $2,000 in cash plus the $1,000 in margin. The $3,000 represents Joe's current buying power.

In a situation favorable to Joe, Joe would invest $3,000 for 300 shares of Company XYZ at $10 per share. After purchasing the 300 shares at $10 per share, the value of the shares would appreciate to $15 per share or $4,500 total. In this case, Joe would sell the shares at $15 per share and then repay the margin loan of $1,000 plus any margin fees. In the end, Joe pockets approximately $3,500 that is comprised of his initial $2,000 in cash and approximately $1,500 in gains. Joe enjoys approximately a 75% gain for his investment on a 50% increase in price. If Joe initially limited his investment to $2,000, Joe would have purchased 200 shares of Company XYZ at $10 per share that would appreciate to $3,000 when the share price increased to $15. Therefore, Joe would enjoy only a 50% return because he only receives his initial $2,000 cash investment plus the $1,000 in gains.

Since margin is essentially a loan, firms want to limit credit risks. Most brokerage firms impose maintenance requirements as a method of limiting credit risks. Maintenance requirements are usually a certain percentage of the value of equity (or assets) in the margin account. There is no set margin maintenance percentage. However, the NYSE, NASD, and Regulation T prescribe minimum margin maintenance requirements. For example, the NYSE's requirement is 25% of the value of all securities "long"[73] in the account from its members.[74] A firm may also increase the margin maintenance percentage in light of the volatility of the stock an investor wishes to purchase. If an investor's account value falls below the margin maintenance amount, then the investor must either deposit cash or shares into the account to increase the equity position in the account to the margin maintenance level. However, if the investor does not increase the equity in the account through a deposit, then the broker may liquidate the remaining assets in the margin account to receive repayment of the margin loan. The investor must pay any remaining debit balance to the brokerage firm.

[71] *See* NASD Rule 2520(c)(2), NASD Manual (CCH) Rule 2520 (July 1996) *and* N.Y.S.E. Rule 431(a), NYSE Constitution and Rules (CCH) ¶ 2431 (Apr. 30, 1987).
[72] *See* 12 C.F.R. § 220.4(b)(1) (2000).
[73] A "long position" refers to the status of one who owns securities which he holds in expectation of a rise in the market or for income as contrasted with one who goes in and out of the market on a short point spread. BLACK'S LAW DICTIONARY 943 (6th ed. 1990).
[74] *See* N.Y.S.E. Rule 431(c), NYSE Constitution and Rules (CCH) ¶ 2431 (Apr. 30, 1997).

Assuming that the maintenance requirement for Joe is 50% of the account's equity value, margin would magnify Joe's losses, if Joe's investment depreciated from $10 per share to $5 per share. If Joe's $3,000 (initial cash plus margin) investment in Company XYZ depreciated by 50%, then Joe would only have account equity equaling 33% of account value because only $500 of $1,500 remaining in the account is account equity (the remaining $1,000 is margin that must be repaid). Once the equity value in the account goes below 50% of the entire account equity value, then Broker-Dealer X would make a maintenance call and demand a deposit of either shares or cash to raise the equity value in the account to 50% of total account value. Therefore, Joe would only take $500 and suffers a 75% loss on a 50% decrease in value. Furthermore, if Joe cannot make a deposit to meet the maintenance requirement, then Broker-Dealer X may liquidate XYZ shares in the account and pocket funds in an amount equivalent to the margin loan plus any fees charged. Additionally, most investment firms place the right to liquidate shares without notice in the customer agreement that the investor signs before opening an account. The recent increased utilization of margin, particularly by on-line investors, appears to have resulted in several high profile arbitration cases. In these cases, on-line investors incurred significant losses that went beyond their financial capacity because brokerage institutions permitted investors to participate in excessive margin trading.

The financial leverage that margin offers is an attractive tool for investors willing to borrow to increase gains. However, abuses by both brokerage institutions and on-line investors have been problematic. A 1999 NASAA study of day trading firms noted that day trading firms encourage lending among intra-day investors in an effort to help each other meet margin calls.[75] The problem with such a practice is that it encourages the pursuit of intra-day trading (a very high-risk form of trading that frequently results in the loss of all invested assets) with borrowed funds. Since a large majority of day traders incur losses, the probability of receiving repayment seems low. The solvency of the day trading firm is also at risk if the practice becomes widespread and the amount of debit payment defaults increase beyond an acceptable limit. Furthermore, many of the loans appear to be illegal and intent on circumventing margin lending limitations.

Day trading firms are not the only type of investment firms troubled with margin problems. On-line brokerage firms also faced margin problems over the past year. The highly volatile market movement in the first week of April 2000 led to numerous account liquidations because of sharp declines in the value of shares (most notably Internet shares).[76] Because of the numerous account liquidations, investors' misunderstanding of brokerage firm liquidation rights became obvious. Some investors did not realize that liquidation was at the discretion of the brokerage firm and that the firms have no obligation to give a margin call prior to liquidating shares. Mike Dunn, a spokesman at Datek, stated that "[t]hree days is the standard [amount of time to meet a margin call], but [brokerage firms are] not really even required to issue margin calls. If [an investor's]

[75] *See* NASAA REP., *supra* note 43, at 26.
[76] *See* Fred Vogelstein et. al., *In Hock for Hot Stocks: Overleveraged Investors Take a Beating in a Huge Sell Off. Is There More to Come?*, U.S. NEWS AND WORLD REP., Apr. 17, 2000, at 36.

account falls below minimum margin requirements, we can close you out."[77] Better understanding of the risks and consequences of margin trading may have prevented the large upheaval caused by the volatile market movements.

Margin problems in the on-line brokerage context frequently begin with a combination of two factors. The first factor is a novice investor that receives margin-trading privileges. The second factor is the calculation of buying power. The story of Lael Desmond illustrates the problem.

Lael Desmond was a medical student enrolled at Indiana University.[78] Desmond originally invested $30,000 in his on-line account at Ameritrade. For the most part, Desmond invested in half a dozen tech stocks. As time passed, the value of his portfolio increased. Desmond then took advantage of margin plus the appreciation of his stocks to purchase shares worth more than $67,000. One report noted that "[a]t its peak, Desmond's account had grown to about $140,000."[79] However in August of 1998, the market dropped and the value of Desmond's portfolio plummeted. The equity in his account fell below the margin maintenance level, and eventually, Desmond lost his entire investment and incurred a debit balance of $10,000.[80] Lael Desmond's story is not an isolated incident. Many other investors shared in Desmond's experience during the most recent large-scale market decline this past April.

Investors increased their use of margin from October 1999 through March 2000.[81] The amount of margin outstanding at NYSE brokerages increased from $179 billion to $278.5 billion during that period.[82] Margin is a very effective tool that investors have at their disposal. However, a large measure of discretion is necessary to effectively take advantage of the financial leverage it offers. Margin also provides a source of income to brokerage firms because of the fees and interest charged on the amount of margin given to clients. One report noted that "[m]argin customers are even more profitable than rapid-fire traders, so no brokerage wants to alienate them. On the other hand, mismanaging margin risk is the quickest way to go out of business."[83]

E. Investor Education and Information

Advertisements describing the relative ease of on-line trading created the popular misconception that there are relatively few risks involved in on-line trading. Furthermore, advertisements have also created the misconception that on-line brokerage firms have direct access to financial markets resulting in a more efficient and lower

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[77] See Thomas S. Mulligan, *E-Brokerages Face Backlash after "Margin" Debacle*, LA TIMES, Jun. 11, 2000.
[78] Scott Bernard Nelson, *Thorny Issues Arise over Protections for Online Investors*, BOSTON GLOBE, Jul. 5, 2000, at A01.
[79] *Id.*
[80] *See id.*
[81] *See* Mulligan, *supra* note 77, at 61.
[82] *See id.*
[83] *See id.*

priced trading alternative.[84] These misconceptions leave some prospective investors in the dark and exposed to risks that they may want to avoid.[85] Thus, education and the availability of objective, understandable information should be key ingredients that will reverse investors' misconceptions and provide effective investor protection.

Although on-line brokerage firms advertise the speed and efficiency of their service, such firms do not immediately execute the trades placed. When an investor places an order with an on-line brokerage firm, the investor does not place his or her order immediately to the market.[86] Education programs should teach investors to understand that:

(1) On-line brokerages operate a tiered system that processes orders.[87]

(2) Delays in order execution may occur because of system problems that happen after the investor initially places the order.

(3) When a stock trades in a fast market environment, the ability to execute orders at a certain price is difficult because of the rapid shifts in the stock's price.

(4) Large volumes of orders placed on the on-line brokerage firm's system may overwhelm the system's capacity and also exacerbate delays in order execution.[88]

(5) Delays in order execution also occur at the market maker level.[89]

Therefore, trading delays may not necessarily happen at the on-line brokerage level. Instead, the delay may occur at the market maker level because the flood of trading volume for a volatile security swamps the market maker's capacity to execute trades.

Since there is a risk that an investor's order may be difficult to execute at a certain price, investors should know the implications of this risk on the trades they place with the on-line brokerage firm.[90] Investors should also know how to mitigate the risk of placing a trade during a fast market by learning how to effectively use limit orders.[91] Limit orders are orders to execute a buy or a sell at a given price or better within a prescribed period of time. Unlike a limit order, a market order is an order to execute a buy or sell trade at whatever price exists in the market. The failure to place a limit order during a fast market period exposes the investor to the large shifts in the stock price. Therefore, an

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[84] *See* N.Y. ATT'Y GEN. REP., *supra* note 46, at 38 (noting advertising claims by on-line brokers of "speed, access, and reliability").
[85] *See id.* at 39.
[86] *See id.* at 34.
[87] Note the discussion of on-line brokerage firms' tiered system in Part II subsection A.
[88] *See* Arthur Levitt, *Statement Concerning On-Line Trading* (Jul. 24, 2000) <http.//www.sec.gov/news/press/99-9.txt> [hereinafter Levitt 99-9].
[89] *See* N.Y. ATT'Y GEN. REP, *supra* note 46, at 61.
[90] *See id*.
[91] *See* Levitt 99-9, *supra* note 88.

individual that placed a trade via the Internet hoping to purchase shares for one dollar a share may have his or her order executed at the current market price of $10 a share.

On-line investors must also know more about the risks, limitations, and obligations involved with the use of a margin account. Some important issues are:

(1) Investors must deposit at least $2,000 in cash or securities to open a margin account.[92]

(2) Once the on-line investor opens a margin account, the on-line investor can borrow up to 50% of the account value to purchase securities.

(3) The amount of margin available is dependent upon the value of the account. Therefore, the amount of margin available for the purchase of a particular security will change with fluctuations in the value of securities in a given account. Thus, on-line investors have a dynamic variable that dictates how much they can borrow to purchase securities.

(4) Furthermore, on-line investors must also maintain a margin requirement for their account. Usually the margin requirement demands that the equity in a given account must be a certain percentage of the amount of margin loaned to the on-line investor. If the value of shares purchased on margin decreases and causes the equity value of the account to dip below the margin requirement, the on-line brokerage firm may demand the deposit of cash or shares into the account to meet margin requirements.

(5) If the on-line investor cannot produce the necessary cash or securities to cover the margin requirement, then the on-line brokerage firm may liquidate securities and garnish the proceeds from the account as repayment of the margin loan.

(6) Margin agreements generally provide on-line brokers the authority to liquidate a customer's account to cover any margined amount at the broker's discretion without notice to the client.

Since an on-line investor's buying capacity fluctuates with changes in the value of securities held in an account, on-line investors must take particular care not to place transactions that are beyond their means to avoid making purchases that they are unable to cover. Margin acts as a leverage tool that can either increase the percentage of profits made on an investment or multiply the percentage of losses incurred on an investment. Since margin is a complicated issue that can make or break the success of an on-line or traditional off-line discount account, investors need to fully understand the complicated processes and implications of margin procedures and operations. Furthermore, investors must gain a full understanding of the complicated written agreement that investors must sign to receive a margin account. Arguably, on-line and written presentation of these kinds of investor education issues would greatly assist in achieving investor protection

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[92] *See* NASD Rule 2520(c)(2), NASD Manual (CCH) Rule 2520 (July 1996) *and* N.Y.S.E. Rule 431(a), NYSE Constitution and Rules (CCH) ¶ 2431 (Apr. 30, 1987).

objectives. Focusing on these issues, the NASD's proposal to amend margin disclosure rules seems to be a partial step in the right direction.

Similarly, education or disclosure to discount investors would also be appropriate regarding options, excessive intra-day trading, bulletin board stock trading, and other high risk strategies and securities.

V. RECENT REGULATORY AGENCY ACTIONS

A. Recent Study Findings and Recommendations

Recent studies by the SEC, GAO, NYAG, and NASAA provide interesting insight into issues and concerns regarding on-line brokerage firms and day trading. The reports produced by the SEC, GAO, and NYAG focus on the on-line brokerage industry as a whole. NASAA's report focused on day trading and the business practices of day trading firms.

SEC Findings and Recommendations

SEC Commissioner Laura Unger released an on-line trading report ("SEC Report") on November 22, 1999.[93] The report summarized findings from a series of on-line investing round table discussions conducted earlier in the year with various members of the on-line investing industry. In regards to the suitability doctrine, Unger stated, "in the on-line trading environment, pinpointing what constitutes a recommendation can be difficult. As data mining technology enables on-line firms to customize information and provide it to customers, the [suitability issue] becomes more pressing."[94] Commissioner Unger uses the following seven hypothetical fact patterns to show the SEC's application of the suitability doctrine to various degrees of interaction between a broker-dealer and a customer:

> 1. AN ON-LINE BROKER-DEALER PROVIDES ONLY ORDER EXECUTION SERVICES TO ITS CUSTOMERS.
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>   This activity should not require a customer-specific suitability review, assuming that the firm acts purely as an order taker. This scenario is substantially similar to when the investor contacts a discount firm by telephone to execute a particular trade. The only difference is the *medium* by which the order is communicated to the firm. A firm's suitability obligation does not depend on whether a trade is executed on-line or otherwise.
>
> 2. AN ON-LINE BROKER-DEALER PROVIDES ORDER EXECUTION SERVICES AND ALLOWS ITS CUSTOMERS TO PULL INFORMATION FROM ITS "VIRTUAL LIBRARY" (WHICH CONTAINS RESEARCH REPORTS, MARKET COMMENTARY, AND NEWS). THE VIRTUAL LIBRARY APPEARS THE SAME TO EVERY CUSTOMER.
>
>   This type of activity should not trigger customer-specific suitability requirements. However, the broader reasonable basis suitability standard would apply in this context. In other words, the firm must have a reasonable basis for believing the research reports and market commentary are plausible and that the

[93] *See* SEC Report, *supra* note 37.
[94] *Id.* at 2.

investments or strategies discussed therein may be appropriate for at least some of its customers.

3. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE CUSTOMER HAS THE ABILITY TO PERSONALIZE WHAT SHE SEES EACH TIME SHE GOES TO THE ON-LINE FIRM'S WEBSITE. THE CUSTOMER'S PERSONALIZED WEBPAGE TRACKS QUOTES IN SPECIFIED STOCKS, AND PROVIDES ALERTS ABOUT RESEARCH IN SUCH STOCKS OR THE SECTOR THEY ARE IN. THE CUSTOMER ALSO IDENTIFIES HERSELF AS A PARTICUALAR TYPE OF INVESTOR.

   Resolving this scenario requires a more difficult determination. On the one hand, the customer has personalized the website, with no intervention from the firm. If the investor had not identified herself as a particular type of investor, this scenario should trigger no customer-specific suitability requirement. If, however, the customer does identify herself as a particular type of investor, the firm is on notice that the customer is following stocks that may be inappropriate for her if she has indicated a very low risk tolerance. This difference between how the investor identifies herself and how she customizes her web page may trigger a firm's suitability obligation. As a good business practice, the firm would probably want to advise the customer (in writing prior to executing any transactions) that risky stocks are not consistent with a conservative investment strategy.

4. THE ON-LINE BROKER-DEALER CLASSIFIES ITS CUSTOMERS INTO DIFFERENT CATEGORIES BASED ON FACTORS SUCH AS ACCOUNT BALANCE, SECURITIES HOLDINGS, AND FREQUENCY OF TRADING ACTIVITY. THE FIRM DIRECTS DIFFERENT INFORMATION TO CUSTOMERS IN EACH CATEGORY.

   This scenario may require more facts to determine whether the firm has a suitability obligation. One relevant factor is how finely the firm segments investors and personalizes the information that they see. If a firm makes individualized recommendations to the customer based on information it has collected about the customer, the firm would have a customer-specific suitability obligation. Firms would most likely not have suitability obligations if customers select certain investment categories and request to receive information appropriate for that category.

5. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE ON-LINE BROKER-DEALER PUSHES SELECTED INFORMATION TO THE CUSTOMER BASED ON OBSERVATIONS THAT THE FIRM HAS MADE OF THE USER WHILE SHE WAS ONLINE. FOR EXAMPLE,

AN ON-LINE BROKER-DEALER SEES THAT SHE TENDS TO PURCHASE SHARES OF BLUE CHIP COMPANIES AFTER THEIR STOCK PRICES HAVE FALLEN AND SENDS AN E-MAIL TO HER WHEN THE PRICE OF A SIMILAR BLUE-CHIP COMPANY HAS FALLEN.

At this point on the continuum, the firm now has a customer-specific suitability obligation. While the process may be somewhat mechanized, the firm is now tailoring particular securities to her.

6. IN ADDITION TO THE SERVICES PROVIDED IN SCENARIO 2, THE ON-LINE BROKER-DEALER HELPS THE CUSTOMER MANAGE HER PORTFOLIO ON-LINE, EITHER BY PROVIDING BENCHMARKS HER PORTFOLIO SHOULD MEET OR BY ADVERTISING ON THE CUSTOMERS' ASSET ALLOCATION FOR HER PORTFOLIO.

   An "asset allocation calculator," where an investor enters basic information and the calculator provides a suggested asset mix (68% in stocks, 20% in bonds, 12% in cash, for example), is usually akin to a generalized recommendation. In those situations the firm should not have to make a customer-specific suitability determination. As always, the reasonable suitability standard would apply.

   Assuming that after entering all of her investment assets into the "asset allocation calculator," she is alerted that she had too much common stock in her portfolio and should consider selling her blue-chip company shares and buying a municipality's industrial development bonds. This situation would be viewed as a personalized recommendation regarding specific securities, triggering a customer-specific suitability obligation.

7. A FULL-SERVICE BROKER-DEALER ALLOWS CUSTOMERS TO ENTER ORDERS ON-LINE OR THROUGH A REGISTERED REPRESENTATIVE. THE REGISTERED REPRESENTATIVE RECOMMENDS A PURCHASE IN A SPECIFIC STOCK TO A CUSTOMER OVER THE TELEPHONE. THE CUSTOMER THEN ENTERS THE ORDER ON-LINE IN THE EVENING.

   In this scenario, the firm has a customer-specific suitability obligation. The registered representative made a personalized recommendation to a customer. The more difficult issue for a firm will be how to monitor a broker's off-line recommendations to its customers for suitability when the customer enters the order on-line.[95]

[95] *Id.* at 32.

Commissioner Unger also described disclosures that on-line investment firms should make to investors. The recommended disclosures are part of an effort to provide the customers with information that will clearly define and describe the risks involved with on-line trading. The report recommends that the SEC should consider requiring broker-dealers to regularly provide customers with plain English information about: (a) the execution quality available on different market centers; (b) the broker-dealer's order handling practices; and (c) inducements for receiving order flow by the broker-dealer. The result of such disclosures may make on-line investors more wary of risks involved in on-line trading and may make investor expectations more reasonable.

The report also recommends that the SEC should consider requiring broker-dealers to test contingency plans, maintain detailed records of significant system outages, and include plain English disclosures of the risks of system delays or outages in new account documents. The report further recommends that the SEC should study on-line investor behavior to determine the best place and time to educate investors on the Internet.

The disclosure recommendation and the education recommendation tend to show that the SEC believes that consumers are unaware of the risks involved with on-line trading. Chairman Arthur Levitt believes that by better informing investors of the points at which order-processing systems may delay customer orders, investor expectations would be more consistent with the capabilities of technology.[96] Therefore, it appears that the SEC advocates the position that educated consumers will protect themselves from harmful risks once they identify the risks involved in on-line trading.

GAO Findings and Recommendations

The GAO also conducted a study of on-line brokerage firms.[97] The GAO discovered that not all on-line broker-dealers warned their customers about the potential for systems delays and outages. The GAO stated that "[s]ecurities regulators generally do not require broker-dealers to report system delays or outages."[98] The NYSE only requires firms to report outages that threaten the viability of firms. Meanwhile, the NASD recommends that firms inform investors of the problems resulting from potential trading system delays and problems. The SEC added information to its website informing investors of the risk that "technological choke points" may exist and may slow or prevent orders from being placed with the on-line broker. Following the position of the SEC's education and disclosure advocacy, the GAO recommended that the SEC require online broker-dealers to maintain consistent records of systems delays and outages and their related causes. The GAO also recommended that firms disclose the potential for disruptions on their websites.

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[96] *See* Arthur Levitt, *Arthur Levitt Discusses Risks and Rewards of On-Line Trading* (Jul. 24, 2000) <http://www.sec.gov/news/press/99-43.txt> [hereinafter Levitt 99-43].
[97] U.S. GEN. ACCT. OFF., ON-LINE TRADING: BETTER INVESTOR PROTECTION INFORMATION NEEDED ON BROKERS' WEB SITES (1999) [hereinafter G.A.O. REP.].
[98] *Id.* at 15.

The GAO also discovered that some on-line brokerage firms failed to adequately supply information describing the risks of margin trading, how margin requirements operate, privacy considerations, and the risks involved in trade execution. In response to those findings, the GAO believes that the SEC Chairman should make sure that on-line broker-dealers include accurate and complete information on their websites. The information should describe the risks involved in online trading and the risks involved in margin trading. The GAO also felt that available information on the on-line brokerage websites should discuss margin requirement protocol, the capacity of trading systems, and the processes involved in trade executions.

<u>New York Attorney General Findings and Recommendations</u>

In November 1999, the NYAG released a report that noted problems related to the on-line brokerage industry.[99] Much like the SEC report and the GAO report, the New York report also documented disclosure deficiencies. The report noted that many on-line investors had little to no understanding of how on-line brokerage firms route orders to the market for execution. The report also noted that investors were often examining incorrect information regarding account balances, because on-line brokerage firms failed to disclose the fact that the previous day's closing account balance instead of a real-time calculation determined the intra-day account balance. Furthermore, on-line investors did not have adequate information describing the risks of on-line trading that relate to system outages, bottlenecks within the system, and overwhelmed market makers dealing with shares in a fast market. The New York report also noted that on-line brokerage firms did not disclose the number of outages suffered by the firm.

In response to the disclosure deficiencies, the NYAG recommended a comprehensive education initiative designed to inform future and current on-line investors of the benefits and risks of on-line trading through available media. The NYAG also recommended that on-line brokerages disclose the number of outages suffered by the firm. Furthermore, the NYAG also suggested that on-line firms provide a clearer explanation of margin-trading risks and a clear description of the methods used to calculate buying power. The recommendations appear to focus on the necessity of protecting investors by enabling investors to make informed decisions by becoming aware of the risks involved with on-line trading.

<u>NASAA Findings and Recommendations</u>

NASAA focused its report on the day-trading industry.[100] While not directly addressing the issue of on-line brokerage firms and suitability, NASAA documented interesting trends and practices that serve as characteristics of day-trading firms. Much like the SEC, GAO, and NYAG, NASAA noted that the day-trading firms failed to effectively warn investors of the risks involved with day-trading strategies. NASAA complained that misleading and deceptive marketing measures lured investors with

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[99] *See* N.Y. ATT'Y GEN. REP., *supra* note 46.
[100] *See* NASAA REP., *supra* note 43.

unsubstantiated claims that day trading is likely to achieve profits. Furthermore, one firm claimed that its "Training and Mentoring Programs" had an 85% success rate for new traders, despite a claim by an industry expert stating that there is a 95% failure rate.[101] Day-trading firms, whether on-line or not, failed to warn prospective investors of the risks involved with day trading. However, in the context of day trading, the problem is more troublesome because of the misleading and deceptive claims of quick and substantial profits.

NASAA addressed the issue of suitability in the day-trading context. NASAA noted that day-trading firms market day trading as an investment program. The marketing of day trading as an investment program distinguishes day trading from ordinary discount brokers, including on-line brokers. The Securities Industry Association ("SIA") objected to a proposed NASD suitability rule that would make the promotion of day trading a recommendation, because the SIA felt that expanding the definition of "recommendation" would obscure the current definition and "raise difficult interpretive questions." NASAA countered by stating that suitability requirements should apply to day trading firms because "the [day trading] firms, by marketing the concept of day trading and by approving accounts, *implicitly have recommended to customers* that they engage in the highly speculative strategy of day trading.[102]

NASAA also noted that day trading firms also attempted to circumvent margin rules by advocating loans among day traders. Since Regulation T applies only to secured loans, Regulation T would not apply to the unsecured loans between day traders. However, in light of other margin rules, the practice of actively promoting lending between day traders is counterintuitive to the policies that underpin margin rules. Preventing securities firms and customers from over-extension of personal assets is the ultimate intent of margin rules. Encouraging loans between day traders undermines the principles of sound margin management because the day-trading firms encourage loans to individuals who do not have the means to repay the loans. It seems that the day-trading firm encourages day traders to bear more risks by participating in day trading and then making loans to overextended day traders. Therefore, the day trading firm may also violate the suitability doctrine because the firm promotes day trading by overextended individuals using borrowed funds. NASAA concluded that such a practice violated the suitability doctrine and the NASD's equitable and fair practice principles.

As a result of the findings, NASAA felt that day trading required specialized suitability obligations. In addition to added suitability obligations, NASAA endorsed the NASD's proposed rules for increased risk disclosures and enhanced protections for day trading investors. Although NASAA believed that existing suitability rules were currently applicable to day trading firms, NASAA stated that the widespread failure of day-trading firms to adhere to current suitability rules called for specialized suitability rules. NASAA also advocated promulgation of a rule that explicitly prohibited day

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[101] *See id*. at 11 (noting a comment stating that first time day traders will have 95% failure rate); *but see id*. at 9 (describing an advertisement that claimed an intra-day trading seminar that produced an 85% success rate).
[102] *Id.* at 20.

trading firms from promoting and arranging lending among customers. Currently, the promulgation of the prohibited lending arrangement rule is still pending.

B. Current Regulatory Activities

NASD Actions

In response to the increasing volatility in the market and the rise of on-line trading, the NASD released Notice to Members 99-11 ("Notice 99-11").[103] The release reminded firms of their obligations to ensure adequate systems capacity to handle the numerous orders and inquiries that are associated with high volume and high volatility market activity. Furthermore, the NASD stated that firms should "provide adequate, clear disclosure to customers about the risks arising out of and evolving from volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner."[104]

The NASD suggested that both on-line firms and regular brokerage firms should consider disclosing their procedures for order execution to their customers. The NASD also highlighted the following:

1. Firms should warn investors that the high volume of trading at the market opening or intra-day may cause delays in the execution of a trade at the price displayed when the order was placed;

2. Firms should disclose the fact that using limit orders is an effective method of ensuring the execution of a trade at a specific price. Furthermore, investors should know that limit orders are especially effective methods of controlling the risk of execution at an undesired price when trading with highly volatile stocks or IPOs;

3. Firms should warn investors that the high volatility and volume for a particular stock might limit investors' ability to buy or sell the stock. In the on-line context, on-line brokerage firms must warn investors of increased web traffic that may slow the placement and execution of orders;

4. Firms should not exaggerate the firm's capabilities in handling order volume or omit material information regarding the risks of delays for order placement and execution.

The NASD also fully adopted Rules 2360 and 2361 shortly after the SEC approved the two rules in response to increasing problems with day trading firms. Essentially, the NASD decided that a suitability determination was necessary for any individual wanting to pursue a day trading investment strategy because the risk of losing the entire investment is very high. Furthermore, the NASD clarified many misconceptions regarding what disclosures are necessary to adequately apprise investors of the risks of pursuing a day trading strategy.

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[103] *See* N.A.S.D. Notice to Members 99-11 (July 5, 2000) <http://www.nasdr.com/pdf-text/9912ntm.txt >.
[104] *Id.*

In an attempt to "protect the safety and soundness of member firms and ensure the overall financial well-being of the securities market,"[105] the NASD also proposed a rule change to the SEC to change margin requirements for day-trading customers by amending NASD Rule 2520. One of the most significant effects of the proposed rule is that firms must immediately designate individuals as day traders, if the firm knows or has a reasonable basis to believe the customer is a day trader.[106] Therefore, firms must identify a customer as a day trader, if the circumstances surrounding the customer's trading patterns lead to the reasonable conclusion that the customer day trades. The changes also increase the initial deposit amount for a margin account. Under the proposed changes, initial deposits for margin accounts for day traders would increase from $2,000 to $25,000.[107] Furthermore, the proposed changes to NASD 2520 also limit buying power to four times the day trader's maintenance margin excess to prevent illusory liabilities that may accrue to the day trading account holder.[108] The proposed changes to the rule also prohibit intra-day traders from becoming guarantors of other margin accounts for the maintenance requirements of other intra-day traders.[109] Overall the changes to the NASD Rule 2520 appear to be an attempt by the NASD to protect day traders from overextending their financial resources.

The Massachusetts Proposal

Recently Massachusetts proposed a policy statement that would clarify what types of on-line activities would constitute a recommendation in response to the rapid growth of on-line discount trading. The proposal offered two sets of definitions.

"Actions not Constituting Solicitation of Recommendation" were defined as:

A. Collection of Information/Profiling: gathering information electronically about a customer for purposes other than generating investment recommendations.

B. Certain broadly disseminated advertisements, "banner advertisements," not explicitly recommending a particular security or investment strategy.

C. Hyperlinks to other investment-related sites: a link to another site offering investment research or publicly available information. The hyperlink site, however, must be independent

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105 NASD Proposed Rule Change to Amend NASD Rule 2520, 65 Fed. Reg. 8,461, 8,463 (proposed February 18, 2000).

106 The NASD proposed the changes to Rule 2520 on February 18, 2000. The comment period has closed and the NASD recently filed its response to the comments on October 3, 2000. Currently, the NASD is waiting for SEC approval.

107 *See id.*

108 *See id.*

109 *See id.* at 8,464.

from the broker-dealer and not designed for the purpose of generating interest in a particular security.[110]

"Actions Constituting Solicitation or Recommendation" were defined as:

A. E-mail or electronic communication promoting a specific security, group of securities, or particular investment strategy directed toward a certain type of investor.

B. Application of "Data-Mining" technology that researches a customer's past investment habits and uses that information to direct investment-related information to that customer. This technology allows targeted "pop-up" investor specific information that the investor may rely on for a particular trade.

C. Advocating a particular trading strategy to a customer.[111]

Industry Responses to the Massachusetts Proposal

Four firms criticized the Massachusetts proposal and expressed their reservations regarding the suitability requirements and their application to on-line brokerage firms. Opponents of the proposal argued the following points:

1. The firms believed that the Massachusetts proposal was premature and would lead to inconsistent regulatory standards among jurisdictions. One firm argued that Massachusetts should refrain from adopting its proposal in light of the activities of national regulatory agencies such as the NASD, SEC, and NASAA.

2. Massachusetts failed to clearly define the standards stated in the proposal that would make suitability requirements applicable. For example one firm noted that the third safe harbor mentioned in the proposal stated that "a hyperlink to another web site is not a recommendation so long as the other site 'is not designed for the purpose of generating interest in a particular security.'" The firm felt the "is not designed for the purpose of generating interest in a particular security" language implies that hyper linking to a site that is designed for such a purpose constitutes a recommendation. In this situation, the firm bears the burden of trying to determine whether a hyperlinked site "generat[es] interest in a particular security." Arguably, any site that mentions a security in a particularly positive light may be trying to "generat[e] interest in a particular security." Therefore, the Massachusetts proposal would inhibit the flow of information to the on-line investor by creating a chilling effect on the provision of information to investors.

3. New suitability requirements will stunt the growth of the on-line brokerage firm industry. The increased regulation of customer transactions would burden the development of newer services and technology to the detriment of the customer.

[110] Mass. Proposed Policy Statement, 2 Blue Sky L. Rep. (CCH) ¶ 31,648 (2000).
[111] *Id.*

Furthermore, the ability to avoid going through an intermediary and quickly place a trade would be lost. Therefore, the Massachusetts proposal will stifle technological development in terms of making order placement faster and more efficient if states impose their separate suitability requirements.

4. The Massachusetts proposal would unduly burden on-line brokerage firms. The firms felt that the Massachusetts proposal singled out on-line firms and subjected suitability standards that were more demanding than suitability requirements applied to traditional full-service firms and non-on-line brokerages.

Amid the criticism from the on-line discount brokerage industry, Massachusetts withdrew its proposed rule. Prior to the completion of this report, Massachusetts has not proposed any further suitability rules.

VI. VIRGINIA STUDY AND CURRENT SUITABILITY REQUIREMENTS

A. Comparison of Virginia Complaints: 1999 vs. 2000

There was an increase in the number of on-line brokerage complaints from 1999 to 2000. In 1999, the on-line brokerage firms studied reported 349 complaints for a period that began in the last quarter of 1998 and ended in the first quarter of 1999. In the year 2000, the on-line brokerage firms studied reported 486 complaints for a time period that only included the first four months of 2000. Thus, there were more complaints in the 2000 complaint survey for a smaller period of time than in 1999 complaint survey. The increase in complaints for the smaller time period is logical given the large growth in on-line investment accounts and does not necessarily indicate degrading service quality in the on-line brokerage industry. In fact in the 2000 survey, account access problems appeared to decline despite the extreme market turbulence that occurred in April 2000. The complaints for both 1999 and 2000 generally fell under one of the following 12 categories:

1. Poor execution of orders;
2. IPO unavailability;
3. Margin liquidation and margin transactions without customer consent;
4. Fee disputes;
5. Difficulty accessing accounts because of system problems and busy phone lines;
6. No notice of execution;
7. Duplicate trades, unauthorized trades, and rejection of order;
8. Poor web design and system problems limiting the availability of regular features;
9. Account set-up or transfer problems;
10. Administrative errors and poor customer service;
11. Consumer error;
12. The on-line firm did not offer a particular service the customer desired.

In the year 2000, there was a shift in frequency of certain complaint types from the results documented in 1999. In 1999, complaints that dealt with account access issues were most frequent. However, in 2000, the most frequent complaint dealt with administrative errors and poor customer service. Thus, it seems that Virginians are able to access their accounts; however, the services Virginians are receiving do not meet their expectations and desires. The fact that complaints dealing with administrative errors and poor customer service are the most frequent complaint for the year 2000 is not surprising. A recent article stated that "the SEC received 5,843 complaints about bad service from on-line and traditional brokers in the first half of [2000] – more than the total number of service-related complaints received in 1998."[112] Furthermore, the rise in complaints dealing with poor customer service is not limited to on-line brokerage firms because "[m]ore than half the complaints to the SEC about traditional brokers [in 1999] involved bad service, up from 43% in 1998."[113]

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[112] Ruth Simon, *Customer-Service Complaints from Investors Are on the Rise*, WALL ST. J., Jul. 13, 2000, at C1.
[113] *Id.*

B. Suitability Rules in Virginia

21 V.A.C. 5-20-280A2 to 3 ("Prohibited Conduct Code") serves as Virginia's suitability rules. The obligation of fair dealing with customers serves as the doctrinal foundation for the prohibition against unsuitable recommendations. The provisions of the Prohibited Conduct Code state:

> A. No broker-dealer shall:
> 1. *Omitted*
> 2. Induce trading in a customer's account which is excessive in size or in frequency in view of the financial resources and character of the account;
> 3. Recommend to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.[114]

The language used in the rule clearly expresses prohibition of the business practices enumerated under subsection A of the Prohibited Conduct Code.

Enforcement protocol of suitability requirements states that, prior to execution of a recommended trade, the salesperson must undertake "reasonable efforts" to obtain information about the customer's financial background, tax status, and investment objectives. Language in 21 V.A.C. 5-20-270A2 states in part that:

> If the broker-dealer, or any of its agents, has made any recommendations to the customer to purchase, sell or exchange any security, the record of such customer shall also state the customer's occupation, marital status, investment objectives, other information concerning the customer's financial situation and needs which the broker-dealer or the agent considered in making the recommendation to the customer.[115]

Therefore, 21 V.A.C. 5-20-270A2 creates a duty that requires broker-dealers and their agents to discover suitability information.

There are four general elements that the Division must prove to show suitability violations. The four general elements are:

1. The transaction was recommended by the salesperson.
2. The recommended transaction involved inappropriate, speculative, risky securities; 20% or more of the customer's liquid net worth; or a transaction not reasonably expected to be beneficial to the customer.

[114] 21 V.A.C 5-20-280A2 to 3.
[115] 21 V.A.C. 5-20-270A2.

3. Facts about the customer were disclosed to the salesperson prior to the recommendation such as:

    a. No sophistication or limited experience in dealing with the risks of the recommended security;
    b. Limited net worth and/or annual income;
    c. Financial needs indicating that the customer could not afford the loss of the entire investment;
    d. Investment objectives of a conservative nature, such as safety of principal and limited risk or otherwise in opposition to the recommended security.

4. There is no reasonable basis for the recommended securities (the nature of the security, and/or the transaction size).

When options or penny stock recommendations are involved, additional evidence that proves that the salesperson failed to inquire about the customer's finances, financial objectives, experience and knowledge with risk assessment in financial matters, and financial ability to bear the risks of the recommended positions may also be necessary.

C. Virginia Suitability Requirements vs. Other Schemes

When compared to other suitability requirement schemes, Virginia's suitability rules appear quite comprehensive. As one of the 33 states that use NASAA suitability language, Virginia's suitability rule imposes an implied duty of inquiry for broker-dealers or broker-dealer agents to learn of a customer's investment objectives, financial situation and needs, and any other relevant information. Furthermore, 21 V.A.C. 5-20-270A2 augments the suitability rule by creating an affirmative duty to inquire and document an investor's financial needs, financial capacity, and investment objectives. However, much like the other suitability rules, the Virginia suitability rule lacks a clear definition dictating what constitutes a recommendation.

In the on-line context, the applicability of the Virginia suitability rule is not clear. Much like the SEC, the Commission must make a fact intensive analysis of the circumstances surrounding a particular situation to determine whether suitability exists. With respect to prosecuting violations of the suitability rule, the Division benefits from the lack of a clear definition for "recommendation" because the lack of a clear definition allows the Division to garner evidence that tends to show that a recommendation existed. On the other hand, the lack of a clear definition provides no clear boundaries that adequately set limits for activities that constitute a recommendation. The fact that firms may not have a clear understanding of what constitutes a recommendation may frustrate firms' efforts to comply with the rule; yet firms may still be subject to enforcement actions because the Division may deem a "recommendation" existed that violated the suitability rules.

Currently no state, SRO, or federal agency enacted or adopted new suitability requirements that are specifically applicable to on-line brokerage firms. The SEC offered some guidance on the issue of suitability. However, most regulators have taken a "wait and see" position because they are comfortable with the current "fact and circumstances" analysis as the preferred method to identify a recommendation and suitability liability on the broker-dealer's part.

Both members of the brokerage industry and regulators share a common concern that narrow or overly broad definitions of what constitutes a recommendation may severely hamper the efficiencies of the market and the scope of suitability enforcement. Push and pull technology is still developing. Thus, inflexible suitability rules may result in counterproductive measures that are either too lenient to effectively enforce or too strict to allow for efficient development of technology enhanced brokerage accounts.

D. Available Investor Education

Education Provided by On-line Firms

In an attempt to bolster the confidence of novice investors, many on-line brokerage firms adopted educational initiatives to teach new investors how to analyze financial data, learn financial terms, and assess investment strategies. These firms offer the on-line investor the opportunity to learn how to perform many of the investment research functions that regular broker-dealers and broker-dealer agents perform. However, tax code interpretation and other legal or technical analysis largely remains the professional domain of tax attorneys, investment advisors, accountants, and some broker-dealers.

Much of the information on-line investors received for opening new accounts dealt with technical issues by discussing general computer and Internet topics. Furthermore, most of the firms offered programs that simulated on-line order placement. New on-line investors also received glossaries to help them understand the technical language used in the financial industry and brief descriptions of the type of orders that investors can place to the firm through the Internet.

Highlighting a change from the results of the 1999 reports by the SEC and the NYAG, this study revealed that more on-line brokerage firms offered information that described the risks involved with Internet trading. Most notably, many of the firms the Division studied included web pages and documents that discussed and clearly explained the numerous risks involved with fast moving markets and the use of margin. Two firms included booklets produced by third parties such as regulatory agencies to objectively educate investors of the risks involved in Internet trading and margin. One firm even sent NASD information slips to educate its customers on the uses and risks of margin. Another firm discussed the issue of "order flow rebates" and the duty of best execution. Furthermore, some of the firms studied informed investors that order cancellations are not instantaneous because the market maker or clearing firm is responsible for executing the actual order cancellation. Those firms even disclosed the level of care for executing cancellations by stating that the on-line firms will attempt to execute cancellations on a best-efforts basis. In all, it appears that on-line brokerage firms are now disclosing more of the risks involved in on-line trading.

E. Survey Results from 30 Person Sample of Virginia Complainants

As part of the Commission's study of on-line brokerage firms, the Commission surveyed a sample of 30 Virginia complainants selected from complaint files received from on-line brokerage firms to learn more about investors' perceptions of on-line brokerage firm risk disclosures and services.

Twenty-one respondents considered themselves to be experienced investors. Experienced investors had approximately 20 or more years of investing experience on average and conducted approximately 80 investment transactions. Three respondents considered themselves to be intermediate investors. Intermediate investors did not consider themselves experienced investors because they did not feel that they had been investing long enough to consider themselves experienced. Intermediate investors conducted fewer investment transactions than experienced investors by entering approximately 40 transactions from January 2000 until early August 2000. Finally, six respondents considered themselves to be novice investors. Novice investors had approximately five years of investing experience on average and had only conducted eight investment transactions from January 2000 until early August 2000.

Nineteen of the 30 respondents felt that their on-line brokerage firm described the firm's order execution practices and policies in plain English. Of the eleven respondents that felt otherwise, nine of the eleven respondents wanted a plain English explanation along with a description of "payment for order flow." Meanwhile, the remaining two respondents of the eleven felt no need for a plain English explanation of their firm's order execution practices nor an explanation and discussion of "payment for order flow."

A majority of the respondents (21 of 30 respondents) received a margin agreement that described the risks, obligations, and procedures involved with a margin account. Of the nine respondents that did not receive a margin agreement, four respondents wanted such a document. The remaining five respondents of the nine, who did not receive a margin agreement, did not feel the need to receive a margin agreement since they did not use nor desire to open a margin account.

In terms of providing on-line help buttons and general directions describing how to use the on-line brokerage firm's website, an overwhelming majority of respondents (approximately 24 of the 30 respondents) felt that their website provided such help buttons and general directions. In fact, two of the 30 respondents felt that using the screens on their on-line brokerage firm's website was so easy that manipulation of the screens was intuitive and obviated the need for general directions and help buttons. This finding may indicate an improvement in web design since the studies of 1999.

Almost half (14 of the 30 respondents) of the respondents stated that their on-line brokerage firm did not offer hyperlinks to investor educational websites. Thus, consumer advocacy resources were not conspicuously available to these investors when they visited their on-line brokerage firm's website. Of the 14 respondents less that half of them felt that having hyperlinks to investor educational sites would be helpful to them. The other half of the 14 felt that such a service would not be helpful or felt that such a service is not important to them.

A majority of the 30 respondents (21 of 30 respondents) stated that their on-line brokerage firm provided them with a warning when the firm's on-line trading system was down and unable to conduct transactions. Of the nine respondents that stated otherwise, five of the respondents knew that their firm did not offer such a warning. Furthermore, these five respondents felt that knowing when the on-line trading system is down and unable to conduct transactions is not helpful information. The remaining four respondents felt that they could not give an answer because their on-line brokerage firm never had a problem with its systems. Thus, such a warning was neither noticed nor needed.

In another response to a series of question regarding the order handling capacity and on-line service reliability, a majority of the respondents (approximately 20 of the 30 respondents) stated that their on-line brokerage firm:

1) did not clearly disclose the number of computer system outages;

2) did not clearly disclose the maximum capacity that the on-line trading system could handle during peak usage hours; and

3) did not disclose the amount of reserve capacity the firm's on-line trading system possessed during peak usage hours.

Approximately half of the 20 respondents, who said their on-line brokerage firm failed to make outage and capacity disclosures, felt that such disclosures would be helpful information. One respondent even stated that knowing the percentage of downtime to total operational time should be disclosed so that consumers could compare the percentages of various on-line brokerage firms and thereby rate the firms in terms of quality.

The remaining respondents (10 of the 30 respondents) did not know if their firm made such disclosures because such information was not important or particularly helpful to them. Furthermore, these respondents did not have problems accessing their accounts due to capacity problems. Such a finding may be an indication that on-line brokerage firms have improved levels of capacity since 1999.

In response to a question regarding on-line trading risk, 20 of the 30 respondents to the Commission's survey felt that their on-line brokerage firm adequately described the risk of on-line trading. Furthermore, 23 of the 30 respondents know how their on-line discount brokerage firm determines the amount of "buying power" available for any given stock purchase. This may be a result of the numerous respondents that claimed to be expert and intermediate investors because such individuals are more accustomed to reviewing disclosures and information necessary to effectively manage their on-line brokerage accounts.

A majority of respondents (21 of 30 respondents) wanted a warning from their on-line broker when any of their stock purchases necessitated the use of margin or some sort of loan. Many felt that this should be mandatory disclosure since they would incur debt liabilities.

There appears to be an even split between on-line investors that want their on-line brokerage firm to provide some sort of warning when a trade is too risky for their financial objectives. In this case, 15 respondents felt that they wanted their on-line brokerage to provide them a warning when the trade they placed with the on-line brokerage firm is more risky than the financial objectives they have identified to the firm. On the other hand, 13 of the remaining respondents did not want their on-line brokerage to provide them with a warning when the trade they placed with the on-line brokerage firm is more risky than the financial objectives they have identified to the firm. For the most part, the 13 respondents felt that they did not need any oversight for the investing decisions they decided to make. Two respondents did not know whether they wanted such a warning. The two respondents felt that such a warning may be a good idea but not acceptable if the warning either prohibits the execution of a trade or substantially slows the trade's execution.

The Commission's survey was an informal perception study. The Commission did not intend the survey to be a source of statistical inference for all Virginia on-line brokerage account holders. Nonetheless, the survey yielded some interesting results. States and regulatory agencies should look to the SEC's current consumer survey mentioned at the conclusion of Commissioner Unger's 1999 SEC Report to get a more accurate idea of consumer preferences, perceptions, and concerns through statistical inference once the SEC releases the results of its survey. Additionally, NASAA should endeavor to perform its own national survey to determine what investors feel are important disclosures and information necessary to effectively manage their on-line brokerage accounts.

F. Best Practices

The study identified areas where on-line firms have the opportunity to utilize best practices to maximize investor protection and minimize liabilities. The best practices focus on the following five categories:

1. Order Placement

Since many on-line investors tend to be novices, on-line brokerage firms would best serve the interests of their clients by providing spontaneous confirmation of order placement. Reassuring the on-line investor that the on-line firm received the order may alleviate the risk of the investor placing a duplicate trade. Furthermore, if an investor nonetheless places a duplicate trade to the on-line firm, then some type of system should warn the investor of the duplicate trade. The precise moment the investor must confirm the order to the firm would be the most effective time for the duplicate trade warning. A simple pop-up screen should suffice.

Restricting after-hours orders to limit orders is another effective measure to protect investors. Limiting after-hours orders to limit orders may minimize the effects of large price fluctuations that are characteristic of early morning trading, since execution of the order is limited to the price stated on the order or better. Obviously, more clear and concise information teaching investors how to use limit orders is necessary to pursue this practice. Therefore, it is imperative that on-line brokerage firms clearly explain the differences and benefits of limit orders versus market orders. Furthermore, it is also imperative for on-line brokerages to disclose the risks of after-hours trading.

If an on-line firm does not restrict after-hours orders to limit orders, then the on-line firm should clearly disclose the risks involved with after-hours trading. For the most part, the disclosure should clearly and adequately describe the large price fluctuations that are characteristic of early morning markets.

Also, whether a firm offers after-hours trading or not, on-line brokerage firms should clearly and adequately explain how their order execution process operates. Explaining how the order execution process operates would allow investors to understand the limitations of their on-line brokerage firm. For example, on-line firms' disclosure of their lack of direct access to the market place may encourage on-line investors to be more wary of price shifts between the time an investor places an order and the moment of order execution. Understanding the order execution process may develop more realistic expectations for an on-line firm's capability to execute orders. Therefore, investors may be less inclined to actively trade as opposed to invest long term.

2. Risk Disclosures

There are numerous risks that on-line and off-line investors must face. To adequately avoid these risks, investors must recognize the risks of both on-line investing and trading privileges such as margin trading or options trading. By recognizing and understanding the risks that are involved with trading, investors may make better trading decisions. Thus, informed investors may be more wary of the numerous ways both on-line trading risks and special trading privileges may adversely increase their investment risk.

To prevent investors from unknowingly participating in high risk trading privileges, on-line discount brokerage firms and off-line discount brokerage firms should make investors apply for margin accounts and options trading privileges on separate and conspicuously noticeable documents or web pages. One of the firms studied automatically granted margin privileges to new account holders by requiring a $2,000 deposit to open an account. Since $2,000 is the minimum amount necessary to open a margin account, all new account holders had margin trading privileges. Unfortunately, some of these novice investors did not know they were eligible for margin and unknowingly traded with margin only to have their assets liquidated when the value of their portfolio dropped significantly.

Although the problem seems to occur on a limited basis, on-line and off-line brokerage firms may avoid the problem altogether by having new customers fill out a separate application for margin privileges. By having a separate application for opening a margin account, investors will be able to affirmatively request margin privileges and will be on notice of their responsibilities and rights in margin transactions. Where feasible technologically, firms should consider informing customers on-line that they will be utilizing margin in their transaction. With such a disclosure, investors will be aware of their use of margin and can adjust their trading decision accordingly.

Since the brokerage firm makes the loan in a margin transaction, the investor must clearly understand the brokerage firm's special rights and the risks of margin trading. The risk that the investor may owe more than the amount the investor initially borrowed is the primary risk that brokerages should convey to the investor. The brokerage firms' discretionary liquidation right is another material fact that brokerages should clearly and conspicuously disclose.

Recently, the NASD Board of Governors proposed a change to Rule 2341 that would require member firms to provide a written statement that fully describes the risks associated with trading securities with a margin account.[116] Along with the two disclosures previously mentioned, the NASD also expects the following disclosures regarding margin:

- A firm may notify the customer of a margin call and allow the customer a few days to meet the call, but the firm also can sell a customer's securities without contacting him or her;

- A customer cannot decide which securities should be sold from his or her account;

- A firm can increase maintenance requirements at any time;

- A firm does not have to grant a customer an extension on a margin call.[117]

The need for risk disclosure is not limited to margin trading. Options-trading also entails a large measure of risk. Therefore, much like margin, brokerage firms should provide for a separate and conspicuous document or web page for consumers to apply for and learn about option-trading privileges. The separate disclosure for options-trading

[116] The SEC published the NASD's proposed changes in the *Federal Register* on October 23, 2000. Currently, the proposed changes are in the public comment period. The comment period will close on November 13, 2000. *See* Proposed Rule Change by the NASD relating to the Delivery Requirement of a Margin Disclosure Statement to Non-Institutional Customers, 65 Fed. Reg. 63,275, 63,278 (proposed October 23, 2000).
[117] *See id* at 63,277.

would also place investors on notice of their options trading privileges and would allow the investors to make their trading decisions accordingly. Furthermore, the separate application could serve as a medium for the clear disclosure of risks involved with options trading.

Finally, on-line brokerage firms should actively try to disclose the risks of fast market conditions. The increased risk of delays in order placement and the large shifts in the price of particular shares usually characterize fast market situations. In light of such a trading environment, on-line investors need to know the consequences and effects of such fast conditions when they attempt to place a trade so they can make a reasonable investment decision in light of all the information available.

3. Suitability Determinations

Brokerage firms should not limit the suitability determination to recommendations and solicitations. The NYSE "Know Your Customer" Rule requires suitability determinations for all transactions channeled through a member firm's system. Suitability determinations should serve as an effective screen when deciding what trading privileges various investors should receive.

In terms of margin, determining whether a margin account is suitable for a customer is one best practice that may prevent individuals without the financial capacity or experience from trading with margin. Furthermore, since margin is a type of loan, on-line and off-line brokerage firms may want to lower the risk of defaults by limiting margin to those investors with the financial capacity to sustain a substantial loss in their portfolio. The same is also true for options-trading. However, the investor's trading experience is also a characteristic that the firm should evaluate before granting options and margin trading privileges because these styles of trading can be highly technical and complex. Thus, options trading and margin is not suitable for all investors. When determining whether to grant special high risk trading privileges, it is imperative that discount brokerage firms gather information describing the investor's investment objectives and financial capacity. In light of the suitability information gathered, the on-line and off-line brokerage firms may make better reasoned decisions to match the investor's objectives and financial capacity with the trading privileges and services offered by the firm.

4. Information Provision

On-line brokerage sites offer a wealth of information. However, the Division noted that there are specific types of information offered by some on-line brokerage firms that are most beneficial to investors.

The Division thinks that on-line investors should have notice of system outages and failures that occur at on-line brokerage firms. Investors should have the ability to compare the reliability of on-line brokerage firms and should know of the necessity to place trades via alternate methods once an on-line trading system is unavailable.

Furthermore, the on-line trading system should warn investors of down time periods when the system performs batch processing or is subject to routine maintenance or upgrades.

The next piece of information that is critical for effective investor assistance is the offering of real time account balances and real time buying power. The Division discovered that it is not a common practice to provide investors with real time account balances. For the most part, firms perform nightly batch processing that calculates an investor's account balance based on the closing prices for that day's market. Thus, the balance the investor sees the following day during open market hours is not an accurate representation of the account's actual balance at that particular moment in time because the on-line firm calculated the balance the investor sees with the previous day's closing values. Providing a real time account balance is a best practice because real time account balance services allow the firm and investor to accurately calculate buying power. Accurately calculating buying power allows the investor to guard against overextending assets to make purchases. By helping the investor avoid overextending, the firm can help the investor prevent purchases that are beyond the investor's means.

If an on-line brokerage firm offers buying power calculations to clients, then the on-line brokerage firm should use real time calculations. The use of real time calculations is especially important to those investors with margin accounts, because the amount of margin available to those individuals is dependent on the value of account equity at the time of the transaction. The use of the previous day's close runs the risk of overstating the balance within a margin account if the account equity drops significantly. With that in mind, it is easy to see how an investor with a margin account may incorrectly place a trade that would overextend his or her financial resources.

Finally, on-line brokerage firms should help investors stay abreast of the duties that on-line brokerages owe the investor. One best practice the Division noticed was providing a conspicuous hyperlink to regulatory authorities. Regulatory agencies such as the SEC, NASD, and NASAA provide websites that help inform and educate investors about investor rights and investment laws. These sites also provide guidance to investors to help them understand and identify investment risks and how to mitigate those risks. These regulatory sites also provide investors with a forum to place any complaints and to ask questions regarding the level of services that their on-line brokerage firm has a duty to provide.

5. <u>Value-added Services and Processes</u>

During the study, the Division noted that full-service retail firms and hybrid firms conducted suitability reviews of unsolicited trades placed by their customers. The suitability review would occur either prior to order placement or following order placement. Fiduciary obligations, professionalism, and maximizing the value of services offered to the investor spurred both full-service firms and hybrid firms to provide the pre- or post-trade suitability review of the unsolicited orders. Both full-service firms and hybrid firms felt that either advising against an unsuitable unsolicited trade or warning the client that the trade is unsuitable in light of the client's investment objectives was a necessary service that clients expected. Therefore, as a form of differentiation from discount brokerage firms (either on-line or otherwise), full-service firms and hybrid firms frequently monitored the suitability of solicited and unsolicited trades by investors.

The Division feels that the pre-or post-review of unsolicited trades is a beneficial practice. In the on-line discount broker context, on-line firms may develop some sort of algorithm to compare investor objectives and an investor's financial capacity with a specific investment or order. The use of such information technology is not a suitability measure that would become mandatory, but rather, such a system and optional service would provide a value-added warning service that would benefit both the on-line brokerage firm and the on-line investor.

The technology to establish such a system is not unrealistic. In fact, one of the firms studied has an information technology system that prevents orders that would exceed a client's buying power. Through the information technology system, the firm protected the client's interests by preventing "over buying." Another firm's information technology system noted duplicate trades and warned the investor that he or she was placing a trade that was substantially similar to one already placed. Thus, on-line brokerage firms can develop such technology. Others in the on-line industry suggest that automated suitability analysis is not unrealistic. However, to facilitate these types of developments, regulators will have to adopt a no action position. Forcing technological suitability analysis would burden firms that are financially unable to develop such technology, but nonetheless, effectively service their clients' needs. Furthermore, forcing technological suitability analysis will restrict the variety of brokerage services desired by different customers.

G. Related Problems

Other problems exist outside of the realm of suitability. The issue of "best execution" practices is one such problem. The term "best execution" deals with a firm's duty to find the most beneficial price for a customer's order. Thus, when a customer decides to purchase stocks, the broker-dealer must try to find the lowest price to purchase the customer's desired stocks. In the case of a sell order, the broker-dealer has an obligation to try to find the highest price available for the customer's stock.

The problem that some broker-dealers have in the area of best execution involves "order flow rebates." "Order flow rebates" are discounts offered by market makers to broker-dealers for the execution of a certain volume of orders. In the typical "order flow rebate" situation, broker-dealers would place orders with the market makers that offered "order flow rebates" to lower the transaction costs of executing trades. However, those savings are not always passed to the consumer because the consumer may not receive the best price for the execution of an order. Instead of routing orders to the market maker that offers the best price for any given order execution, the broker-dealer routes orders based on the amount of rebate he or she may receive from a market maker. Thus, the driving rationale for finding an execution price may have nothing to do with the best interests of each investor.

Determining the best risk management methods was another problem identified during the study. Problems with computer systems may occur at any time. However, the issue here is determining what are the best practices available to mitigate the risks of computer outages and the subsequent problems that follow. This is especially important when fast market conditions place additional strains on the capacity of an on-line broker's computer systems.

The issue of privacy and the content of on-line discussion forums were two important consumer protection issues identified during the study. With the rise of information gathering techniques through the Internet, the privacy rights of consumers appear more strained. In the on-line brokerage context, the vast amounts of private financial information that consumers divulge to financial services firms over the Internet needs some sort of protection from misuse. In today's world of direct marketing via mailings, telemarketing, and e-mail, targeted marketing schemes bombard consumers with numerous offers and deals. With that in mind, consumers may need some sort of measure that will allow them to take control of their personal financial information to limit the information's use by firms.

Furthermore, since the Internet is an effective method for disseminating information to large audiences, the messages sent through the Internet, in terms of investment information, must maintain a level of integrity that will prevent misconceptions and misinformation. This is especially true in the context of on-line chat rooms and bulletin boards, where individuals may interact with one another. Therefore, the claims made to on-line investors in various chat rooms on the Internet must not become a vehicle for misrepresentations and fraudulent activities perpetrated by those who wish to undermine the efficiencies of an informed market place. Firms and regulators alike should prosecute these types of violators to the fullest extent of the law.

VII. FINDINGS AND RECOMMENDATIONS

A. Key Findings

This study concludes that there is no present need for further legislation to enact more stringent suitability requirements. The rule making process presently available to the Commission jurisdiction can address the investor protection issues raised in this report. Through rule making, the Commission can quickly enact administrative rules to immediately address any issues that may arise or develop in the course of the near future. Furthermore, if any such changes become necessary in the future, then the Commission should participate in developing uniform provisions through NASAA, the SEC, and SROs. The Commission adopts this view in light of the circumstances and facts in existence at the time of this study. The following findings provide the foundation for the Commission's rationale:

Virginia's statutory requirements rules are sufficient.

The Virginia Securities Act under section 13.1-523, grants the Commission the authority to adopt such disclosure, suitability and margin rules as are necessary to carry out the provisions under the Act. Any changes contemplated by this report can be accomplished through the Commi9ssion's rule making authority.

As a member of the majority of states that have suitability requirements that follow the language of NASAA suitability requirements, Virginia's 21 V.A.C. 5-20-280A2 to 3 is a fairly broad rule that provides the Commission with expansive authority to enforce suitability analysis on broker-dealers that make recommendations or solicitations. The language in the current statute allows the Commission to pursue a fact intensive inquiry to determine whether a recommendation existed in particular transactions. Furthermore, 21 V.A.C. 5-20-270A2 creates an affirmative duty for broker-dealers to examine and document a customer's financial capacity and investment objectives via reasonable inquiry. The fact that broker-dealers must partake in a reasonable inquiry and learn of a customer's particular financial situation and investment objectives means that broker-dealers must consider a customer's suitability characteristics before making a recommendation to comply with 21 V.A.C. 5-20-280A3. Therefore, under Virginia's current scheme, on-line and off-line brokerage firms must consider some form of suitability factors for transactions on-line and off-line brokerage firms execute involving a recommendation.[118]

The current suitability scheme also affords investors the freedom to invest quickly and efficiently to take advantage of the efficiencies and savings delivered by discount brokerage services that only offer order execution services. Therefore, the Commission's current suitability rules allow self-directed investors to trade without the burden of having their trade placement and execution slowed by suitability analysis. However, the suitability rule automatically becomes applicable in situations where self-directed

[118] To determine the applicability of 21 V.A.C. 5-20-280A3, the facts and circumstances surrounding the transaction determine whether a "recommendation" existed.

investors receive some sort of recommendation or solicitation from their discount broker-dealer or broker-dealer agent. The need for government intervention in the realm of self-directed trading is minimal because investor problems in this area are not widespread. In fact, the study's discovery that less than one percent of self-directed on-line trading account holders complain of problems shows that a large majority of self-directed investors do not need regulatory assistance to protect their financial interests. Thus, the enactment of more stringent suitability rules may inconvenience investors by reducing the efficiencies of the order execution process to the detriment of competent self-directed investors who are more concerned with speed and efficiency than some form of government or institutional oversight.

Canada has a regime that requires broker-dealers to perform suitability analysis for any transaction placed with any type of brokerage or investment firm. Recently, however, Canada relaxed its suitability analysis requirement by allowing discount brokerage firms that only perform order execution services to apply for exemption from the suitability analysis required for any trade placed with a brokerage firm. The benefit of increased efficiency and speed in the placement and execution of orders placed by self-directed investors allows self-directed investors to limit their exposure to market movement and the inconvenience of manual suitability analysis.

It should be noted that there appears to be a need for the Commission to pursue adoption of rules addressing suitability, disclosure and margin requirements regarding day traders. Possible rules are discussed in detail in this report.

There is still a need for extensive disclosure and education programs for on-line investors.

Although some firms disclose the risks involved with various aspects of on-line trading, the need for more risk disclosure and consumer education remains. Some disclosures and educational information is difficult for on-line investors to access because the information is not readily apparent from the glut of information that bombards an on-line investor once an on-line trading system is accessed. Also, some investors complained about the layout of websites. Thus, on-line investors do not fully understand how to manipulate the websites efficiently, thereby causing user errors. Additionally, disclosures regarding delays and outages are currently inadequate in the on-line brokerage firm sector.

Furthermore, the documented problems of investors excessively using margin tends to show that on-line investors do not fully understand the ramifications of margin agreements. The problems also show that some investors fail to fully comprehend their respective rights and obligations and their broker-dealer's rights and obligations. The study also noted problems with investors overextending the buying power of their accounts. Such instances of "overbuying" may also indicate that on-line investors do not fully understand the nature of their buying power.

There does not seem to be an overwhelming epidemic of problems with on-line brokerage accounts in Virginia.

Although the year 2000 study examined over 400 complaints of Virginians with on-line accounts, the number of account holders that made complaints represents less than one percent of the total number of on-line brokerage accounts at the firms surveyed in Virginia during the period of this study. Therefore, problems with on-line brokerage firms do not appear rampant. However, the fact that some continuing complaints and problems do exist means that on-line brokerage firms should address some issues to improve their services to on-line investors.

B. Recommendations

All firms should increase and improve their risk disclosure and investor education schemes through collaboration with NASAA, SEC, SROs, and SIA.

Disclosure should be available to on-line customers covering topics such as a firm's order capacity, recent peak usage, and system down times. All firms should endeavor to divulge more information that accurately and fully describes the risks of fast market trading that are associated with placing on-line orders and having them executed during such fast market conditions. More information describing how firms route orders to market and how market makers execute orders is also necessary to make on-line investors' expectations match on-line brokerage firms' current levels of performance. All disclosures and educational material should be readily available to the consumer and easy to understand. Furthermore, the Commission should act swiftly to deter any attempts to revive the misleading advertising by certain on-line brokerage firms characteristic of 1998 and 1999.

On-line and off-line brokerage firms should also increase disclosure of the rights, obligations, and risks involved in margin trading. The margin information and risk disclosure should be in a conspicuous place and described with plain and simple explanations. Furthermore, on-line brokerage firms must improve customer education disclosures describing the use and manipulation of their particular on-line trading system to prevent user errors.

The website and on-line trading system should be more user friendly.

Many of the websites offered by on-line brokerage firms have a wealth of market and investment information that the on-line investor may review. However, there is very little information on most websites that addresses technical issues in regards to manipulation of the many features offered on the website. Thus, on-line firms appear to assume that most on-line investors have a high level of computer proficiency and that the on-line brokerage firms' systems are simple to use. However, the study's research showed that a high level of computer proficiency is not always the case for on-line investors.

Unfortunately, such an assumption can lead to consumer errors because there is not always an "owners manual" that an on-line investor can reference if he or she gets confused. Although almost all on-line brokerage firms offer technical assistance over the phone, it seems that such technical assistance would greatly improve, if an operations manual of some kind augmented the live technical assistance.

<u>On-line brokerage firms should collect suitability information even if the firms do not make recommendations.</u>

On-line firms that do not make recommendations should gather suitability information to protect their financial interests and their customers' financial interests. On-line brokerage firms need the invested assets of on-line investors to remain solvent. Thus, suitability evaluations may help on-line brokerage firms warn the investor of transactions that have a high risk of failure and are not consistent with the investor's investment objectives. Furthermore, on-line firms should be free to develop a pre- or post-trade transaction review similar to systems in use at certain full-service firms and hybrid firms without extraneous interference from regulatory agencies.

<u>Virginia, NASAA, the SEC, and SROs should continue to monitor trends and practices within the on-line brokerage industry.</u>

Since on-line brokerage services are becoming a more integral part of the financial investments industry, Virginia, NASAA, the SEC, and SROs have an increasing responsibility to make sure that on-line and off-line brokerage firms do not abuse current rules. Regulatory agencies must also consistently evaluate on-line brokerage firms' business practices to identify the best practices that maximize investor protection and the firms' financial solvency. The key issue here is that the solvency of both the brokerage firm and the investor are necessary to maintain the overall efficiency of the market because all parties involved in financial transactions must be able to fulfill various financial obligations that may arise during the course of investing.

<u>Virginia, NASAA, the SEC, and SROs should consider other uniform measures of investor protections that are uniformly applicable to both on-line firms and off-line firms.</u>

The need for uniformity of rules is of paramount importance to both regulators and members of the on-line brokerage industry and off-line brokerage industry. Uniform rules allow firms to transact business efficiently in various jurisdictions, because the uniform rules provide a consistent means of enforcement and a uniform set of standards applicable to both on-line firms and off-line firms. A uniform rule that is applicable to on-line firms and off-line firms ensures a level playing field between the two types of brokerage firms. Therefore, investors can expect similar levels of quality service whether the investor uses an on-line firm or an off-line firm. Working with NASAA and other regulatory agencies would allow the Commission to assist in the creation of uniform rules that would be consistent throughout the states. Accordingly, Virginia could make a significant contribution to the development of national investor protection policy. A good starting point would be the best practices identified in this report.

<u>In regards to day trading, the Commission should consider making a policy statement that recognizes and adopts NASD Rules 2360 and 2361.</u>

The Commission should work with NASAA to adopt a rule identical to the new day trading rules adopted by the NASD with the approval of the SEC. NASD Rules 2360 and 2361 make suitability determination mandatory for day trading firms. By adopting a similar rule through collaborative efforts with NASAA, the Commission would show that it also expects day trading firms registered in Virginia to make such suitability determinations. Recognizing and adopting NASD Rules 2360 and 2361 would also mandate the risk disclosures defined in the rules and would give the Commission the ability to bring actions against alleged day trading firms that fail to comply with the guidelines prescribed by the NASD.

<u>In regards to margin trading, the Commission should consider coordinating with NASAA to adopt a uniform policy statement that addresses the day trading margin rules stated in NASD Rule 2520.</u>

To prevent day traders from overextending their financial capacity, the NASD proposed changes to its margin rules to protect individuals that pursue day trading strategies. Virginia may benefit from a similar policy because the NASD's proposed margin amendments would make margin requirements more stringent for day traders. By adopting rule also stated as a uniform policy statement through NASAA, Virginia would enjoy having the authority to require day trading firms and on-line brokerages to meet the stringent margin requirements stated by the NASD's proposed amendments to Rule 2520. Working through NASAA would also allow Virginia to assist in the creation of a uniform policy that would be consistent throughout the states.

<u>By letter from the Commission, Virginia should recommend to NASAA that it conduct a nationwide survey of on-line and off-line discount brokerage account holders.</u>

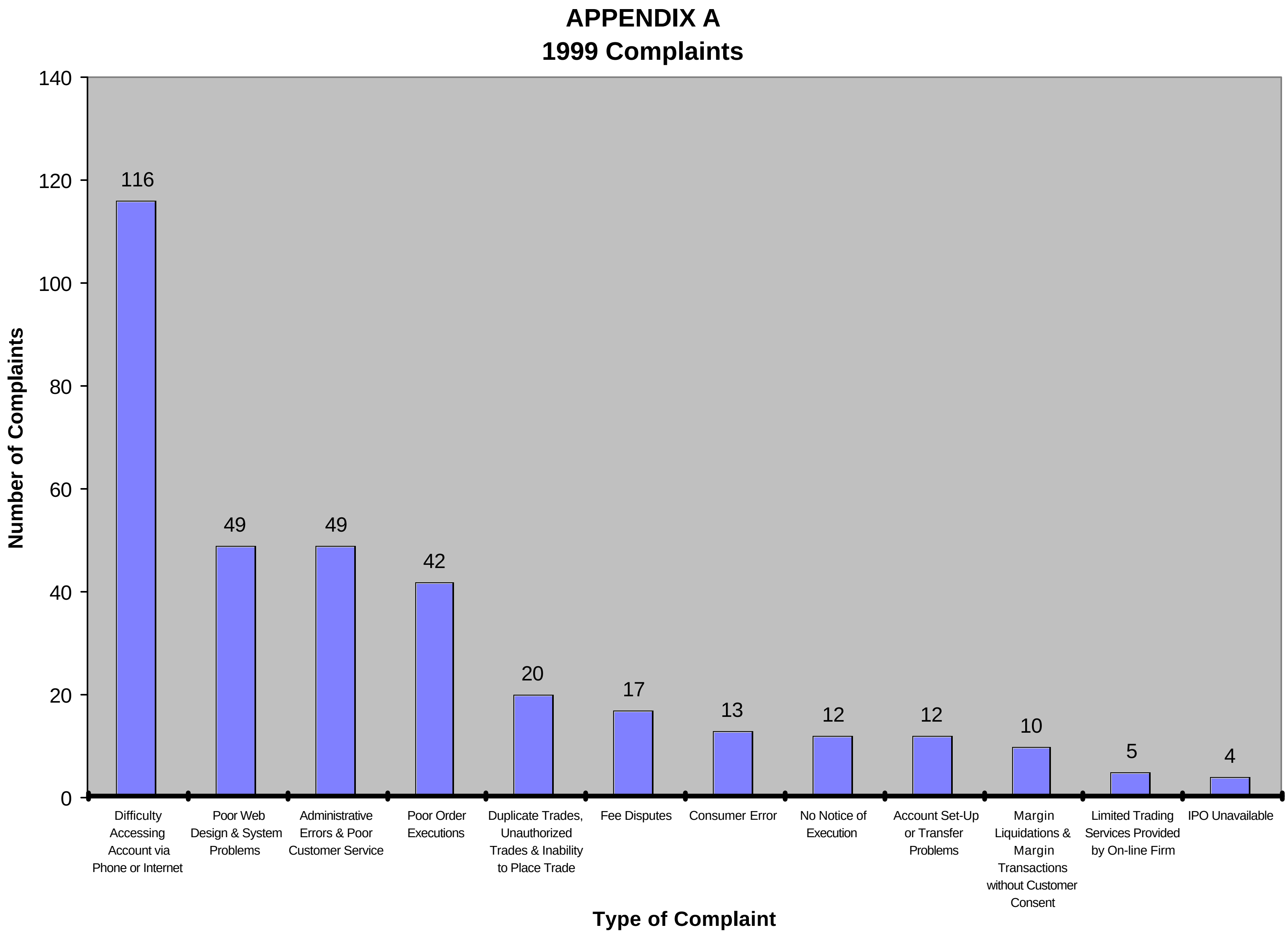
NASAA should conduct a nationwide survey of on-line and off-line discount brokerage account holders and their representatives to identify what information investors want disclosed. NASAA should try to identify investor's perceptions, preferences, concerns, and trends to determine how to effectively tailor state regulations to meet investor needs.

APPENDICES

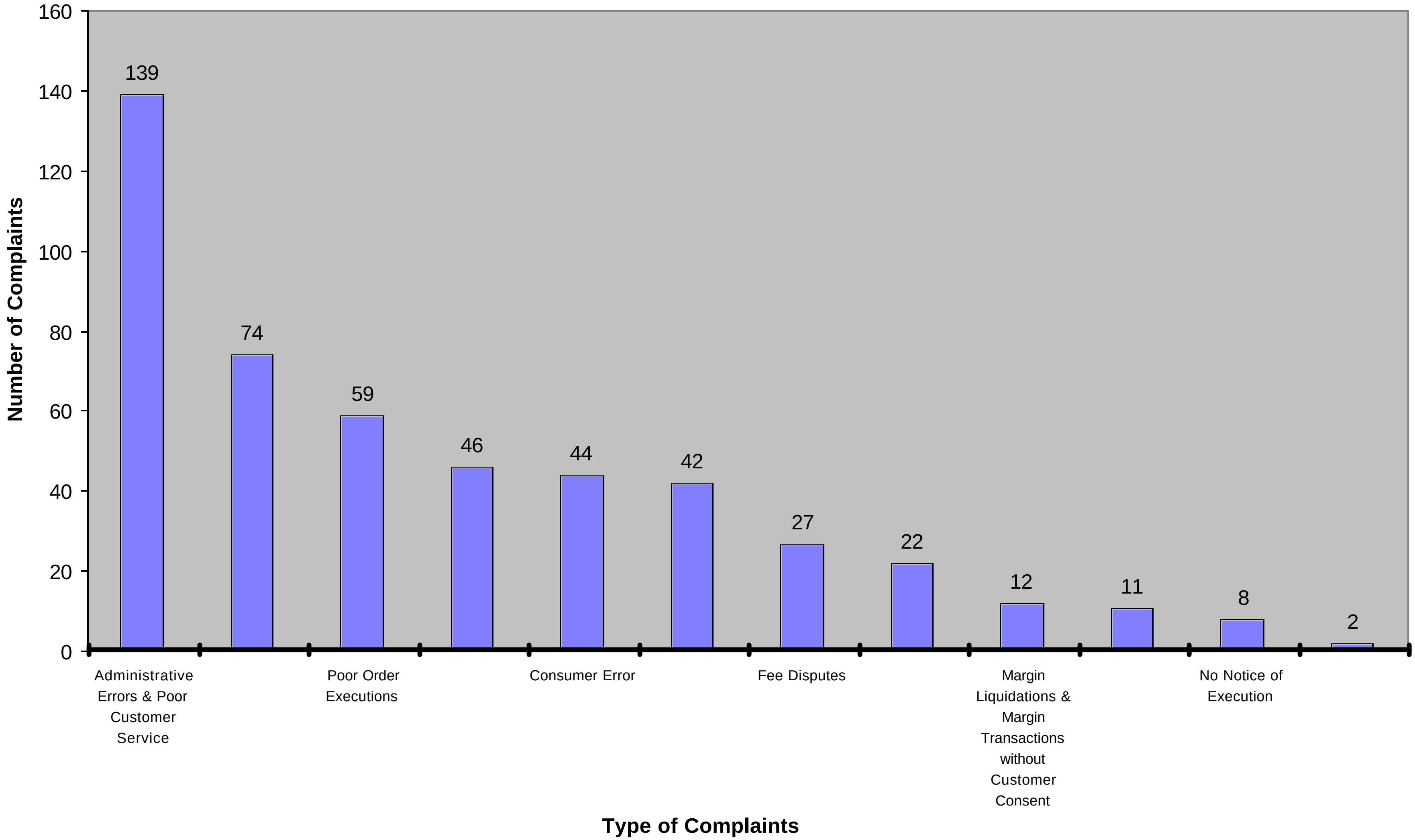
Appendix A: Graph of Complaints for 1999 and 2000

Appendix B: Questions asked during Consumer Survey with Answer Results

Appendix C: Graph of Consumer Responses


APPENDIX A
1999 Complaints
Number of Complaints
140
120
100
80
60
40
20
0
116
49
49
42
20
17
13
12
12
10
5
4
Difficulty Accessing Account via Phone or Internet
Poor Web Design & System Problems
Administrative Errors & Poor Customer Service
Poor Order Executions
Duplicate Trades, Unauthorized Trades & Inability to Place Trade
Fee Disputes
Consumer Error
No Notice of Execution
Account Set-Up or Transfer Problems
Margin Liquidations & Margin Transactions without Customer Consent
Limited Trading Services Provided by On-line Firm
IPO Unavailable
Type of Complaint

APPENDIX A
2000 Complaints



APPENDIX B

1) Do you consider yourself an:

Experienced Investor	Intermediate Investor	Novice Investor
70%	10%	20%

2) How long have you been investing?

20 Years or more	Less than 20 years but More than 10 Years.	10 Years or less
44%	19%	37%

3) How many trades have you made so far this year?

More than 50	Less than 50 but more than 19	19 or Less
35%	30%	35%

4) Did your on-line brokerage firm explain the concept of best execution and describe the firm's order execution practices and policies in plain English?

Yes	No	Don't Know/Not Concerned
63%	37%	0%

a) If you answered **no,** would you like your on-line brokerage firm to explain the concept of best execution and to describe the firm's orders execution practices and policies in plain English including "payment for order flow?"

Yes	No	Don't Know/Not Concerned
81%	19%	0%

5) Did you receive a margin agreement or on-line explanation that described risks, obligations, and the firm's margin procedures in plain English?

Yes	No	Don't Know/Not Concerned
70%	30%	0%

a) If you answered **no,** would such information be helpful to you?

Yes	No	Don't Know/Not Concerned
44%	56%	0%

6) Does your on-line brokerage firm's website offer per screen help buttons that give directions describing how to use the screen you are currently viewing?

Yes	No	Don't Know/Not Concerned
77%	17%	6%

a) If you answered **no,** would such a service be helpful to you?

Yes	No	Don't Know/Not Concerned
40%	40%	20%

7) Does your on-line brokerage firm provide general directions that tell you how to use all the screens on the website?

Yes	No	Don't Know/Not Concerned
80%	13%	7%

a) If you answered **no,** would such a service be helpful to you?

Yes	No	Don't Know/Not Concerned
75%	25%	0%

8) Does your on-line brokerage firm provide you with hyperlinks to educational information that describes the risks of on-line investing?

Yes	No	Don't Know/Not Concerned
37%	47%	16%

a) If you answered **no,** would such a service be helpful to you?

Yes	No	Don't Know/Not Concerned
43%	50%	7%

9) Does your on-line brokerage firm clearly warn you when their on-line trading system is down and unable to conduct transactions?

Yes	No	Don't Know/Not Concerned
70%	17%	13%

a) If you answered **no,** would such a service be helpful to you?

Yes	No	Don't Know/Not Concerned
100%	0%	0%

10) Does your on-line brokerage firm clearly disclose the number of computer system outages that occur on their system?

Yes	No	Don't Know/Not Concerned
7%	63%	30%

a) If you answered **no,** would such information be helpful to you?

Yes	No	Don’t Know/Not Concerned
63%	37%	0%

11) Does your on-line brokerage firm disclose the maximum capacity that the on-line trading system can handle during peak usage hours?

Yes	No	Don’t Know/Not Concerned
3%	67%	30%

a) If you answered **no,** would such information be helpful to you?

Yes	No	Don’t Know/Not Concerned
55%	35%	10%

12) Does your on-line brokerage firm disclose the amount of reserve capacity the trading system possesses during peak usage hours?

Yes	No	Don’t Know/Not Concerned
0%	63%	37%

a) If you answered **no,** would such information be helpful to you?

Yes	No	Don’t Know/Not Concerned
53%	47%	0%

13) Do you know how your on-line brokerage firm determines how much “buying power” you have for a stock purchase?

Yes	No	Don’t Know/Not Concerned
77%	23%	0%

a) If you answered **no,** do think a plain English explanation would help?

Yes	No	Don’t Know/Not Concerned
57%	43%	0%

14) Would you want your on-line brokerage firm to provide you with some sort of warning when you place a trade that is more risky than the financial objectives you’ve identified?

Yes	No	Don’t Know/Not Concerned
50%	43%	7%

15) Would you want your on-line brokerage firm to provide you with some sort of warning when you place a trade that will require your brokerage firm to loan you money?

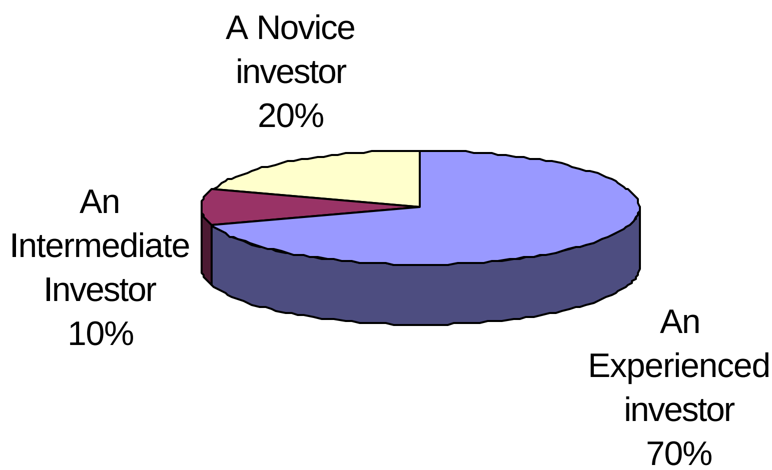
Yes	No	Don't Know/Not Concerned
70%	17%	13%

16) Do you think your on-line brokerage firm adequately described the risks involved with on-line trading?

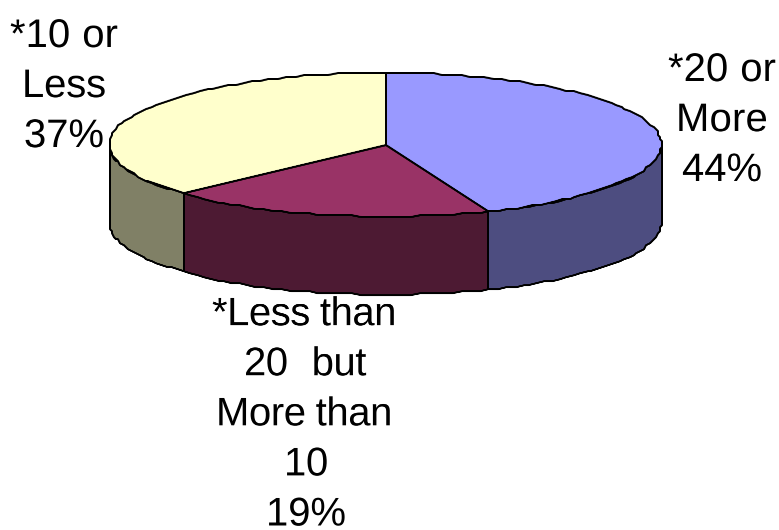
Yes	No	Don't Know/Not Concerned
67%	23%	10%

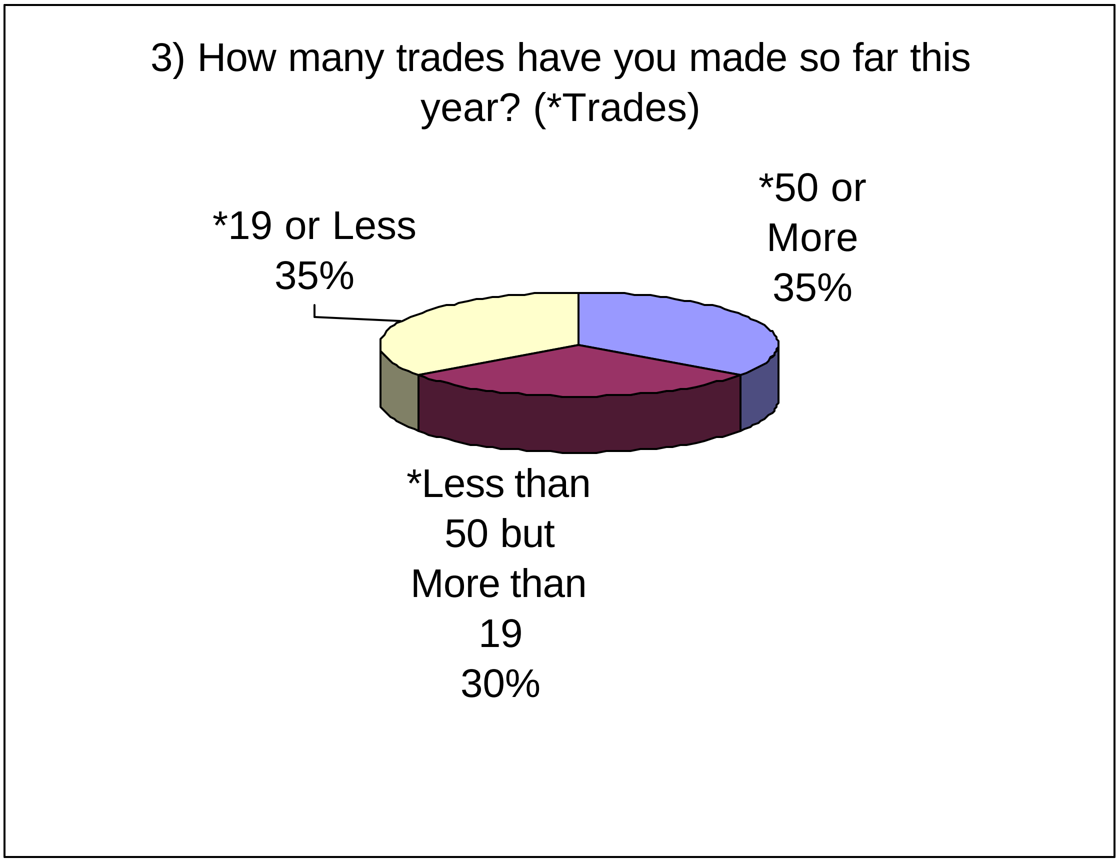
APPENDIX C

1) Do you consider yourself:

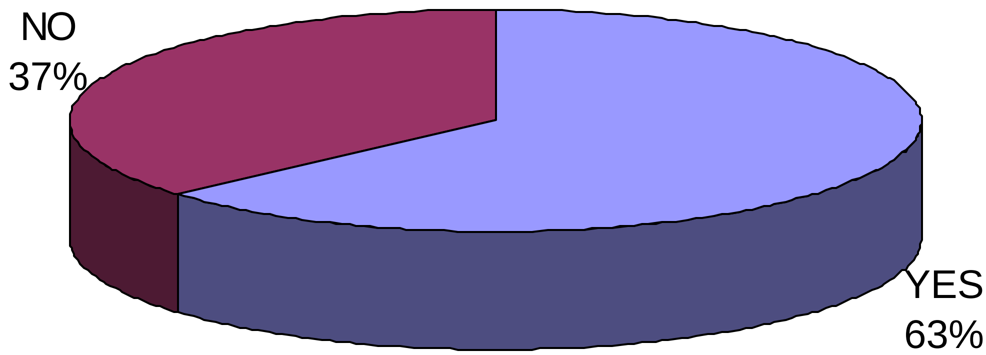


2) How long have you been investing? (*Years)

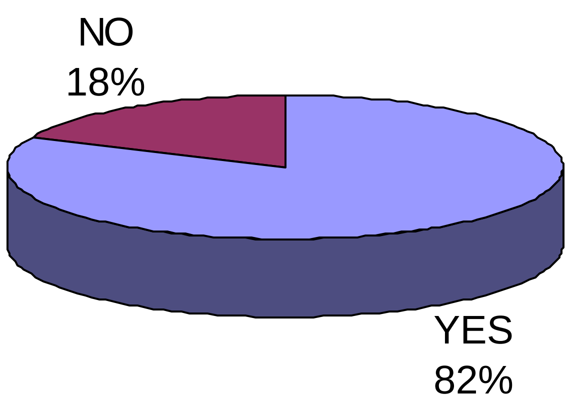



3) How many trades have you made so far this year? (*Trades)
*19 or Less
35%
*50 or More
35%
*Less than 50 but More than 19
30%

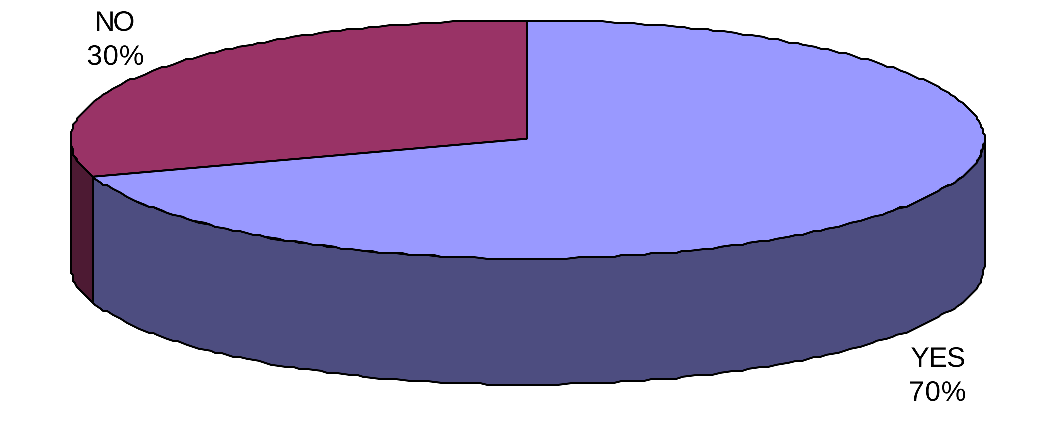
4) Did your on-line brokerage firm explain the concept of best execution and describe the firm's order execution practices and policies in plain English?



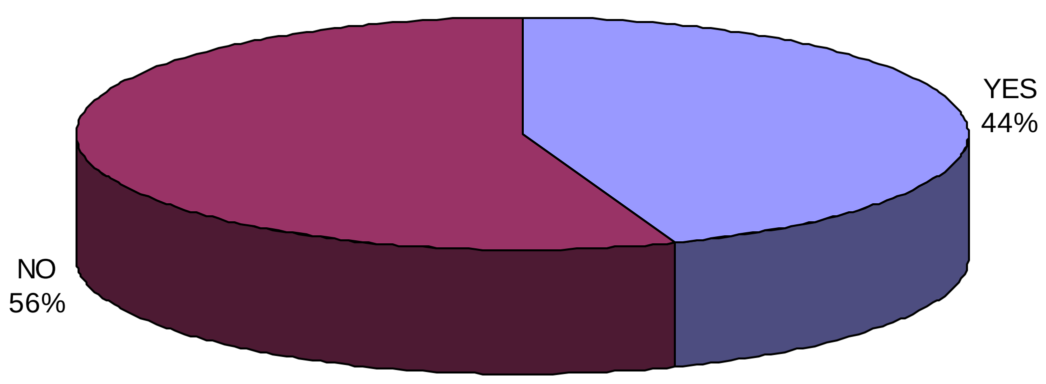
If you answered no, would you like your on-line brokerage firm to explain the concept of best execution and to describe the firm's orders execution practices and policies in plain English including "payment for order flow?"

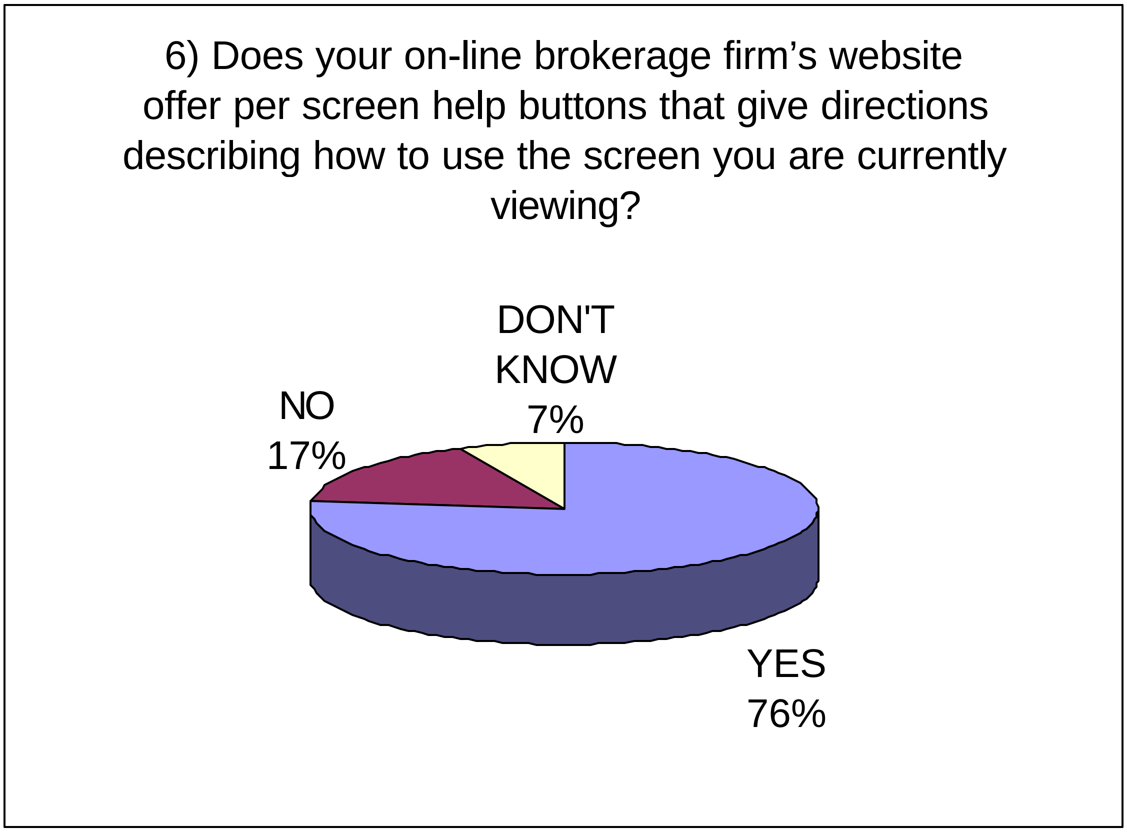


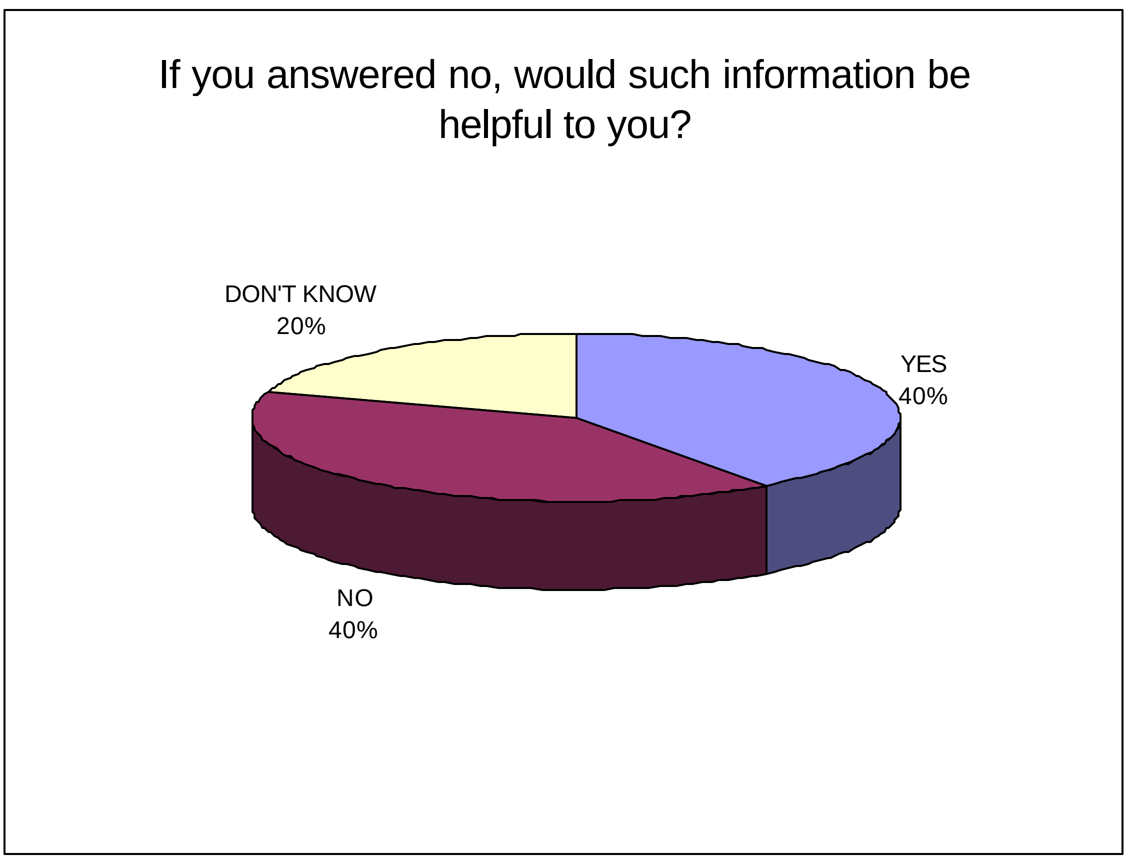
5) Did you receive a margin agreement or on-line explanation that described risks, obligations, and the firm's margin procedures in plain English?



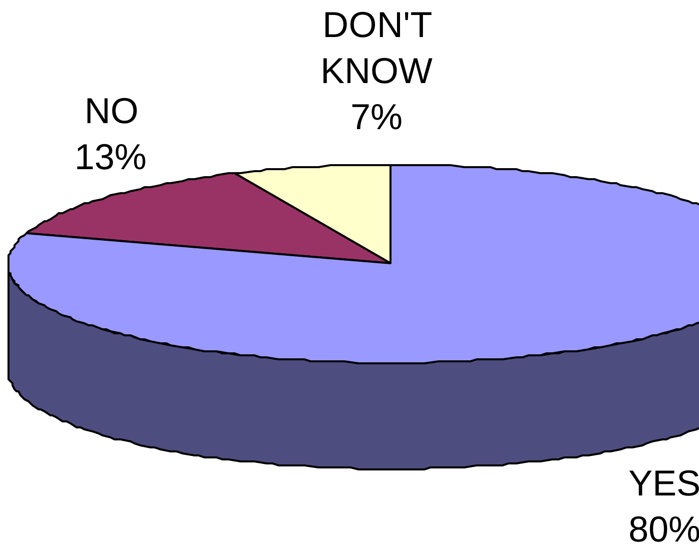
If you answered no, would such information be helpful to you?



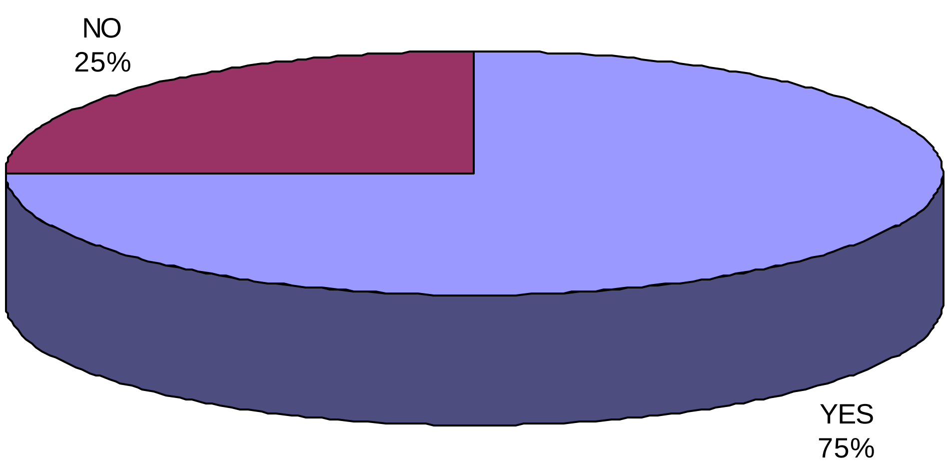

6) Does your on-line brokerage firm’s website offer per screen help buttons that give directions describing how to use the screen you are currently viewing?
DON'T KNOW 7%
NO 17%
YES 76%


If you answered no, would such information be helpful to you?
DON'T KNOW 20%
YES 40%
NO 40%

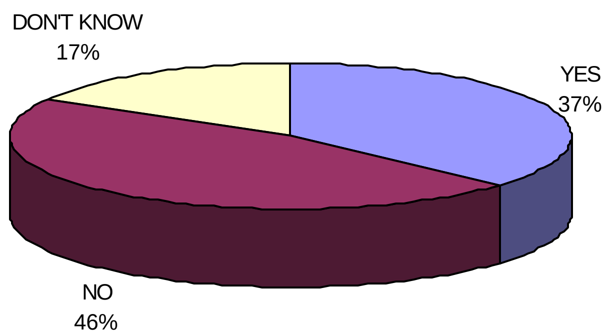
7) Does your on-line brokerage firm provide general directions that tell you how to use all the screens on the website?



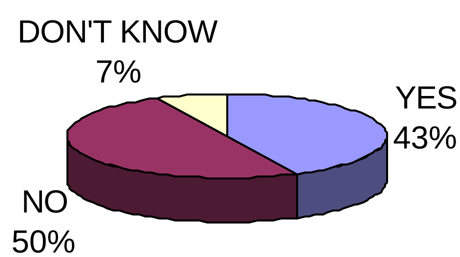
If you answered no, would such information be helpful to you?



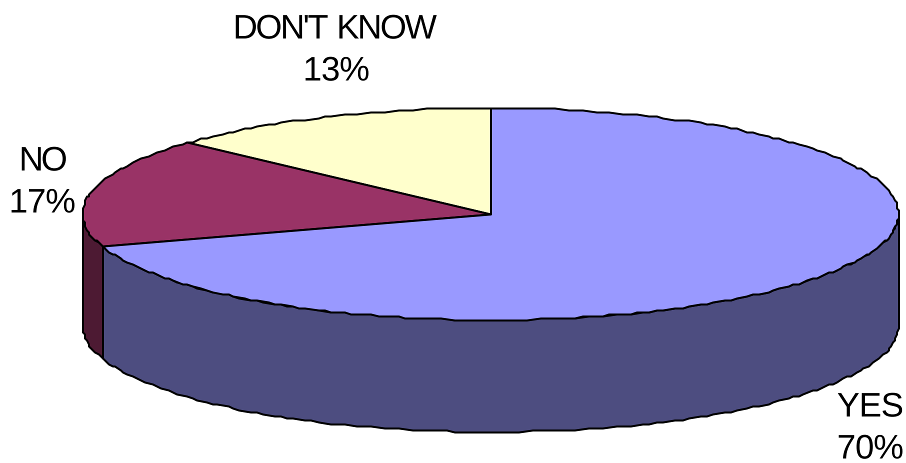
8) Does your on-line brokerage firm provide you with hyperlinks to educational information that describes the risks of on-line investing?



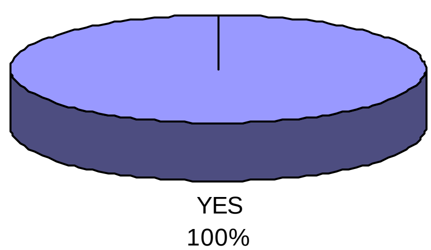
If you answered no, would such information be helpful to you?



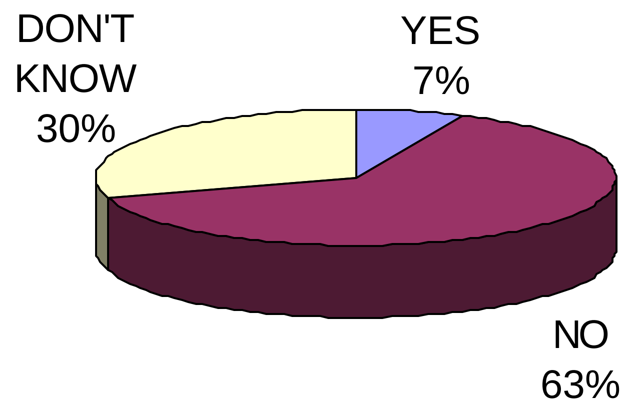
9) Does your on-line brokerage firm clearly warn you when their on-line trading system is down and unable to conduct transactions?



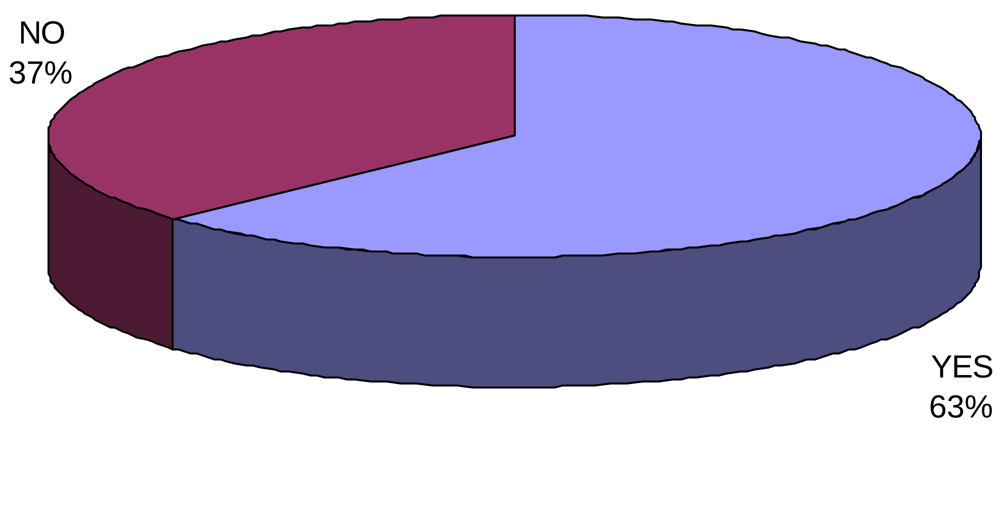
If you answered no, would such information be helpful to you?



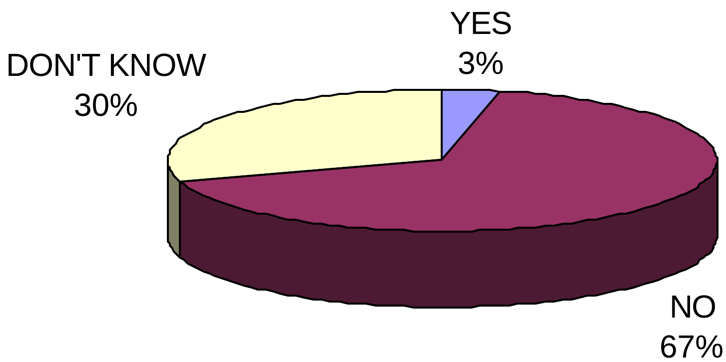
10) Does your on-line brokerage firm clearly disclose the number of computer system outages that occur on their system?



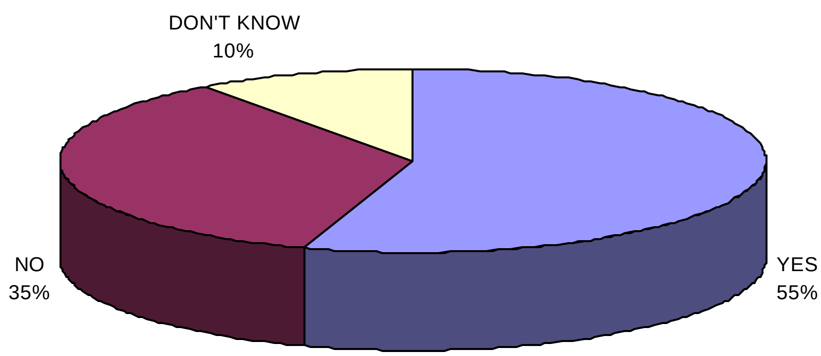
If you answered no, would such information be helpful to you?



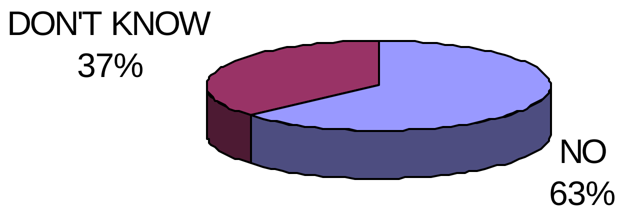
11) Does your on-line brokerage firm disclose the maximum capacity that the on-line trading system can handle during peak usage hours



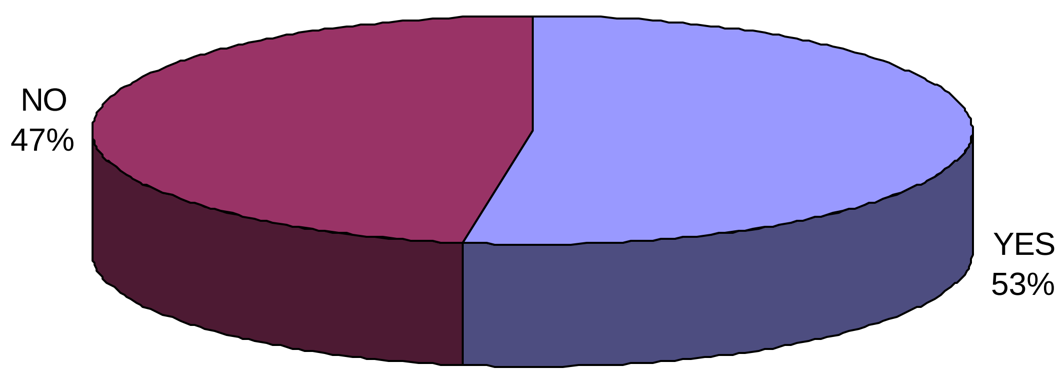
If you answered no, would such information be helpful to you?



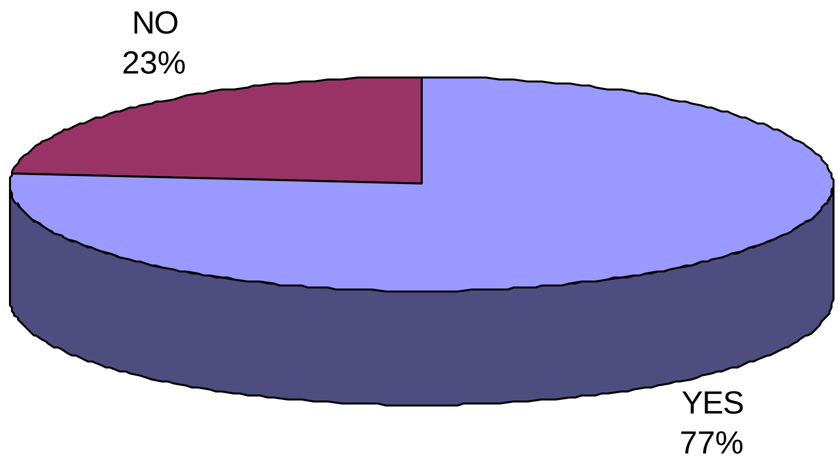
12) Does your on-line brokerage firm disclose the amount of reserve capacity the trading system possesses during peak usage hours?



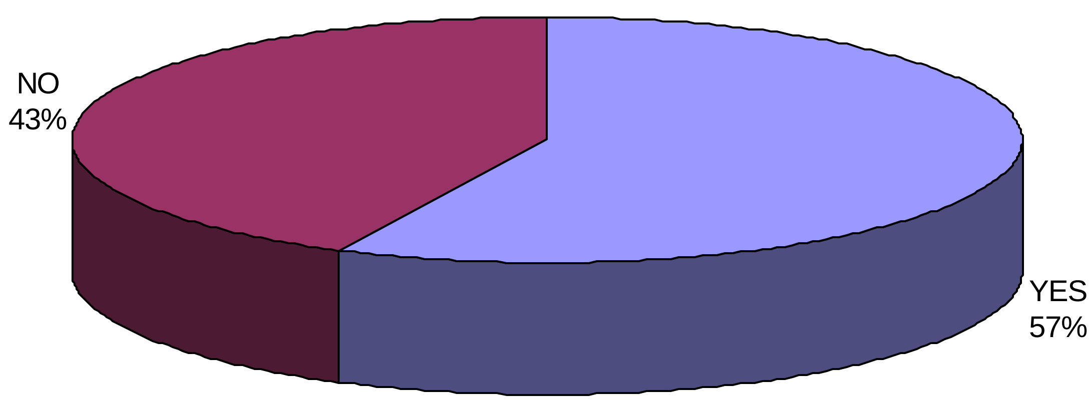
If you answered no, would such information be helpful to you?



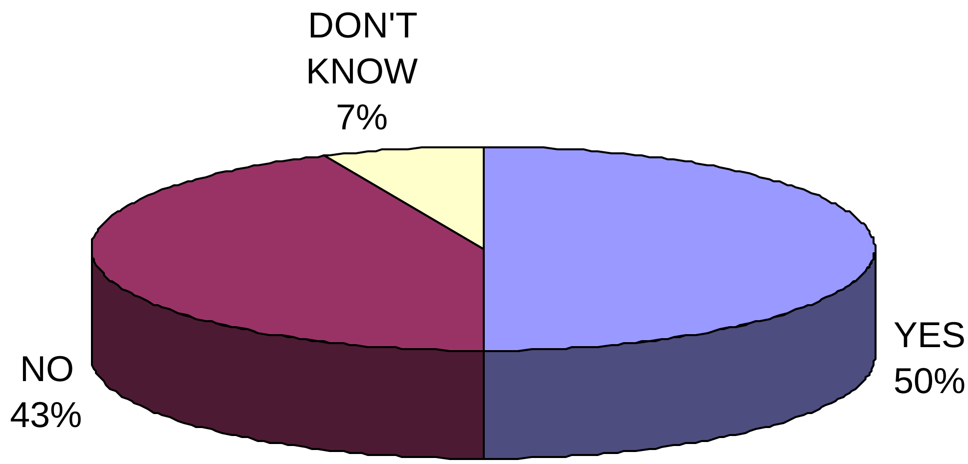
13) Do you know how your on-line brokerage firm determines how much "buying power" you have for a stock purchase?



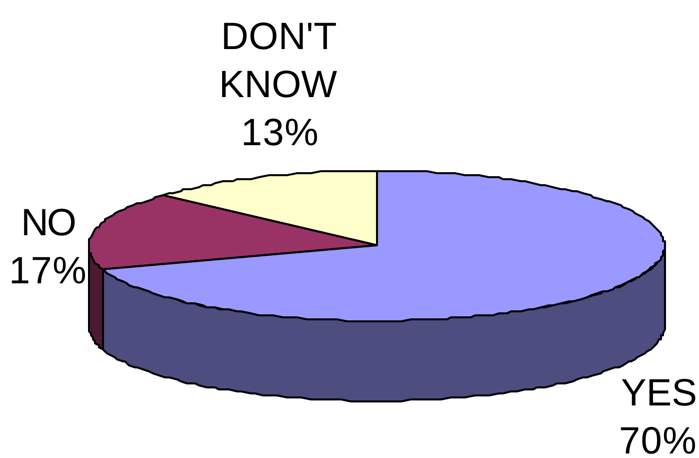
If you answered no, would such information be helpful to you?



14) Would you want your on-line brokerage firm to provide you with some sort of warning when you place a trade that is more risky than the financial objectives you've identified?



15) Would you want your on-line brokerage firm to provide you with some sort of warning when you place a trade that will require your brokerage firm to loan you money?



16) Do you think your on-line brokerage firm adequately described the risks involved with on-line trading?