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## Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?

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# Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?

## COMMENTS

# ONLINE TRADING AND THE NATIONAL ASSOCIATION OF SECURITIES DEALERS' SUITABILITY RULE: ARE ONLINE INVESTORS ADEQUATELY PROTECTED?

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## INTRODUCTION

More people currently use the Internet to trade securities than to purchase books, CDs or any other products online.<sup>1</sup> Online trading is the method by which an investor uses a computer to place either a buy or sell securities order, electronically, through a broker's Internet site.<sup>2</sup> Although online trading has only been in existence since 1995, it has already revolutionized the brokerage industry.<sup>3</sup> In particular, online trading offers investors a number of advantages over

1. See Joel Dreyfuss, *Facts about the Online Investor* (last visited Nov. 28, 2000) available at <http://pathfinder.com/money/onlineinvesting/start/g7.html>; see also Peter C. McMahon, *Securities Law and the Internet: Enforcement Issues*, in SECURITIES LAW & THE INTERNET, at 265, 273 (PLI Corp. L. & Practice Course, Handbook Series No. 1127, 1999) (citing Leah Nathans Spiro, *Who Needs A Broker?*, BUS. WK., Feb. 22, 1999, at 113) (stating that the popularity of online trading is topped only by that of online pornography).

2. See Laura S. Unger, *On-Line Brokerage: Keeping Apace of Cyberspace* 11 (Nov. 1999), available at <http://www.sec.gov/news/spstindx.htm> [hereinafter *Cyberspace*]; Hardy Callcott, Memorandum from Charles Schwab & Co. to Frank G. Zarb, Chairman, NASD and Mary L. Schapiro, President, NASDR, Inc., *Suitability Obligations in Internet Investing*, 4 (Jan. 29, 1999) (on file with author) [hereinafter *Suitability Obligations in Internet Investing*].

3. See Blake Bell, *Online Trading Losses and Suitability Claims Against Ebrokers*, 2 NO. 9 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 18, \*1 (1999) ("Online securities trading is experiencing explosive growth."); *Cyberspace*, *supra* note 2, at 11 (explaining that in 1995 broker-dealers introduced the first systems enabling individuals to place buy and sell orders over the Internet and subsequently, in less than five years, online trading has become an important part of brokers' service offerings); *On-Line Trading: Better Investor Protection Information Needed on Brokers' Web Sites* 3 (GAO/GGD-00-43 May 2000) [hereinafter *Better Investor Protection*] ("On-line trading is transforming the relationships that investors have with broker-dealers."); Laura S. Unger, Remarks at the American Conference Institute's National Conference on Securities Trading on the Internet, *Customer Expectations Online: Are They Your Obligations?* 1 (Jan. 25, 1999) [hereinafter *Customer Exceptions Online*] (noting that while there were no online brokers prior to 1995, online brokers accounted for 25% of all trades on the New York Stock Exchange and the NASDAQ in 1999), available at <http://www.sec.gov/news/speeches/spch249.htm>; Laura Unger, Remarks at the Practising Law Institute's SEC Speaks, *How Best Can SEC.gov Regulate Securities.com?* 1 (Feb. 26, 1999) [hereinafter *Can SEC.gov Regulate Securities.com*] (noting that the *Wall Street Journal* publishes an article involving online trading almost every day), available at <http://www.sec.gov/news/speeches/spch257.htm>.

traditional offline trading, including lower fees and the ability to access account information and industry data at any time from their personal computers.<sup>4</sup>

Online trading, however, has its shortcomings.<sup>5</sup> For example, the United States Securities Exchange Commission ("SEC") received over 3,000 complaints against online brokers in fiscal year 1999, which is an increase of almost 200% over fiscal year 1998 and about a 1200% increase over complaints received in fiscal year 1997.<sup>6</sup> One concern is that online brokers could potentially entice unsophisticated individual investors<sup>7</sup> to trade online and encourage investment

4. See *Cyberspace*, *supra* note 2, at 16 (explaining that online investors can access market information, investment information and other tools via the Internet); Douglas Schulz, *Internet Trading Take A Walk On The Wild Side*, in SECURITIES ARBITRATION 1999: SETTLEMENTS, LAPTOPS, EXPERTS & ARBITRATORS, at 229, 233 (PLI Corp. L. & Practice Course, Handbook Series No. 0092, 1999) (discussing the benefits of online trading, such as 24 hour access and lower fees).

5. See Ianthe Jeanne Dugan, *E-Trade's Growing Pains*, WASH. POST, June 18, 2000, at H1 [hereinafter *E-Trade Growing Pains*] (noting that the SEC and NASD "say online trading has come to account for the majority of consumer grievances"); Sandra Sugawara, *Studies Address Online Trading: More Disclosure, Consumer Education Needed, Reports Say*, WASH. POST, Nov. 23, 1999, at E1 (explaining that recent studies discuss the benefits from online trading while addressing evolving problems with the industry).

6. See Laura Unger, *Investing in the Internet Age: What You Should Know and What Your Computer May Not Tell You . . .*, Remarks at the Association of Retired Persons National Legislative Council Annual Meeting, Washington, D.C., 2 (Feb. 3, 2000) (explaining that customer complaints about online brokers have increased dramatically, but that this increase may be in part because more investors use online brokers), available at <http://www.sec.gov/news/speeches/spch342.htm>; see also Arthur Levitt, *Plain Talk About On-line Investing*, 51 ADMIN. L. REV. 1093, 1101 (1999) [hereinafter *Plain Talk About On-line Investing*] (stating that the SEC has inspected firms that represent 80% of market share for the online trading industry); Securities and Exchange Commission, *Statement by Chairman Arthur Levitt Concerning On-line Trading* 1 (Jan. 27, 1999) (noting that over the last two years the SEC has become aware of growing concerns about retail, online investing), available at <http://www.sec.gov/news/levonlin.htm>.

7. A number of factors should be considered in determining an investor's level of sophistication. See Edward Fletcher, III, *Sophisticated Investors under the Federal Securities Laws*, 1988 DUKE L. REV. 1081, 1083 (noting that courts often treat unsophisticated and sophisticated investors differently). These factors include: "1) financial and business acumen, 2) individual characteristics of sophistication, and 3) investment-specific behavior." *Id.* at 1149. Each of these broad categories also contain relevant considerations, none of which should in themselves be determinative. See *id.* For example, the most important general category, financial and business acumen, includes the following additional factors: investment experience; professional status; history of speculative investments; government or business experience; professional experience in the securities industry; and general familiarity with securities transactions. See *id.* at 1149-50. Factors under individual characteristics of sophistication include: understanding trading in an investment account; education; special access to information; intelligence; age and; wealth and income. See *id.* at 1150. Investment specific behavior examines how an investor behaves with respect to his or her investments. See *id.* Elements to consider in this category include: regular consultation with investment professionals; number of brokerage accounts; stock club membership; amount of money invested; scrutiny over investment accounts; attending investment conferences; subscribing to financial

purchases that are not appropriate for such investors.<sup>8</sup> Under current law, all broker-dealers, whether online or traditional, may only recommend the purchase of a specific security that is suitable for the customer based on the customer's investment objectives and individual needs.<sup>9</sup> This legal obligation, known as "suitability," is one of the most important, yet nebulous doctrines under the federal securities laws.<sup>10</sup> The parameters of the suitability doctrine become even more indefinite when applied in the online trading context.<sup>11</sup>

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or investment journals; viewing financial television programming; and reviewing confirmation slips or monthly statements. *See id.* at 1149.

8. *See Plain Talk About On-line Investing*, *supra* note 6, at 1096 (discussing concerns about the influx of new, inexperienced investors who maybe "seduced" to trade online in a manner that is not appropriate for them).

Online firms try to minimize the level of responsibility they have for their customers' trades by arguing that online customers are sophisticated and knowledgeable because they are trading via an online broker. *See Schulz*, *supra* note 4, at 240 (stating that this type of assumption of sophistication is not unlike the belief that because an individual has money, he or she must be a sophisticated investor). This assumption is fallacious insofar as many online investors are rather naïve about investing. *See id.* at 240. *See generally* Schulz, *supra* note 4, at 233 (discussing that more individual investors are able to enter the stock market with the help of online trading); Ruth Simon & Rebecca Buckman, *Can Brokerage Advice and Internet Mix?*, WALL ST. J., June 7, 1999, at C1 (reporting that as online trading's popularity explodes, a debate has escalated over who is responsible for protecting investors who place orders themselves via the Internet); Laura S. Unger, *Does the Internet Empower or Just Excite Investors?* 3 (Sept. 10, 1999) [hereinafter *Does the Internet Empower*] (asking how far online firms should have to go to get investors to consider the risks of buying and selling securities), available at <http://www.sec.gov/news/speeches/spch294.htm>; Michael K. Wolensky, *Securities Law And The Internet Enforcement Issues: Application of Suitability Obligations*, in SECURITIES LAW & THE INTERNET, at 251, 253 (PLI Corp. L. & Practice Course, Handbook Series No. 00BS, 1999) (finding that smaller investors are able to utilize online brokerages to trade stocks).

9. *See* NASD Conduct Rule 2310, NASD Manual (CCH) 4261 (Apr. 1997) (stating that an online securities dealer "shall have reasonable grounds for believing that the recommendation is suitable" for the investor); *see also* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557, 1557 (1999); *Cyberspace*, *supra* note 2, at 24; Wolensky, *supra* note 8, at 254 (explaining that a broker who recommends a particular security to a particular customer must be satisfied that the security is suitable to the investor's financial ability and investment objectives).

10. *See* Lowenfels & Bromberg, *supra* note 9, at 1557 (establishing that the doctrine is "somewhat nebulous and amorphous with respect to its content and parameters"); *see also* Robert N. Rapp, *Rethinking Risky Investments For That Little Old Lady: A Realistic Role For Modern Portfolio Theory Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 189 (1998) (discussing that the genesis of the suitability requirement lies with self regulatory organizations ("SRO")); *Plain Talk About On-line Investing*, *supra* note 6, at 1095 (noting that in the midst of enthusiasm over online trading, online brokers cannot lose sight of the fundamental obligations owed to customers).

11. *See* Laura S. Unger, *Remarks at the National Regulatory Services Fall 1999 Compliance Conference* (Sept. 14, 1999) [hereinafter *Unger's Compliance Conference Remarks*] (stating that the most important issue arising from the explosion of online trading thus far appears to be determining what suitability obligations online brokers have to their customers), available at <http://sec.gov/news/speeches/spch296.htm>; *Cyberspace*, *supra* note 2, at 24 (discussing that pinpointing what constitutes a

A number of disenchanted online investors have begun alleging suitability violations in arbitration complaints, which demonstrates the growing confusion surrounding online suitability issues.<sup>12</sup> For example, in May of 1999, Lael Desmond, a twenty-seven year old graduate student from Indianapolis, Indiana, convinced a three-person National Association of Securities Dealers' ("NASD") arbitration panel that Ameritrade Holding should pay him fees and compensatory damages after he lost \$40,000 trading stock with the online broker.<sup>13</sup> Desmond claimed that Ameritrade allowed him to make investments that were unsuitable for him based on his experience and financial situation.<sup>14</sup> Desmond lost money for his medical school tuition when he traded stocks on margin.<sup>15</sup> Like many

recommendation is more difficult online).

12. See RJ, *Everybody is Talking about Suitability in Qualifying Online Investors—Except Online Firms*, SEC. WK., Vol. 26, No. 42 (discussing an Indianapolis law firm's statement that in the last year it filed seven or eight arbitration claims for unsophisticated investors who overtraded online accounts); see also Bell, *supra* note 3, at \*2, \*3 (stating that the number of suitability claims will most likely increase as the number of online investors increase); Arthur Levitt, Investors Town Meeting, Cleveland, Ohio, *Investing With Your Eyes Open* (July 25, 2000) (explaining his concern that investors do not seem to know the basic, but important fundamentals of investing), available at <http://www.sec.gov/news/speeches/spch393.htm>. See generally *E-Trade to Pay Customer for Order Gone Awry* (Aug. 7, 2000) (noting that the NASD handled 55 arbitration cases involving online trading disputes last year), available at <http://biz.yahoo.com/rf/000807/n07120666.html>.

13. See Rebecca Buckman, *Student Awarded \$40,000 From Firm in Trading Case*, WALL ST. J., Jan. 17, 2000, at C16 [hereinafter *Student Awarded \$40,000*] (noting that the NASD letter and award did not detail the panel's reason for the decision); James Kim, *Should Online Brokerages Curb Risky Trades? Some Investors Blame Internet Services for Losses*, USA TODAY, Feb. 2, 2000, at 1B (stating that Desmond's lawyer argued that Ameritrade should not have let his client trade in the manner he did); see also Rebecca Buckman & Aaron Lucchetti, *Cooling It: Wall Street Firms Try To Keep Internet Mania From Ending Badly*, WALL ST. J., Feb. 24, 1999, at A1 (explaining that Desmond opened an account with Ameritrade in 1997 because he thought it was a way to make a lot of money quickly). See generally Danielle Fugazy, *Brokerage: Ameritrade Loses Arbitration Case*, WEB FIN., Feb. 14, 2000 (noting that, as is typical with NASD arbitration awards, the Desmond decision carries limited precedential value), available at 2000 WL 4044301.

14. See *Student Awarded \$40,000*, *supra* note 13, at C16 (noting that Desmond also alleged a variety of other claims, including that Ameritrade was negligent, conducted unauthorized trading and participated in "unreasonable business conduct"). But see Fugazy, *supra* note 13 (reporting that Ameritrade has commented that the Desmond case has been mischaracterized as a suitability case when it is really a margin sell-out case).

15. See Eileen Ambrose, *Buying stocks on Margin Can be Risky*, BALTIMORE SUN, Feb. 27, 2000, at 1D (explaining that, as seen in the Desmond case, the downside of trading on margin is that the investor's losses can be amplified); Gretchen Morgenson, *Page Buying on Margin Becomes a Habit; Investors Turn to Credit in a Bull Market*, N.Y. TIMES ABSTRACTS, Mar. 24, 2000, at C1 (discussing that the investor's stock serves as the asset backing the loan from the broker, and thus, when the value of the stock declines the customer must add more money to their account or risk having the broker sell their stock to obtain the money owed to them), available at 2000 WL 19065635; *Student Awarded \$40,000*, *supra* note 13, at C16 (stating that investors who trade on margin use borrowed funds to increase the amount of capital

novice investors, Desmond did not understand the concept of trading on margin.<sup>16</sup>

Shortly after Desmond filed his suit, Kathleen Kourie, a button and trim salesperson in New York's garment industry, filed a complaint with the New York Stock Exchange ("NYSE") against Charles Schwab & Co.<sup>17</sup> Kourie claimed that Charles Schwab violated suitability requirements by allowing her to make a \$265,000 trade when she only had \$50,000 in her Schwab account.<sup>18</sup>

More investor suits, similar to Desmond's and Kourie's, are likely to occur if the stock market declines.<sup>19</sup> A market decline could result in severe financial losses for many online investors.<sup>20</sup> These disenchanted online investors may expend even more resources

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that they have to invest in stocks).

A margin account is defined as a "brokerage account allowing customers to buy securities with money borrowed from the broker. Margin accounts are governed by REGULATION T, by the NASD, by the NYSE, and by individual brokerage house rules. Margin requirements can be met with cash or with eligible securities." *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 344 (5th ed. 1998).

16. See Buckman & Lucchetti, *supra* note 13, at A1 (discussing that Desmond did not know what trading on margin was and thought that it was similar to taking out a bank loan in the way that it would require regular payments).

17. See Simon & Buckman, *supra* note 8, at C1. The NYSE, another Self Regulatory Organization ("SRO"), has rules that embody the suitability doctrine. See Lowenfels & Bromberg, *supra* note 9, at 1571. The NYSE's "know your customer rule," Rule 405, does not require a recommendation like the NASD's rule and instead applies to "every customer, every order, every cash or margin account." See *id.* (acknowledging that the "NYSE does not have a suitability rule per se"); NYSE Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1999).

The SEC, however, relied on NASD precedents relating to the suitability doctrine in cases like *In re Rangen*. See Exchange Act Release No. 38,486, 64 SEC Docket 731 (Apr. 8, 1997). One commentator notes that this cross-citing of authorities raises support for the use of the NASD suitability rule. See Lowenfels & Bromberg, *supra* note 9, at 1577.

18. See Simon & Buckman, *supra* note 8, at C1 (reporting on claim by Kourie that "Charles Schwab & Co. allowed her to make an unsuitable investment by executing trades for \$265,000 in shares of theglobe.com when the net worth of her account was just \$50,000").

19. See Bell, *supra* note 3, at \*1 (commenting that, with the tremendous growth of online trading, there is likely to be a growing number of suitability claims against online brokers after online traders suffer losses); Scott Bernard Nelson, *Thorny Issues Arise Over Protections For Online Investors*, BOSTON GLOBE, July 5, 2000, at A1 (quoting the executive director of the North American Securities Administrators Association, Marc Beauchamp, who says that there is a "good chance there will be a slew of cases like [Desmond's]").

20. See Judith Burns, *Regulators, Entrepreneurs See Gains From Online Trading*, DOW JONES BUS. NEWS, June 22, 1999 (reporting that SEC Commissioner Laura Unger stated she did not know what will happen to online brokerage use if the market takes a downturn, but that perhaps some investors will turn back to full service brokers); Megan Barnett, *Edward Jones: The Last Not-Com Brokerage*, INDUSTRY STANDARD, Aug. 7, 2000 ("At the first real downturn, the do-it-yourselfers are going to be in total disarray."); *cf.* *Does the Internet Empower*, *supra* note 8, at 4 (discussing that investor optimism has reached record levels and has skewed investors' perspectives of risk, thus heightening the possibility that many investors are currently holding securities that are too risky for their financial situations).



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suings their broker. The way in which regulators apply the suitability doctrine online will affect the level of protection investors receive.<sup>21</sup> Regulators, however, are faced with the challenge of balancing investor protection with investor abuse because online investors may attempt to use the suitability doctrine as an insurance policy for poor investment choices. The clarification of suitability obligations online may curtail the number of investor claims brought following a severe market downturn.<sup>22</sup>

This Comment discusses how broker's online activities become subject to suitability obligations as articulated in NASD and NYSE rules.<sup>23</sup> More specifically, this Comment explores the issue of when a broker makes a recommendation via the Internet, and thus, triggers the NASD's suitability obligation. In addition, this Comment will recommend that, because of certain characteristics specific to online trading, online brokers should monitor their unsophisticated clients' online trades to ensure that each trade is suitable for the investor.

In analyzing these issues, this Comment will first provide a history of online trading and note how it differs from day trading. Additionally, this Comment will define suitability and discuss the purpose of suitability obligations, focusing on the NASD suitability requirement. Second, this Comment will examine some of the characteristics of online brokers to determine whether additional protection for online investors is warranted. Third, considering the characteristics of online brokers, this Comment will discuss approaches to ensure there is adequate protection for online investors and advocate suitability checks for all unsophisticated online investors.

## I. BACKGROUND OF ONLINE TRADING AND SUITABILITY OBLIGATIONS

### A. *The Explosive Growth of Online Trading*

Since 1995, online trading has grown dramatically, both in the

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21. See *Does the Internet Empower*, *supra* note 8, at 5 (discussing that how broadly or narrowly suitability obligations are applied to online brokers will influence how effective the rule is at protecting investors).

22. See Lowenfels & Bromberg, *supra* note 9, at 1575 (noting that "the line between conduct which is suitable and conduct which is unsuitable under SRO rules remains ambiguous and uncertain").

23. For an explanation of the difference between the NYSE Rules and the NASD Rules regarding suitability obligations, see Michael J. Hogan & Richard H. Neiman, *Electronic/Online Brokerage Regulating Cyberspace*, in STRATEGIES FOR FINANCIAL INSTITUTIONS IN THE NEW E-COMMERCE ECONOMY, at 33, 39 (PLI Corp. L. & Practice Course, Handbook Series No. B0-00E5, 1999).

availability of services and the number of customers.<sup>24</sup> Currently, approximately 160 brokers offer online trading and more than 10,000 Internet Websites execute online trades.<sup>25</sup> The explosion of online trading is due in part because it is less expensive, more convenient and faster to execute trades online than through a traditional broker.<sup>26</sup> The features available on brokers' Websites, such as research, market information and investment tools, also have contributed to online trading's popularity.<sup>27</sup>

Industry professionals state that online trading has democratized America's capital markets by enabling an increased number of middle-class Americans to participate in the stock market.<sup>28</sup> With the

24. See Laura S. Unger, *The Net Changes Everything . . . Or at Least a Few Things*, 2 No. 12 WALLSTREETLAWYER.COM: SECURITIES IN THE ELECTRONIC AGE, at \*1 (1999) [hereinafter *The Net Changes Everything*] ("The phenomenal growth in online brokerage is particularly astonishing when you consider that it did not exist in 1995."); *Cyberspace*, *supra* note 2, at 11 (noting that the first system allowing online trading began in 1995).

The number of online customers has dramatically increased. U.S. Bancorp Piper Jaffray ("Piper Jaffray") assessed that there were 9.7 million online accounts by the end of the second quarter of 1999. See *Cyberspace*, *supra* note 2, at 1 (highlighting the drastic growth in the industry by explaining that there were 3.7 million online accounts in 1997 and 7.3 million in 1998) (citing U.S. Bancorp Piper Jaffray, *On-line Financial Services Update* 11 (Sept. 1999)). In fact, trades placed online now account for 25% of all trades on the NYSE and Nasdaq. See *Customer Expectations Online*, *supra* note 3, at 1; see also *Cyberspace*, *supra* note 2, at 15 (discussing a study by U.S. Bancorp Piper Jaffray concluding that in 1998 online broker-dealers 37% of all retail equities trades and options trades). Jupiter Communications calculated that in 1998, investors held \$415 billion in assets in online accounts. See *Cyberspace*, *supra* note 2, at 12 (citing Jupiter Communications: *\$3 Trillion in Assets by 2003 in Online Brokerage Accounts, But Customer Service Still Lacking* (Sept. 1, 1999), available at <http://www.com/jupiter/press/releases/1999/0901.html>).

25. See *Cyberspace*, *supra* note 2, at 11; Tracey Longo, *Keeping Online In Line: Online Brokerages Say They're Not Subject to Suitability Requirements, But Regulators May Argue Otherwise*, FIN. PLANNING, July 1, 1999, at 1, available at 1999 WL 7351388.

26. See Laura Unger, *Empowering Investors in an Electronic Age*, Remarks at IOSCO Annual Conference, Sydney Australia (May 17, 2000) ("The ease of internet access, the unprecedented availability of on-line investment information and reduced transaction costs have empowered individual investors to enter the financial markets in record numbers."), available at <http://www.sec.gov/news/speeches/spch380.htm>; see also *Better Investor Protection*, *supra* note 3, at 10 (discussing that some of online trading's attractive features include low fees and free company research); Burns, *supra* note 20 ("It's cheaper, it's faster, it's more efficient' to use online brokerage firm.").

27. See *Better Investor Protection*, *supra* note 26, at 27. Online brokers provide a variety of information on their sites, including Web links to research providing a recommendation. See *id.* Some firms charge "customers for general stock recommendations by specific industry or risk category." *Id.* Some regulators are concerned that some investors may believe that this information is a recommendation by their broker. See *id.* See generally Sam Scott Miller, *Online Brokers: The Next NASD Target?*, SD44 ALI-ABA 1, \*3 (1999) (explaining that computer technology and the Internet has enabled growth in online financial services).

28. See *Good Morning America Report: Trading Stocks Over the Internet* (ABC television broadcast, Feb. 18, 1999) (discussing that the stock market is no longer just for wealthy professionals, in part, because of new online trading technologies which

ability to execute a trade for as little as five dollars,<sup>29</sup> online trading is particularly attractive to smaller investors who may not have been able to afford to pay the higher fees associated with traditional, “offline” brokerages.<sup>30</sup> In fact, some online brokers have started offering free trades.<sup>31</sup>

The growth of online trading is expected to continue. Forrester Research believes there will be 20.4 million online accounts by 2003.<sup>32</sup> These accounts are expected to hold \$3 trillion in investor assets, which is a sevenfold increase from 1998.<sup>33</sup> The increased number of online accounts will contribute to revenue growth for the online brokerage industry, which the Securities Industry Association (“SIA”) predicts to exceed \$5 billion by the year 2001.<sup>34</sup> Another factor that will contribute to online trading’s continued growth is the increasing number of industry players.<sup>35</sup> Although discount brokerages were the first to establish online trading sites, full service firms, like Merrill Lynch, Salomon Smith Barney, Prudential Securities and PaineWebber, entered the online arena after witnessing online brokerages’ growing market shares.<sup>36</sup>

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allow “everyday people” to invest); *Plain Talk About On-line Investing*, *supra* note 6, at 1102; Mary L. Schapiro, President of the NASD Regulation, Inc., Speech at the Society of American Business Editors and Writers Conference (Nov. 17, 1998) (on file with author) [hereinafter Schapiro Speech] (describing that the new typical investor makes less than \$70,000 per year and 38% of new investors are non-professionals); *see also Cyberspace*, *supra* note 2, at 12 (stating online investors have a median age of 41 and median income of \$73,800).

29. *See* Brian A. Carlis et al., *The True Cost of Internet Investing*, in SECURITIES ARBITRATION 1999: SETTLEMENTS, LAPTOPS, EXPERTS & ARBITRATORS, at 175, 180 (PLI Corp. L. & Practice Course, Handbook Series No. 0092, 1999) (noting the inexpensive fees associated with online trading).

30. *See The Net Changes Everything*, *supra* note 24, at 1 (noting that online trading greatly impacts smaller investors’ ability to participate in the stock market); Carlis, *supra* note 29, at 180 (discussing that investors can trade online for as little as \$5.00 a trade, although online trades fluctuate and can cost up to approximately \$30.00 a trade); David Lipton, *Risky Business: D.C. News Headlines and Internet Stock Trading*, CONTACT (The Catholic University of America Columbus School of Law), Summer 1999, at 17, 18 (stating that online trading fees are as low as \$6.00 or \$7.00 a trade).

31. *See* Cassell Bryan-Low, *Web Brokers Begin to Offer No-Commission Stock Trades*, June 19, 2000, at C1 (noting that Ameritrade, FinancialCafe.com and FreeTradez offer certain online trading for free); *see also E-Trade Growing Pains*, *supra* note 5, at H1 (discussing that E\*Trade offers customers promotions like frequent-flier miles and points with big hotel chains).

32. *See Cyberspace*, *supra* note 2, at 17 (projecting that by 2003, 9.7 million U.S. households will manage online accounts).

33. *See id.*

34. *See* Longo, *supra* note 25, at \*1 (stating that online sales revenues were \$1.2 billion in 1997).

35. *See* Carol McGinn, *Online Brokers Link Front, Back Office*, WALL ST. & TECH., Apr. 1, 1999, at 14 (noting that more and more firms are jumping on the online trading bandwagon); Simon & Buckman, *supra* note 8, at C1.

36. *See* Robert Sales, *Uncharted Waters: Brokerages Wade Into Web Trading*, WALL ST. & TECH. at 4045 (July 1, 1999). One reason full service brokerage firms hesitated to

*B. Online Trading versus Day-Trading: Distinguishing Between Two Different Types of Investment Activities*

Although day traders and online traders both use computers to execute trades, these two types of investors are distinct. Day traders and online investors typically have different investment objectives.<sup>37</sup> According to a recent report issued by the North American Securities Administrators Association ("NASAA"), a day trader is a retail customer of a brokerage firm who attempts to make daily profits by executing frequent trades to take advantage of small changes in a stock's price.<sup>38</sup> Consequently, day traders' transactions, typically placed through a day trading firm, must be executed quickly to take advantage of small price changes.<sup>39</sup> Through frequent trading, day

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enter the online environment is the impersonal nature of the Internet, which seems inconsistent with the type of personalized investment advice full service brokerages provide. *See id.* Full service brokerages generate revenue by providing customers with recommendations on what investment instruments to purchase, processing orders, and/or by managing customers' funds on a discretionary basis. *See id.* Therefore, the firm makes all the investment decisions for a customer's brokerage account. *See id.* Discount brokerages create revenue by executing customer's trades and are far less likely to make recommendations to customers and do not permit discretionary accounts. *See* Simon & Buckman, *supra* note 8, at C1.

37.

At the outset, NASAA believes that a distinction must be drawn between online investing and day trading. Too often the news media use these descriptors interchangeably, when in fact they are distinct market segments although some commonality may exist. Definitions of these terms are of course not included in the securities laws or orders and sometimes the two areas may blur together.

NASAA'S *Letter to Committee on Commerce, in* SECURITIES LAW & THE INTERNET: DOING BUSINESS IN A RAPIDLY CHANGING MARKETPLACE, at 909, 911 (PLI Corp. L. & Practice Course, Handbook Series No. 00BS, 1999). *See Day Trading: An Overview: Hearing Before the Permanent Subcomm. on Investigations of the Senate Comm. on Governmental Affairs*, 106th Cong. 55 (1999) [hereinafter *Levitt Day Trading Testimony*] (prepared testimony of Arthur Levitt, Chairman of the SEC) (exploring the differences between day traders and online traders), available at <http://www.sec.gov/news/testimony/tsty2199.htm>.

An additional difference between the day trading industry and the online trading industry is size. The day trading industry is considerably smaller than the online brokerage industry. *See* Saul S. Cohen, *The Empire Strikes Back, Part I: The War Against Day Trading*, 2 No. 12 WALLSTREETLAWYER.COM: SECURITIES IN THE ELECTRONIC AGE 9, \*3 (1999). The NASAA reports there are 62 active day trading firms that operate a total of 287 branches. *See* North American Securities Administrators Association Project Group on Day Trading, *Report of the Day Trading Project Group: Findings and Recommendations*, at 7 (Aug. 9, 1999) [hereinafter *Day Trading Project*]. The Electronic Traders Association ("ETA") reports that there are approximately 4,000 to 5,000 full time day traders and about 225,000 people who use the Internet to day trade on a part-time basis. *See* Cohen, *supra*, at \*1. Full time day traders account for a total of 150,000 to 200,000 trades per day which is about 15% of Nasdaq's volume. *See id.* at \*2.

38. *See Day Trading Project*, *supra* note 37, at 5, 7.

39. *See Levitt Day Trading Testimony*, *supra* note 37 (explaining that online brokers provide "real time" stock quotations, but do not provide "real time" links to major stock markets and the Nasdaq, like day trading firms, and therefore, unlike day

traders attempt to generate quick profits.<sup>40</sup> In contrast, online investors typically aim to leave their money invested for a longer period of time, hoping to make a profit at some point in the future.<sup>41</sup> As such, the speed of trade execution is not as critical to many online investors.<sup>42</sup> Online investors, however, typically execute trades more often than investors who use traditional “offline” brokers.<sup>43</sup>

These two types of investors also differ in the degree of risk they expect to undertake. In his or her quest for quick returns, a day trader takes on a substantially higher degree of risk than the average online investor.<sup>44</sup> Arthur Levitt, the Chairman of the SEC, stated that

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traders, online traders do not have the power to directly access market operated order execution systems and execute their trades within seconds).

40. See Levitt *Day Trading Testimony*, *supra* note 37 (commenting that it is difficult to define clearly a day trader or day trading, but noting that the differences can be seen by examining the spectrum of investors from those who hold investments for a longer period of time to those who engage in rapid-fire buying and selling, sometimes only owning a stock for a matter of seconds); Securities and Exchange Commission, *Investor Tips: Day Trading: Your Dollars at Risk* (Sept. 27, 2000) [hereinafter *Day Trading: Your Dollars at Risk*] (discussing that day traders are not “investors,” like online traders, because they often only own stocks for minutes or even seconds and never own stocks overnight because of the extreme risk of overnight negative price fluctuations), available at <http://www.sec.gov/consumer/daytips.htm>.

41. The NASAA notes that online investors may execute a day trade by buying and selling the same security within the same day, through an online broker’s website, even though they do not have the same advantages provided by firms that cater to a day trading strategy. A day trader, however, is not and cannot be an investor. See NASAA’S *Letter to Committee on Commerce*, *supra* note 37, at 912.

42. The speed of trade execution is still very important to online brokers and some investors may even try to use an online broker to carry out a day trading or part-time day trading strategy. See generally Gaston F. Ceron, *Direct-Access Trading Expected to Move Online Investing to the Next Generation*, WALL ST. J., Aug. 14, 2000 (discussing new direct-access technology that will allow online traders to access the markets directly without going through a broker). The *Direct-Access* article goes on to discuss that the use of direct-access technology is not for everyone because “it requires a level of understanding and a level of knowledge in order to benefit fully from it and to use it safely.” *Id.*

43. See Brad M. Barber & Terrance Odean, *Online Investors: Do the Slow Die First?*, at 24 (Dec. 1999) (draft version) (finding that investors begin trading more actively when they switch to an online broker, after using a traditional, “offline” broker), available at <http://www.gsm.ucdavis.edu/~odean/papers/Online/Online.html>; see also John Reed Stark, *Securities Regulation and the Internet*, in SECOND ANNUAL INTERNET LAW INSTITUTE, at 793, 801 (PLI Patents, Copyrights, Trademarks, and Literary Property Course, Handbook Series No. G0-001, 1998) (“Online investors also tend to be more active, holding larger positions, making bigger trades, and enjoying better discounts trading through a computer than they could obtain by trading through a full-service broker.”).

44. Typically, day traders expose themselves to even more risk by trading on margin. Trading on margin means an investor uses borrowed funds to purchase stocks. More specifically, when an investor trades on margin they borrow cash against the value of the securities that they own to purchase more stock. By using borrowed funds an investor hopes to magnify profits, but trading on margin also increases an investor’s risk exposure. If the stock the investor is using to borrow against decreases in value, the loss can be compounded and the investor will be required to make a margin call, which means he or she must put up more cash or

individuals who wish to engage in day trading should understand that day trading poses a significant risk of financial loss; therefore, individuals should not trade with funds they cannot afford to lose.<sup>45</sup> One study by a Florida investment consultant concluded that only 11.5% of individuals using a day trading strategy were able to turn a profit.<sup>46</sup>

### C. *Suitability Obligations Under NASD and NYSE Rules*

Suitability is a doctrine that requires brokers to recommend only those securities purchases that are suitable to an investor's financial needs.<sup>47</sup> In securities arbitration claims, suitability is the most frequently cited securities industry standard.<sup>48</sup> The suitability doctrine emerged because, in broker-customer relationships,

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risk that his or her securities will be sold. See NASD Notice to Members 98-102, *Calculating Margin for Day-Trading and Cross-Guaranteed Accounts* (Dec. 1998) (providing detailed discussion of margin-related issues); *Day Trading: Your Dollars at Risk*, *supra* note 40, at 2.

The practice of trading on margin exposes an investor to the possibility of losing more than he or she originally invested. Trading on margin is not exclusive to the day trading industry and some online traders may also choose to trade on margin. Because of the speed with which day traders move in and out of particular securities, the NASD stated in a December 1998 Notice to Members that day traders must trade using a margin account because day trading in a cash account could amount to free riding, which occurs when an individual purchases a security and then sells it prior to actually paying for the initial purchase. See NASD Notice to Members 98-102 (Dec. 1998); *Day Trading: Your Dollars at Risk*, *supra* note 41, at 2.

45. See *Levitt Day Trading Testimony*, *supra* note 37, at 1. The chief of licensing at the Massachusetts Securities Division stated that "day trading isn't investing, it's at best speculating[.] . . . most traders will lose all of their money." State Securities Regulators Highlight Problems with Day Trading, Press Release by the North America Securities Administrators Association, Aug. 9, 1999 <<http://www.nasaa.org/whoweare/media/dtreportrelease.htm>>.

46. See *Day Trading Project*, *supra* note 37, at 6; see also Ronald L. Johnson, *Day Trading: An Analysis of Public Day Trading at a Retail Day Trading Firm* (Aug. 9, 1999) (reporting that numerous studies have shown that market timing is not possible, "even for professional money mangers"), available at <http://www.nasaa.org/RJReportFinal.html>.

47. See Lowenfels & Bromberg, *supra* note 9, at 1557 (noting that suitability requires the matching of the investment needs of a particular client with the characteristics of a recommended security); Wolensky, *supra* note 8, at 254 (describing the suitability doctrine as a broker's duty to recommend to a customer only those securities that are suitable to the peculiar needs of that particular customer); *Cyberspace*, *supra* note 2, at 24 (explaining that "suitability refers to a broker-dealer's obligation to recommend only those specific investments that are suitable for its customers.").

48. See Lowenfels & Bromberg, *supra* note 9, at 1557 (noting that in 1998 unsuitability claims accounted for 95% of filings under NASD "errors and omissions" insurance policies); Rapp, *supra* note 9, at 189 (noting that the suitability requirement is the most frequently cited standard in the securities industry); Simon & Buckman, *supra* note 8, at C19 (stating that the NASD received 1,104 arbitration claims based on suitability violations last year, but they are not sure how many of these claims relate to online trading). See generally Wolensky, *supra* note 8, at 254 (describing suitability as a well-established doctrine).

customers place trust in their brokers and rely on them to recommend only securities suitable for their financial position.<sup>49</sup> This concept is premised on the fact that brokers have a special relationship with their customers that is different from the typical merchant-customer relationship.<sup>50</sup> The broker-customer relationship is one of special trust and confidence approaching that of a fiduciary.<sup>51</sup> The suitability doctrine is rooted in a concept known as the shingle theory.<sup>52</sup> The shingle theory is a common law principle stating that brokers make an implied representation to customers when they “hang out a shingle” that they will deal with the customer fairly.<sup>53</sup>

Self Regulatory Organizations (“SROs”), such as the NASD and the NYSE have rules that articulate suitability obligations governing broker-dealers.<sup>54</sup> Currently, all broker-dealers conducting any substantial interstate retail business are members of the NASD, and thus abide by its suitability rules.<sup>55</sup> As discussed below, however, what constitutes a viable unsuitability claim under the NASD and NYSE rules is often difficult to discern.<sup>56</sup>

49. See Wolensky, *supra* note 8, at 255 (explaining that the suitability doctrine aims to protect investors from broker sales abuses like high pressure selling).

50. See Rapp, *supra* note 9, at 196.

51. See *id.* (noting that an SEC disciplinary case described the broker-customer relationship as one of “special trust and confidence approaching, and perhaps even equaling, that of a fiduciary”).

52. See *id.* at 254 (noting the origins of the suitability doctrine).

53. See *Cyberspace*, *supra* note 2, at 26 (explaining that the shingle theory arises from common law and provides that by virtue of hanging out a shingle as a securities professional, a broker-dealer makes an implied representation to customers); see also Roberta S. Karmel, *Is the Shingle Theory Dead?*, 52 WASH. & LEE L. REV. 1271, 1271 (1995) (explaining that the shingle theory presumes that a broker-dealer who hangs out a shingle and solicits customers makes an implied representation of fair dealing).

54. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 10.2, at 458 (3d ed. 1996) (noting that the bulk of broker-dealer regulation is attributable to SROs); MARC I. STEINBERG, *SECURITIES REGULATION* 868 (3d ed. 1998) (explaining that SROs such as the NYSE and NASD play an important role in broker-dealer regulation); see also Rapp, *supra* note 9, at 189 (noting that SROs such as the national securities exchanges and the NASD articulate suitability obligations). A qualifying SRO is either a national exchange, like the NYSE, or a registered securities association. See HAZEN, *supra*, § 10.2, at 464.

55. Broker-dealers must register with the SEC, unless they fall under an exception, and the SEC requires that broker-dealers join the NASD. See STEINBERG, *supra* note 54, at 869. All members of the NASD must comply with its rules and regulations. See *id.* at 869-70. See generally HAZEN, *supra* note 54, at 464 (noting that broker-dealers registered with the NASD may also be members of one or more national exchanges); Rapp, *supra* note 9, at 197 (stating that the SEC established the NASD as the only “Registered Securities Association” under the authority of Section 15A of the Securities Exchange Act of 1934); Schapiro Speech, *supra* note 28, at 1 (noting that the NASD is currently responsible for regulating 5,600 brokerage firms and approximately 600,000 registered representatives).

56. See Lowenfels & Bromberg, *supra* note 9, at 1557 (discussing that unsuitability claims are the most common yet most ambiguous client accusations) (citing *Zarb*

Under NASD Rule 2310(a), "Recommendations to Customers (Suitability)," brokers must recommend only those securities suitable for a particular investor.<sup>57</sup> 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 other security holdings and as to his financial situation and needs.<sup>58</sup>

Therefore, a broker must first make a recommendation to trigger Rule 2310(a) and be subject to suitability obligations.<sup>59</sup>

Brokers can violate the suitability rule in two ways.<sup>60</sup> First, a broker-dealer can make a recommendation that is unsuitable for any investor.<sup>61</sup> Second, a broker may make a recommendation that is inappropriate for a specific investor because of that investor's wealth, investment objectives, age, or other individual characteristics.<sup>62</sup>

The NYSE also has a rule related to the suitability doctrine, although the term suitability is not used in the rule.<sup>63</sup> NYSE Rule 405, the "know your customer rule," requires members of the NYSE to use

*Urges Broker-Dealers to 'Be on Guard' About Suitability*, 30 Sec. Reg. & L. Rep. (BNA) No. 22, at 810 (May 29, 1998)) (noting that what constitutes a viable unsuitability claim is open to debate).

57. See NASD Conduct Rule 2310, NASD Manual (CCH) 4261 (Apr. 1997) (outlining NASD's suitability rule); see also Wolensky, *supra* note 8, at 254 (discussing that the suitability doctrine is outlined in NASD Rule 2310).

58. NASD Conduct Rule 2310(a), NASD Manual (CCH), at 4261; see also NYSE Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1999) ("Every member organization is required . . . to use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account. . . ."); AMEX Rule 411, 2 Am. Stock Exch. Guide (CCH) ¶ 9431, at 2647 (Oct. 1995) ("Every member or member organization shall use due diligence to learn the essential facts relative to every customer and to every order or account accepted."); Rapp, *supra* note 9, at 205-06 (noting that the NASD's suitability rule has emerged as the "standard of conduct and disciplinary baseline").

59. See McMahon, *supra* note 1, at 277-78 (explaining that questions about when suitability rules apply usually depend on whether the broker made a recommendation); see also Lowenfels & Bromberg, *supra* note 9, at 1560 (explaining that the majority of authorities take the position that the suitability obligation is imposed on a broker only in the context of a recommendation). NASD Rule 2210(d)(2)(B) states that "in making a recommendation, whether or not labeled as such, a member must have a reasonable basis for the recommendation." NASD Conduct Rule 2210(d)(2)(B), NASD Manual (CCH) at 4174; see also *Customer Expectations Online*, *supra* note 3, at 4 (explaining that the outcome of a suitability analysis will turn on the facts and circumstances of a given case).

60. See Rapp, *supra* note 9, at 190.

61. See *id.* (noting that a broker may violate the suitability rule if a recommendation is unsuitable for any investor, regardless of the investor's individual characteristics).

62. See *id.*

63. See Lowenfels & Bromberg, *supra* note 9, at 1571 (discussing the NYSE's "know your customer" rule).



due diligence to attain relevant facts about every customer, every order, every margin account accepted or carried by a member firm, and every person holding power of attorney over any account.<sup>64</sup> Unlike the NASD suitability rule, NYSE Rule 405, does not require a recommendation to trigger the rule's obligations.<sup>65</sup>

*D. Suitability Doctrine Enforcement Mechanisms: Arbitration's Affect on Consumer Protection*

Enforcing a claim based on suitability rules, particularly in a judicial proceeding, is difficult and presents another justification for ensuring there are clear rules designed to protect online investors. In particular, the lack of a private cause of action under NASD and NYSE rules, combined with mandatory arbitration proceedings, support the importance of ensuring SRO rules adequately protect investors.<sup>66</sup> First, courts have held there is no private right of action under both NASD and NYSE rules.<sup>67</sup> Therefore, investors generally

64. See NYSE Rule 405(1), 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3696 (Aug. 1994); Rapp, *supra* note 9, at 207 (discussing NYSE Rule 405); see also *Cyberspace*, *supra* note 2, at 25 (discussing NYSE Rule 405).

65. See NYSE Rule 405(1), 2 N.Y.S.E. Guide (CCH), at 3696 (requiring that a broker use "due diligence to learn the essential facts relative to . . . every order, every cash or margin account") (emphasis added); Schulz, *supra* note 4, at 240 (explaining that the NYSE rule does not limit its applicability to recommendations). See generally AMEX Rule 411, 2 Stock Exch. Guide (CCH) ¶ 9431, at 2647 (Aug. 1995) (stating that brokers have a duty to know and approve their customers); Rapp, *supra* note 9, at 207 (explaining that the American Stock Exchange ("AMEX") Rule 411 relates to suitability and imposes an express requirement that a supervisory person know of the essential facts pertaining to the customer and the nature of the account and approve the opening of the account prior to or concurrently with any transactions occurring in the account).

66. See Rapp, *supra* note 9, at 190-91 & n.7 (discussing that the SEC and SRO's enforce SRO rules).

67. See *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679 (9th Cir. 1980) (concluding that there is no private of action under NYSE's "know your customer" rule and NASD "suitability" rule); *Porter v. Shearson Lehman Bros.*, 802 F. Supp. 41, 63 (S.D. Tex. 1992) (explaining that the NASD's suitability rule is the guideline of a private association and therefore does not provide a private right of action); *Klock v. Lehman Bros. Kuhn Loeb, Inc.*, 584 F. Supp. 210, 217 (S.D.N.Y. 1984) (holding that neither the NASD's "suitability" rule nor NYSE Rule 405, which also governs suitability determinations, provide a private right of action); *Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 532 F. Supp. 480, 482-83 (S.D. Ohio 1982) (explaining that under the Supreme Court's test established in *Cort v. Ash*, 422 U.S. 66 (1975), there is no implied private right of action under NASD rules); *Klitzman v. Bache Halsey Stuart Shields, Inc.*, 499 F. Supp. 255, 259 (S.D.N.Y. 1980) (holding that there is no private right of action for violations of NASD rules); *Alvod v. Shearson Hayden Stone, Inc.*, 485 F. Supp. 848, 855-56 (D. Conn. 1980) (refusing to imply a private right of action under securities exchange rules); *Musser v. Bache & Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,183, at 92,335-36 (N.D. Cal. 1977) (contending that there should be no private right of action for NASD regulations because it would undermine the concept of cooperative self-regulation which is the underlying purpose of the NASD); *Parsons v. Hornblower & Weeks-Hemphill Noyes*, 447 F. Supp. 482, 494 (M.D.N.C. 1977) ("[U]nder the clear

cannot use courts to settle disputes pertaining to the NASD's suitability requirement or the NYSE's "know your customer rule."<sup>68</sup>

Second, virtually all brokers require customers to sign pre-dispute arbitration agreements prior to opening a brokerage account.<sup>69</sup> By entering into a pre-dispute arbitration agreement, customers waive their right to commence judicial proceedings against their broker and instead must settle disputes through arbitration.<sup>70</sup> The Supreme

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weight of authority, there is no private right of action for alleged violations of NASD rules in the absence of facts which demonstrate fraud, independently cognizable under the antifraud provisions of the securities laws."); *Zagari v. Dean Witter & Co.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777, at 90,812 (N.D. Cal. 1976) (contending that implying a private right of action for SRO or exchange rules would hamper self-regulation by creating a fear of damaging liability); *see also* HAZEN, *supra* note 54, § 10.6, at 504 (explaining that it is unlikely that a violation of an exchange's and/or a SRO's suitability doctrine will provide an independent basis for private relief by an injured investor); Christopher Q. King & Steven L. Merouse, *Claims Arising From Market Volatility*, in SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES, at 9, 18 (PLI Corp. L. Practice Course, Handbook Series No. 1062, 1998) (noting that SRO and exchange rules do not provide a private course of action). *But see* *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 336 (5th Cir. 1991) (finding that where there is proof of a churning violation, i.e., where a broker excessively trades a customer's account, the suitability requirement will give rise to a private cause of action).

Although NASD's suitability requirement does not generally provide individuals a private right of action, investors can bring a breach of fiduciary duty claim against their online broker. *See* HAZEN, *supra* note 54, § 10.6, at 500 (noting that broker-dealers are subject to fiduciary obligations). Courts analyze three elements to determine if there is a breach of fiduciary duty. The court will examine: (1) whether a fiduciary duty exists, (2) the scope of the duty, and (3) whether the conduct involved breached such a duty. *See id.* at 501. Courts examine fiduciary duty claims on a case-by-case basis and heavily rely upon the facts of each case. *See id.* at 500; *see also* *Burdett v. Miller*, 957 F.2d 1375, 1381 (7th Cir. 1992) (explaining that the relationship between a broker and customer may become fiduciary on an ad hoc basis). *See generally* Lowenfels & Bromberg, *supra* note 9, at 1591-92 (discussing state unsuitability claims for breach of fiduciary duty).

68. *See supra* note 67 and accompanying text; *see also* Bell, *supra* note 3, at \*5 (noting that investors can base a suitability claim on the SEC's Rule 10(b)(5), but that it is highly unlikely that a court will find any online broker responsible under this rule, in part, because of its scienter and loss causation requirement).

69. *See Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, at 14 (GAO/GGD-00-115, June 2000) [hereinafter *Securities Arbitration*] (explaining that brokers generally have customers sign a pre-dispute arbitration clause when they open an brokerage account); *see also* Janet E. Kerr, *The Arbitration of Securities Law Disputes after Rodriguez and the Impact on Investors Protection*, 73 MARQ. L. REV. 217, 256 (1989) (noting that many brokerage firms make clients sign pre-dispute arbitration agreements prior to receiving service); Thomas Mulligan, *E-Brokerages Face Backlash After "Margin" Debacle*, L.A. TIMES, June 11, 2000, at C1 (noting that lawsuits against brokers are difficult because brokerage firms require their customers to sign agreements that they will settle disputes in arbitration, rather than in court).

70. *See* Karimu F. Hill-Harvey, *How Arbitrators Decide*, in SECURITIES ARBITRATION 1999: SETTLEMENTS, LAPTOPS, EXPERTS & ARBITRATORS, at 547, 550-51 (PLI Corp. L. Practice Course, Handbook Series No. 1131, 1999) (explaining that arbitration is final and binding and subject to judicial review only on a limited basis); *Securities Arbitration*, *supra* note 69, at 6, 14 (describing arbitration procedures).

Court has upheld these pre-dispute arbitration agreements.<sup>71</sup>

Many have criticized the arbitration process as being pro-industry and anti-investor,<sup>72</sup> as investors are not afforded the protections that formal judicial proceedings provide.<sup>73</sup> In addition, arbitrators are not bound by precise legal standards, and therefore, arbitrators look to SRO rules, industry custom, and concepts of equity and fairness for guidance.<sup>74</sup> Hence, arbitration awards have little, if any, precedential value.<sup>75</sup> On the other hand, the bulletins issued by the NASD, known as NASD Notice to Members, can provide guidance relating to brokers' obligations to investors.<sup>76</sup>

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71. In *Shearson/American Express, Inc. v. McMahon*, the Supreme Court upheld the validity of a pre-dispute arbitration agreement between a customer and a broker-dealer. See 482 U.S. 220, 242 (1987) (holding that the McMahons have no right to commence judicial proceedings for a § 10(b) and RICO claim against their broker after they agreed to a pre-dispute arbitration agreement); see also Timothy J. O'Connor, *The Use of NASD Notice to Members Bulletins as Precedent in Arbitration Proceedings*, in SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES, at 253, 257 (PLI Corp. L. Practice Course, Handbook Series No. 1061, 1998) (noting that since the Supreme Court ruling in *McMahon*, a majority of customer claims against brokers are resolved in arbitration proceedings rather than in courts).

In *Rodriguez de Quijas v. Shearson/American Express, Inc.*, the Court further held that a pre-dispute arbitration agreement was enforceable under the Securities Act. See 490 U.S. 477, 485 (1989) (holding that pre-dispute arbitration agreements do not undermine any of the substantive rights given by the Securities Act of 1933).

72. See STEINBERG, *supra* note 54, at 884 (noting that many believe securities arbitration favors the securities industry); Kerr, *supra* note 69, at 256 (contending that pre-dispute arbitration agreements may harm the securities laws investor protection goals); *Securities Arbitration*, *supra* note 69, at 4 (discussing concern that there is a pro-industry bias, but finding that there does not seem to be such a bias in SRO arbitration).

73. See Kerr, *supra* note 69, at 256 (noting that in arbitration proceedings discovery procedures are not utilized, the review process is limited, the Federal Rules of Evidence are not applicable, and punitive damages are unusual); see also *Securities Arbitration*, *supra* note 69, at 33 (finding that during 1998 brokers did not pay 49% of arbitration awards and 12% of awards were only partially paid).

74. See Hill-Harvey, *supra* note 70, at 556 (explaining that arbitrators are not bound by case precedent and statutory law, leaving arbitrators with a lot of latitude in interpreting legal concepts); see also STEINBERG, *supra* note 54, at 885 (noting that many arbitrators are not lawyers, and those who are may have little experience in securities law).

75. See STEINBERG, *supra* note 54, at 885 (explaining that arbitrators are not even required to issue a written opinion, which would explain the rationale for their decision); see also Kerr, *supra* note 69, at 256 (noting that it is neither mandatory that an arbitrator issue an opinion, nor are they required to provide the reason for the decision).

76. See O'Connor, *supra* note 71, at 257-58 (explaining that some courts have relied on NASD Notices to Members in fashioning theories of liability); see also *Harden v. Raffensperger Hughes & Co.*, 65 F.3d 1392, 1401 (7th Cir. 1995) (relying on NASD Notice to Members to clarify broker-dealer obligations to investors); *General Bond & Share Co. v. SEC*, 39 F.3d 1451, 1456-57 (10th Cir. 1994) (reviewing a NASD Notice to Members).

### *E. Online Suitability*

Both online brokerage firms and regulators recognize that it is necessary to address the question of online suitability requirements.<sup>77</sup> Online suitability claims occur when an investor alleges that an online broker, through its Website or other electronic communication, prompted them to purchase a security that was unsuitable because of the investor's risk profile, financial needs or fact-specific situation.<sup>78</sup> Although some brokers argue that suitability obligations do not apply online,<sup>79</sup> the suitability issue is complicated online, especially when online brokers offer, what many may consider, personalized investment information.<sup>80</sup> The current debate over the application of suitability obligations in the online environment leaves both online brokers and investors in a state of uncertainty.

## II. ONLINE BROKERS AND SUITABILITY OBLIGATIONS: IS THERE A NEED FOR REGULATORS TO DO MORE TO PROTECT ONLINE INVESTORS?

To analyze whether online investors need certain specific protections, it is necessary to examine some of the novel characteristics associated with the online trading industry. First, online brokers enable a larger number of individuals to invest in

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77. See *Customer Exceptions Online*, *supra* note 3, at 3 (listing a series of questions concerning "gray" areas of the law pertaining to suitability obligations and online brokerages).

Some of these questions include the following: (1) Is it a recommendation if a broker makes research and other information available to a customer based on information gathered through profiling that customer from his movements online, and (2) Does an investor assume that information received from a broker constitutes a recommendation? See *id.*; see also Jane Bryant Quinn, *What Some Online Brokerages Don't Tell You*, WASH. POST, Mar. 21, 1999, at H2 (explaining that in response to online trading securities, regulators are looking into whether there should be new investor protection rules); *Can SEC.gov Regulate Securities.com*, *supra* note 3, at 1 (discussing that a goal of the SEC Commissioner is to examine how the Internet is changing the securities industry and how the SEC can protect investors without impeding innovation).

78. See Bell, *supra* note 3, at \*1 (explaining the nature of customer online suitability claims against e-brokers).

79. See Laura Unger, Remarks at the Conference on Integrating Technological Advances for Online Brokerages, New York, New York, *Regulating on Internet Time* (Sept. 22, 1999) [hereinafter *Regulating on Internet Time*] (stating that online brokers believe that they do not have any suitability obligations because customers control and direct their own investment decisions), available at <http://www.sec.gov/news/speeches/spch298.htm>; see also RJ, *supra* note 12 (asserting that online brokers like E\*Trade and Ameritrade and Charles Schwab believe suitability obligations do not attach to its online services).

80. See *Cyberspace*, *supra* note 2, at 29 (discussing possible ways that online brokers disseminate what could constitute personalized information, and how these practices may affect suitability obligations).

securities, including newcomers to the investing arena.<sup>81</sup> An examination of online brokers' advertisements shows that online brokers may be targeting new, unsophisticated investors.<sup>82</sup> Additionally, online brokers' advertising encourages frequent trading, which highlights the conflict between an online brokers' obligation to investors and its desire to increase firm revenue.<sup>83</sup>

Second, in the online environment, determining when a broker makes a recommendation under NASD Rule 2310 is difficult.<sup>84</sup> This determination affects what transactions, and thus what investors, receive the protections provided by the NASD's suitability rule. Many online brokers argue that no suitability obligations arise when investors place orders electronically because online brokers do not make recommendations.<sup>85</sup> In discussing what constitutes a recommendation, however, the NASD has stated that an analysis of all the relevant facts and circumstances is necessary to determine if a

81. See *supra* notes 28-30 and accompanying text.

82. See Schulz, *supra* note 8, at 242 (noting that Internet firms market to the masses and firms should know they may attract inexperienced investors); see also *infra* Part II.B (discussing online brokers' aggressive advertising campaigns that appear to target unsophisticated investors).

83. See *Does the Internet Empower*, *supra* note 8, at 3-4 ("Because higher trading velocity is still tied to the bottom line of an online broker that depends on transactional revenue, there is an inherent conflict between online brokers' interest in investors trading more often and investors' interests in trading less often."); see also *Plain Talk About On-line Investing*, *supra* note 6, at 1098 (noting that the cardinal rule for brokers, whether traditional or online, is to act in the customer's interest).

84. See Wolensky, *supra* note 8, at 257 (noting that the NASD has refused to define the term "recommendation" as used in Rule 2310); see also *Customer Expectations Online*, *supra* note 3, at 3 (discussing the difficulty of determining when a broker makes an online recommendation); *Cyberspace*, *supra* note 2, at 28 ("[W]hen does a firm make a recommendation on-line?").

85. See *Suitability Obligations in Internet Investing*, *supra* note 2, at 1 (noting that impersonal information found on a broker's website does not constitute a recommendation).

Charles Schwab's Chief Counsel concluded that: (1) a broker is not required to analyze the suitability of an investor's decision when the investor makes an unsolicited securities order, either through the Internet or otherwise; (2) the type of impersonal information found on a broker's website does not constitute a recommendation and does not impose a responsibility to monitor the customer's investment selection; and (3) an NASD requirement to review trades placed online would diminish the advantages to trading online for investors. See *Suitability Obligations in Internet Investing*, *supra* note 2, at 1; see also Simon & Buckman, *supra* note 8, at C1 (explaining that discount brokers argue that suitability obligations do not apply to them online because they do not have stockbrokers that recommend specific stocks to customers).

Online brokers believe that consumers are making their own investment decisions when investing online and, thus, no suitability obligations should attach. Commissioner Unger agrees that mere order execution online most likely does not create a suitability obligation. When online brokers provide personalized information that a customer sees online, however, Commissioner Unger believes that online brokers may have suitability obligations. See *Regulating on Internet Time*, *supra* note 79, at 5.

broker made a recommendation.<sup>86</sup> With online trading, these facts and circumstances will often center around the information found on an online broker's Internet Website.<sup>87</sup>

*A. The Type of Investor that Online Trading Attracts*

Online trading often attracts smaller, unsophisticated investors because online trading is inexpensive and frequently has lower account minimums than traditional brokerage firms.<sup>88</sup> Although the increased accessibility to securities markets provided by online trading can be beneficial to investors, unsophisticated investors are more vulnerable to financial losses when they direct their own transactions online.<sup>89</sup> For example, unsophisticated investors may use online trading to undertake investments that are too risky for their financial situation by purchasing stocks that are not suitable for them.<sup>90</sup> Additionally, many online investors, even unsophisticated ones, trade on margin, which heightens the level of risk.<sup>91</sup> Fortuitously, the stock market has flourished in recent years and, as a

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86. See Wolensky, *supra* note 8, at 258 (discussing Clarification of Notice to Members 96-60 (Mar. 1997)).

87. *Cf. id.* at 261 (discussing that the information available on a broker's website and its impact on creating a recommendation).

88. See Schulz, *supra* note 4, at 242 (stating that in terms of raw numbers, there are probably more naïve investors participating in the securities markets today than ever before); Simon & Buckman, *supra* note 8, at C19 (stating that unsophisticated investors are flocking to the Internet to invest and the NASD is concerned about investor protection); Wolensky, *supra* note 8, at 253 ("The past few years have seen a dramatic increase in the number of small investors who have become 'on-line traders' eager to test their investment ability with ready market access."); see also Lipton, *supra* note 30, at 18 (noting that online trading has vastly expanded investment opportunities for the average investor); *cf. Cyberspace*, *supra* note 2, at 12 (noting a study reporting that online stock investors are younger and more affluent than customers at traditional, full service firms); *supra* text accompanying note 7 (discussing the definition of an unsophisticated investor).

89. See Schulz, *supra* note 4, at 242 (explaining that trades placed online do not utilize a stockbroker and, thus, Internet firms have basically eliminated the one safeguard for many investors); RJ, *supra* note 12 (comparing do-it-yourself, unsophisticated online investors selecting stocks to customers selecting their own drugs in a self-service pharmacy).

90. See Lipton, *supra* note 30, at 18 (noting that small investors, on occasion, select securities trading strategies that are too risky for them and are not basing investment decisions on the underlying fundamentals of a company, which can result in purchasing securities that are not appropriate for them); RJ, *supra* note 12 (quoting NASAA's president, Mr. Skolnick, who states "despite the record number of people investing, financial literacy remains dangerously low").

91. See Lisa Reilly Cullen, *The Margin-Debt Hole: How Deep Is Too Deep? Borrowing Money to Play the Stock Market Is Both Alluring and Dangerous*, MONEY MAG., Apr. 1, 2000, at 135 (discussing that when investors start trading online they tend to trade more frequently and hold higher margin balances, in large part because it is so easy to open an account online and start trading on margin); see also *infra* notes 7, 15 and accompanying text (discussing investor sophistication and trading securities on margin).

result, investors have experienced increased gains and fewer losses.<sup>92</sup> If the market falls, however, many unsophisticated investors may experience financial ruin because they held investments that were too risky for their financial situations.<sup>93</sup>

Exacerbating potential hazards for unsophisticated online investors are certain phenomena that occur when investors trade online. A recent study explains that online investors tend to be overconfident in their trading ability<sup>94</sup> due, in part, to an illusion of knowledge and control.<sup>95</sup> As a result, online investors tend to be overly self-attributive of their successes, especially in light of the market's recent

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92. See RJ, *supra* note 12 (reporting that the long bull market, along with media coverage and advertising, have created a "speculative fervor" among investors); David Segal, *Investors Are Trading Brokers for Computers; By Going Online, Wall Street Is Just a Keystroke Away*, WASH. POST, Aug. 23, 1999, at A6 (noting that some in the industry believe that the market has been so positive in the past seven years that virtually anyone can turn a profit); see also Paul Lim, *The Virtual Trade*, at 2 (visited Nov. 14, 2000) (noting that the recent bull market is enabling even novice traders to earn 20% on their funds invested in the stock market), available at <http://www.money.com/money/onlineinvesting/trading/trade1.html>.

93. See *Does the Internet Empower*, *supra* note 8, at 3 (stating that in today's strong stock market investors "feel impervious to risk"); Ianthe Jeanne Dugan, *Where No Investor Has Gone Before; Amateurs Steered the Ship Through a Spacey Year*, WASH. POST, Jan. 3, 1999, at H12 (noting that individual investors may be too optimistic about the stock market's performance and not take into account the fact that the market will likely decline at some point); see also Simon & Buckman, *supra* note 8, at C19 (explaining that suitability obligations for online brokers will become important after the market takes a nose dive); *E-Trade's Growing Pains*, *supra* note 5, at H1 (discussing one investor's story of severe financial loss after becoming an E\*Trade customer because the investor said "the constant advertising, the enticement of margin, [and] the ability to do it at home sucked me right in"); cf. Burns, *supra* note 20, at 1 (reporting on a statement by SEC Commissioner Unger that she is uncertain about the future of the online brokerage industry should the market take a downturn).

94. Researchers found this overconfidence and illusion of control is a product of the vast amounts of financial information available on the Internet combined with the power of being able to execute trades with a click of the mouse. See Barber & Odean, *supra* note 43, at 6-8. Online brokers often promote the quantity of financial information on their Web page and state that the information provided is the same as that reviewed by professional brokers. See *id.* at 6. For example, one online broker's advertisement states that "you'll make more, because you know more." *Id.* Even though there is a lot of information online, the study notes that online customers do not have the same training and experience as professional brokers. See *id.* Online customers, however, become overconfident because they confuse the availability of the information with knowledge. See *id.*; see also *Online Trading: New Online Traders Vulnerable to Overconfidence*, UC Davis Scholars Find, 31 Sec. Reg. & L. Rep. (BNA) 1213, 1213 (Sept. 17, 1999) [hereinafter *New Online Traders Vulnerable to Overconfidence*] (repeating the study's conclusions that excessive information creates an illusion of overconfidence); Leslie Walker, *Online Traders' Net Impact on the Increase*, WASH. POST, Sept. 4, 1998, at E1 (discussing online investor behavior).

95. See Fred Barbash, *Investing Online? It's Going to Cost You*, WASH. POST, Sept. 26, 1999, at H1 (discussing the researchers' study); Barber & Odean, *supra* note 43, at 6-7 (noting that online brokers' advertisements bolster investors' illusion of knowledge and control); *New Online Traders Vulnerable to Overconfidence*, *supra* note 94, at 1213 (discussing the conclusions reached in the Odean and Barber study).

prosperity.<sup>96</sup>

The result of these online investing characteristics is that online investors were more profitable investors prior to opening online accounts.<sup>97</sup> One study showed investor accounts went from outperforming the market by 2.4% when they were investing offline to underperforming the market by about 3.5% after they switched to online trading.<sup>98</sup> One reason for this decline appears to be that once investors go online, they tend to "trade more actively, more speculatively and less profitably."<sup>99</sup> Another factor that may influence online investors' trading choices is online brokers' advertising.<sup>100</sup>

### B. Online Brokers' Aggressive Advertising Campaigns

Online brokers' extensive advertising campaigns appear to target the average American.<sup>101</sup> Therefore, online brokers know, or should know, they will attract unsophisticated investors, as well as knowledgeable, experienced investors.<sup>102</sup> Online brokers' television

96. See Barber & Odean, *supra* note 43, at 2; *New Online Traders Vulnerable to Overconfidence*, *supra* note 94, at 1213 (reporting investors' mistake in crediting themselves for trading success when luck deserves the credit).

97. See Barber & Odean, *supra* note 43, at 2 (explaining that the investors in the study that switched from phone-based trading to online trading performed more poorly because they became overconfident in their investing ability); see also Barbash, *supra* note 95, at H1 (admitting that personal overconfidence resulted in poor albeit not disastrous returns); *New Online Traders Vulnerable to Overconfidence*, *supra* note 94, at 1213 (quoting Odean and Barber's assertions of lagging online profits).

98. See Barber & Odean, *supra* note 43, at 4 (discussing that online investors' worsening performance does not seem to rationally follow the benefits purportedly gained by trading online such as lower trading costs, improved execution speed, and increased accessibility to market information); see also Barbash, *supra* note 95, at H1 (discussing the statistical underperformance of online investors).

99. Barber & Odean, *supra* note 43, at Abstract; see *Does the Internet Empower*, *supra* note 8, at 2 (questioning whether online investor excitement and frequency of trades is prudent); *New Online Traders Vulnerable to Overconfidence*, *supra* note 94, at 1213 (discussing trends in online investing where investors, excited by the plethora of information available to them online, tend to trade more frequently); cf. Ianthe Jeanne Dugan, *Online Trading Fees Headed Lower*, WASH. POST, Nov. 18, 1999, at E1 (discussing that some analysts believe investors "will realize that rapid-fire trading is self-defeating" and the novelty of the online trading may start to wear off).

100. See Barber & Odean, *supra* note 43, at 1 (discussing online brokers' advertisements).

101. See Sugawara, *supra* note 5, at E1, E2 (citing a recent Lehman Brothers Inc. report stating that in fiscal year 2000 the eight largest online brokers combined will spend an expected \$1.2 billion on advertising).

102. See Schulz, *supra* note 4, at 242 (noting that online firms market to the masses so that they should know that they will attract a spectrum of investors, some inexperienced, others experienced). Online brokers also should know the nature of their customers because every time a customer opens an account with a broker, the customer is asked to provide information about their net worth, trading history, and investment goals. See *id.* at 240. The securities rules require brokers to gather this information. See *id.* (suggesting that this requirement is in place so that brokers can meet suitability obligations).



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and print advertisements assert that online trading is easy, convenient and profitable.<sup>103</sup> Thus, even though online brokers' advertisements solicit individuals of all sophistication levels to trade online, nothing about online brokers' systems or business practices distinguishes between novice and sophisticated investors.<sup>104</sup>

Many online brokers' advertisements seem to encourage a get rich quick mentality.<sup>105</sup> Chairman Levitt stated many online trading ads "border on irresponsibility" and "resemble commercials for the lottery."<sup>106</sup> These types of online broker advertisements indicate that

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103. See Beth Burkstrand, *Online Investing: A Consumer Guide; Taking the Trading Floor to the Home Front; Choosing the Right Broker on the Internet Isn't Always Easy*, WASH. POST, Aug. 23, 1998, at H1 (stating that television Internet brokerage advertisements convince "wannabe Warren Buffets" that they can easily "point and click their way to an online fortune by simply forking over a \$10 bill to one of the many firms that now have homes on the Net"); James K. Glassman, *Internet Is Ideal For a "Fun" Account*, WASH. POST, Aug. 23, 1998, at H1 (stating that "online trading makes buying and selling securities look easy, fast and cheap"); see also Barber & Odean, *supra* note 43, at 1 (discussing examples of online brokers' advertisements).

For example, many online broker advertisements cater to the average American's "do-it-yourself" mentality and general distrust of Wall Street's traditional brokerage structure, which many perceive as being available only for very wealthy investors. See Segal, *supra* note 92, at A1 (noting that in decades past Americans thought that Wall Street was a "bewildering jungle"); Walker, *supra* note 94, at E1 (discussing that with online trading, more average Americans are now starting to be active traders whereas previously typical active traders were wealthy individuals and institutional investors); see also Barbash, *supra* note 95, at H1 (explaining that part of the reason that investors are drawn to online trading is because it is fun for investors to do it themselves). Recent online trading advertisements epitomize this trend. See, e.g., Discover Brokerage, in BARRONS MAG., Sept. 6, 1999, at 29 (advertisement) (showing an average looking woman watering her flowers with a slogan that reads "If Pros Can Trade After The Market Closes Why Can't Joan?"); Ameritrade, in BARRONS MAG., Sept. 20, 1999, at 17 (advertisement) (displaying a slogan that reads "After trying several different brokers, I finally found a stock market whiz. Me."). The advertisement continues: "You can pick stocks with the best of them. All you need is a computer and Ameritrade. We give you the same research tools that many professionals use. So it is easy to gain the knowledge you need to make the right picks." *Id.*

104. See Schultz, *supra* note 4, at 242 (stating that online brokers market to the masses, but their business practices do not make any allowances for the different types of investors that they attract).

105. See Walter Hamilton, *Securities Chief Slams TV Ads on Online Investing Consumers*, L.A. TIMES, May 5, 1999, at A1 (outlining recent criticisms of the get-rich quick mentality pervasive in online trading ads); see also Barber & Odean, *supra* note 43, at 1 (describing the "sudden wealth" connotations of advertisements).

106. See Ann Monroe, *Regulators to the Internet: No Gamblers Wanted*, INV. DEALERS' DIG., June 21, 1999 (recounting the SEC chairman's scrutiny of online brokerage advertising), available at 1999 WL 19513991; *Plain Talk About Online Investing*, *supra* note 6, at 1099 (commenting that when brokerage firms "create grandiose and unrealistic expectations" they expose themselves to disgruntled customers, who will be unhappy when their expectations are not met).

In addition, Bradely Skolnik, Indiana Securities Commissioner and NASAA's president, noted that many online trading ads encourage investors to actively trade their own accounts, a strategy that is not appropriate for most investors. See Bloomberg News, *Online Trading Ads Under Scrutiny* (visited Nov. 14, 2000) [hereinafter *Online Trading Ads Under Scrutiny*] ("These ads seem to be encouraging

just using an online broker and trading frequently will result in profits.<sup>107</sup>

The NASD recognizes the potential abuses that can occur through advertising, and thus the need for its regulation. In addition to NASD Rule 2210,<sup>108</sup> which governs "Communications with the Public," the NASD has more specifically examined the interplay between advertising and the "recommendation" of a day-trading strategy.<sup>109</sup> Although the final day-trading rules do not define the term "promoting a day-trading strategy," the proposed version of the rules directly indicated that a firm's advertising could be a factor in determining the recommendation of a day-trading strategy.<sup>110</sup> Even

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you to engage in activity that would be downright wrongful if your broker recommended it."), *available at* <http://news.cnet.com/category/0-1007-200-341647.html>. Skolnik explains that most investors should invest in longer-term investments, but the "not-so-subliminal" message of some online broker advertisements is that customers should trade frequently. *See id.* (lamenting the "trade, trade, trade" mentality).

107. *See* Barber & Odean, *supra* note 43, at 1 (discussing examples where online advertisements assure inexperienced investors that they can trade online and infer that they will become wealthy fast if they trade frequently).

For example, one well known industry television advertisement for Discover Brokerage Direct promotes the idea that any average person can open an online brokerage account and trade their way to riches. *See* Barber & Odean, *supra* note 43, at 1 (describing Discover's "two truck" advertisement); *Online Trading Ads Under Scrutiny*, *supra* note 106. In this advertisement a tow truck driver is towing a businessman's car and a conversation ensues as the businessman hitches a ride in the tow truck. *See id.* The conversation centers around the tow truck driver's recently purchased island (that turns out to be its own country), which he bought with his online investing proceeds. *See id.* Discover Brokerage Direct, now a part of Dean Witter decided to take this advertisement off the air. *See* Sugawara, *supra* note 5, at caption under picture.

In another television advertisement, for Ameritrade, a woman is embarrassed that she chose to invest in a mutual fund, which is typically a lower risk, longer term investment, instead of selecting stocks via online trading. *See Plain Talk About On-Line Investing*, *supra* note 6, at 1100 (noting that the message sent by this type of advertisement is that longer-term, diversified investments are undesirable). One television advertisement for E\*Trade implies that any stock broker who must actually work for a living must not be a very good broker. *See* Barber & Odean, *supra* note 43, at 1 (describing an E\*Trade advertisement as suggesting that online trading requires no work).

Even J. Joe Ricketts, founder and chairman of Ameritrade, notes that trading heavily is not something that makes investors a lot of money. *See* David Whitford, *Are They Allies or Enemies?* (visited Nov. 14, 2000) (discussing the inherent contradictions of online trading's popularity), *available at* <http://www.money.com/money/archive/magarticle/0,4015,8011,00.html>. Online brokers, like Ameritrade, generate a fee each time a person trades using their website. *See id.* Therefore, online firms have an obvious incentive to encourage frequent trading. *See id.*

108. NASD Conduct Rule 2210, NASD Manual (CCH) 4171 (Aug. 2000).

109. *See* NASD Notice to Members 00-62, *Day-Trading Rules* (Sept. 2000) (discussing the approval of the Day-Trading Rules: (1) "Approval Procedures for Day-Trading Accounts," NASD Conduct Rule 2360 (Sept. 2000) (having an effective date of October 16, 2000), and (2) "Day-Trading Risk Disclosure Statement," NASD Conduct Rule 2361 (Sept. 2000) (having an effective date of October 16, 2000)).

110. *See* NASD Notice 00-62, *supra* note 109, at n.2 ("The new rules do not define

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though the new rules are more vague on this issue, they leave open the possibility that the NASD may determine that a firm is “promoting a day-trading strategy” because of the firm’s advertisements.<sup>111</sup> In addition to broadcast, print and television advertising, brokers’ Internet Web pages impact customers’ choices, and thus, may require some form of regulation.

*C. Online Brokers’ Websites: What Should Constitute a Recommendation Under NASD 2310?*

Regulators acknowledge that recommendations may be more complicated in the online environment where advice is provided more subtly.<sup>112</sup> Many online brokers’ Websites furnish information that may constitute a recommendation.<sup>113</sup> The NASD, in particular, has recognized that communication media, such as the Internet or electronic mail, can create recommendations.<sup>114</sup> In September of 1996 the NASD distributed Notice to Members 96-60<sup>115</sup> stating that:

[A] broad range of circumstances may cause a transaction to be considered recommended, and this determination does not

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the term ‘promoting a day-trading strategy.’”). *But see* NASD Notice to Members 99-32, *NASD Regulation Requests Comment On Proposed Rules Regarding Approval Procedures For Day-Trading Accounts, Including Appropriateness Determinations, and Disclosure of Risks of Day-Trading Activities* (Apr. 15, 1999) (noting that, in addition to advertising, the promotion of day trading training seminars and/or direct day trading outreach programs may also constitute the “recommendation” of a day trading strategy).

A recommendation would occur if an individual, in response to such promotions, decided to engage in a day trading strategy. *See id.* An additional indication that illustrates that the firm generally promotes day trading strategies would be the fact that other customers of the firm typically use a day trading strategy. *See id.*

111. *See* NASD Notice 00-62, *supra* note 109, at n.2.

112. *See Does the Internet Empower*, *supra* note 8, at 3 (noting that some people may argue that when a broker brings a security to the attention of a customer, a suitability obligation is triggered); *Cyberspace*, *supra* note 2, at 27 (questioning when online brokers trip the recommendation threshold).

113. *See Broker-Dealers: Unger Says Online Brokers to Face Suitability, Liability Issues*, 31 Sec. Reg. & L. Rep. (BNA) 211, 211 (Feb. 12, 1999) [hereinafter *Unger Says Online Brokers to Face Suitability*] (asserting that online brokers who provide information to investors can be exposed to liability over suitability obligations).

Information found on an online broker’s Web page include stock screeners, customized financial plans, and high-end Wall Street research, such as research reports that have a buy or sell recommendation. *See Cyberspace*, *supra* note 2, at 16 (discussing that online brokers’ websites include features like comprehensive charts, market data, securities analyses, customizable home pages, and interactive calculators). *But see Suitability Obligations in Internet Investing*, *supra* note 2, at 1, 8 (discussing that brokerage firms, like Charles Schwab, only offer general, impersonal information to customers through their websites, which does not trigger suitability obligations because general information and advertisements are not recommendations).

114. *See* NASD Notice to Members 96-60, *Clarification of Members’ Suitability Responsibilities Under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities* (Sept. 1996).

115. *See id.*

depend on the classification of the transaction by a particular member as "solicited" or "nonsolicited." In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.<sup>116</sup>

Because a recommendation can occur "through any means," information on a broker's Website could constitute a recommendation, but the more difficult issue is determining what information creates a recommendation.<sup>117</sup> Some of the offerings found on many online brokers' Websites that may create a recommendation include research and investment tools for their customers.<sup>118</sup> In addition, many online broker sites provide at least

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116. *Id.* After Notice 96-60 was issued, brokers remained concerned over what they interpreted as an expansion in the suitability doctrine. *See Suitability Obligations in Internet Investing*, *supra* note 2, at 13 (discussing the confusion over 96-32, its withdrawal, and clarification by 96-60). In 96-60, the inclusion of the word "will" in the phrase "a transaction will be considered a recommendation" caused particular confusion because it appears to determine that materials distributed on a specific security creates a recommendation. *See id.* Therefore, mass distribution of general information on a security may indeed constitute a recommendation. *See id.* (noting that this expansion of a recommendation potentially creates "an unprecedented expansion of suitability obligations").

In March of 1997, the NASD further tried to clarify their position in Clarification of Notice to Members 96-60. *See NASD, For Your Information: Clarification of Notice to Members 96-60* (Mar. 3, 1997) [hereinafter *96-60 Clarification Notice*], available at <http://www.nasdr.com/pdf-text/9703fyi.txt>. Here, the NASD stated that Notice 96-60 intended to emphasize that recommendations could be made "in a variety of ways" by providing examples of practices that may result in a recommendation. *See id.*

The NASD issued this clarification in response to industry concern that the original Notice 96-60 expanded suitability obligations. *See id.*; *see also Suitability Obligations in Internet Investing*, *supra* note 2, at 13 (discussing NASD's guidance regarding what is a recommendation). The clarification stresses that Notice 96-60 was not intended to indicate that every mention of a security through the outlined modes of communication constitutes a recommendation. *See 96-60 Clarification Notice, supra*; *see also Suitability Obligations in Internet Investing*, *supra* note 2, at 14. Instead the NASD emphasized that actions constituting a recommendation depend on "relevant facts and circumstances." *96-60 Clarification Notice, supra*; *Suitability Obligations in Internet Investing*, *supra* note 2, at 14.

117. *See NASD Notice 96-60, supra* note 114.

118. *Cf. Suitability Obligations in Internet Investing, supra* note 2, at 5-6.

The broker's site may allow access to a variety of investing information, directly on the website and/or through links to sites of third-party information providers. This information may include issuer financial statements, industry outlook information, historical earnings data, consensus issuer earning estimates, and consensus issuer and industry recommendations.

*Id.*

*See Kathy Berger, Helping Hand for Internet Investors*, CHI. TRIB., Jan. 20, 2000, at 56 (stating that Ameritrade President Michael Anderson cites suitability requirements as

“generalized recommendations and ratings of specific securities.”<sup>119</sup> In addition, brokers choose to provide information on some securities, but neglect to provide information about others.<sup>120</sup> Consequently, an investor, trusting his or her online broker, may believe that a stock listed on the online broker’s Website is a wise investment.<sup>121</sup> Practically speaking, an online broker can also use the placement and style of Internet icons and hyperlinks to make a particular stock more attractive to site surfers.<sup>122</sup> One important factor in determining whether a recommendation has been made is

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the primary reason Ameritrade, unlike their competitors, refuses to offer their clients a broader range of services). Mindful that research offerings are an attractive and potentially differentiating feature, one major firm chose to give away free research for a limited period of time to attract customers. *See Customer Expectations Online*, *supra* note 3, at 3.

119. *Suitability Obligations in Internet Investing*, *supra* note 2, at 6. A broker-dealer “website may provide stock selection tools, which allow investors to sort companies based on criteria selected by the investor.” *Id.*; *see* Miller, *supra* note 27, at 1 (explaining that online brokers use various techniques to inform online customers of potential investments).

120. Brokerage firms have argued that when they present a customer with a variety of stock choices, the brokerage firm is not responsible for the selection the customer makes. *See* Schulz, *supra* note 4, at 240, 242. This situation, however, would be like a doctor lining up a row of medicines in front of his or her patient and disclaiming responsibility for the result because the patient selected the prescription. *See id.* Brokerage firms argue that they are insulated from liability by opting for the consumer choice format. *See id.*; *cf. Customer Expectations Online*, *supra* note 3, at 4 (discussing potential liability related to hyperlinks, which is either an icon or text that allows a Web user to connect to another document, because it may appear that the linking party has adopted and approved the information viewed through the hyperlink).

121. *Cf. Cyberspace*, *supra* note 2, at 30 (discussing that some believe that a recommendation should depend on if the “customer reasonably believed that information set to him took into account his ‘personal circumstances.’”).

A customer is not going to think that their broker would place information about a “bad” stock on their website and unsophisticated investors, especially, may not understand that different investors have different risk tolerances, and thus, some stocks may be appropriate for other investors, but not necessarily appropriate for them. *Cf. Customer Expectations Online*, *supra* note 113, at 3 (noting online investor/broker relationships are based on “convenience, access, and trust”).

122. *See* Whitford, *supra* note 107 (discussing that everything about the online investing experience is geared toward creating profits for the online broker, including the colorful graphics because the online brokers make money per transaction and therefore want to encourage customers to trade every time they visit their site). *But see Suitability Obligations in Internet Investing*, *supra* note 2, at 8 (asserting that the reports and other information available on websites, while making the sites more attractive to consumers, are not specifically tailored to any particular type of investor).

Online brokers argue that online investors are the ones who select which securities they want to receive information about through pointing and clicking with their mouse, thus indicating that brokers do not control the materials that the consumer obtains. *See* Schultz, *supra* note 4, at 240-42 (critiquing the consumer choice defense to liability). The placement of icons and hyperlinks, however, can certainly alter where a customer decides to “surf.” *See* Whitford, *supra* note 107 (discussing the allure of colorful graphics and other broker website enticements).

the personalized nature of the information provided to an investor.<sup>123</sup>

*D. Personalized Investment Research*

A recommendation must be made to a particular person, therefore, as a broker makes its online information more personalized it inches closer to the recommendation threshold.<sup>124</sup> Chairman Levitt stated that “[a]ny firm, day trading or online, that recommends a type of investment strategy or customizes research should ensure that it is suitable for its customers.”<sup>125</sup> The controversy remains, however, as to what threshold a broker must cross to create a recommendation.<sup>126</sup>

Online brokers argue that online information found on their Websites cannot constitute a recommendation because online investors use “pull” technology to gain access to information.<sup>127</sup> “Pull” technology means that the customer sets his or her preferences and the online merchant sends the customer information tailored to these preferences.<sup>128</sup> Online brokers, however, are more likely to face

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123. See *Regulating on Internet Time*, *supra* note 79 (explaining that when an online broker offers more than execution services and starts providing personalized information, suitability obligations become more likely).

124. The increasingly personal investment guidance available through online brokers’ websites illustrates that recommendations can occur online. See *Cyberspace*, *supra* note 2, at 20 (noting that some online brokers personalize website content for each user); *Customer Exceptions Online*, *supra* note 3, at 5 (noting that a recommendation can occur where a broker helps manage a portfolio online by providing tools like benchmarks for the portfolio or asset allocation assessments); Burns, *supra* note 20, at 2 (noting that online brokers may use customer information to send unsolicited research reports to the customer that the broker believes the customer may find of interest).

Providing online personal advice seems to contradict Charles Schwab’s claim made in their Memorandum to the NASD and the NASDR entitled *Suitability Obligation and Internet Investing* that Schwab’s website provides “only impersonal, general endorsements distributed to the public at large.” See *Suitability Obligations in Internet Investing*, *supra* note 2, at 1. Schwab argued that no suitability obligations were appropriate because the information on their website was impersonal in nature. See *id.*; cf. Longo, *supra* note 25, at 162 (discussing that the next planned push for firms like Charles Schwab, T. Rowe Price and Vanguard is to develop software that allows customers to receive customized advice and a streamline financial plan from the broker’s website).

125. *Plain Talk About On-line Investing*, *supra* note 6, at 1101.

126. See *Cyberspace*, *supra* note 2, at 32 (outline a number of hypotheticals to explore which facts and circumstances may constitute a recommendation online); *Customer Expectations Online*, *supra* note 3, at 3-4 (offering scenarios to explore when an online broker has crossed the threshold and made a recommendation).

127. See *Can SEC.gov Regulate Securities.com*, *supra* note 3, at 2 (questioning whether suitability obligations should arise when online brokerage firms offer investor access to information via “pull” technology).

128. See *Cyberspace*, *supra* note 2, at 21 (describing and giving an example of pull technology); *Customer Expectations Online*, *supra* note 3, at 4 (discussing five different scenarios of broker-investor information exchange via the Internet and stating that if online investors solely control the information that they view, then there is a stronger

a suitability obligation if its site utilizes “push” technology. With “push” technology the online merchant creates a user profile by monitoring a user’s activities online.<sup>129</sup> Using this information, the merchant can direct certain information to the customer.<sup>130</sup> In this case, the investor is still clicking on certain information from the Web, but the online broker has personalized the information available.<sup>131</sup> Furthermore, the investor may not even know that the broker has personalized the site.<sup>132</sup>

For example, brokerage firms, both online and traditional, “segment” investors into particular investment types after collecting information from them.<sup>133</sup> This practice of segmenting investors may occur using technology known as data mining.<sup>134</sup> “Data mining enables brokerage firms to track a customer[’s] behavior, both in the securities[,] and depending on the firms affiliates[,] the non-securities context.”<sup>135</sup> An online firm could use this research to target information toward a specific investor or group of investors.<sup>136</sup> One

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argument that online brokers are acting only as order takers).

129. See *Cyberspace*, *supra* note 2, at 21 (addressing online merchants’ ability to “track the clickstream” to classify consumers and recommend certain products).

Online brokers can collect information from customers in a variety of ways. See *Customer Exceptions Online*, *supra* note 3, at 3. First, customers may enter their personal information, such as their age, risk tolerance and savings, via the Internet. See *id.* In fact, customers often have to enter this type of information to open an online trading account. See *id.* Second, online brokers may collect information by monitoring what information a customer selects while on their website. See *id.* A broker can even monitor what other websites a customer visits by use of a “cookie,” which is a device that is stored on a visitor’s browser and stores information about the customer’s activities online. See *id.*; see also David Whalen, *The Official Cookie FAQ* (visited Nov. 14, 2000) (explaining the function and purpose of “cookies”), available at <http://www.cookiecentral.com/faq>. “Cookies can store database information, custom page settings, or just about anything that would make a site individual and customizable.” *Id.*

130. See *id.* See, e.g., *Customer Expectations Online*, *supra* note 113, at 1 (noting that an online broker can tell what stocks a customer may be interested in purchasing because they can tell when a customer checks a stock price over the Internet, whereas previously a broker could not tell what stock quotes a customer checked in the newspaper, so they could not use this information to further encourage the purchase of the viewed stock).

131. See *Customer Exceptions Online*, *supra* note 3, at 4 (posing examples of how online brokers could personalize via website profiling).

132. See Whalen, *supra* note 129 (describing the unsuspecting way websites “mark” visitors with cookies).

133. See *Regulating on Internet Time*, *supra* note 79 (discussing a 1998 Deloitte and Touche survey that found that 100% of full-service firms, 62% of full-discount firms, and 43% of deep-discount firms “segmented” customers).

134. See Laura Unger, Remarks Before the Securities Industry Association, Palm Desert, California, *Technology Bytes the Securities Industry: The New Millennium Brings New Investors and New Markets* (Mar. 14, 2000) [hereinafter *The New Millennium*] (discussing that data mining adds a new dimension to the discussion of suitability obligations online), available at <http://www.sec.gov/news/speeches/spch354.htm>.

135. *Id.*

136. See *id.*

example of this type of technology's application is that an online broker may find that an investor tends to buy blue-chip stocks after its price falls.<sup>137</sup> In response to this information, a broker may send an e-mail to the customer informing him or her that the price of a given blue-chip stock has fallen.<sup>138</sup> Determining whether this type of personalized information would constitute a recommendation would depend on how finely a broker segmented and distributed information to customers.<sup>139</sup> If an online broker sends this type of information to one customer, this conduct should constitute a recommendation.

Technology, like data mining, will most likely become more prevalent in the future. Industry analysts expect that the online research found on brokers' Websites will become increasingly personalized.<sup>140</sup> Securities and Exchange Commissioner, Laura Unger, noted that the future value for online firms is in providing personalized advice to investors.<sup>141</sup> As the online brokerage industry becomes even more competitive, providing commodities such as basic research, information, and the execution of trades will not be enough for an online broker to survive.<sup>142</sup>

*E. Additional Factors that may Impact the Creation of a Recommendation*

In addition to the personalized nature of information provided to customers, there are other factors that will also impact the determination of when a broker, whether online or traditional,

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137. See *Cyberspace*, *supra* note 2, at 23 (providing examples of how brokers can discover information about investors by monitoring customer activities online).

138. See *id.* (explaining how brokers can use the information they gather on investors to provide personalized information to the investors).

139. See *The New Millennium*, *supra* note 134, at 3 (the smaller and more specific the targeted group, the more likely a recommendation would occur). See generally *Customer Exceptions Online*, *supra* note 3, at 5 (explaining that determining whether there is a recommendation depends on the particular facts and circumstances of the situation).

140. See *Cyberspace*, *supra* note 2, at 22 (discussing firms' inevitable use of increasingly customized information to compete); *Customer Exceptions Online*, *supra* note 3, at 3 (forecasting that brokers will benefit from customizing the information they provide to customers); *Regulating on Internet Time*, *supra* note 79.

141. See *Customer Exceptions Online*, *supra* note 3, at 3 (commenting on predictions for the increase of personalized information for investors); *Unger Says Online Brokers To Face Suitability, Liability Issues*, *supra* note 113, at 211 (discussing the prediction of Laura S. Unger, SEC Commissioner, that online brokerage firms will provide increasingly personalized information to customers); see *Regulating on Internet Time*, *supra* note 79 (noting that one firm is holding off on developing new products for customers until suitability obligations become more clear).

142. See *Unger Says Online Brokers to Face Suitability*, *supra* note 113, at 211 (reporting that personalized advice for investors will be of utmost importance for online brokerage firms).



makes a recommendation.<sup>143</sup> For example, the investor's sophistication level is important.<sup>144</sup> Less sophisticated investors may be more likely to believe that information provided by a broker is a recommendation and less able to analyze the information for themselves.<sup>145</sup> How the brokerage firm advertises its services is another factor that may be considered.<sup>146</sup> For example, if a firm advertises itself as a discount operation that only takes orders and provides little to no personalized information on its Internet site, then they would be less likely to be viewed by either sophisticated or unsophisticated investors as a firm that makes recommendations to customers.<sup>147</sup>

### III. ADEQUATELY PROTECTING INVESTORS: THE NEED FOR SUITABILITY CHECKS, INVESTOR EDUCATION AND WARNING LABELS

One purpose of securities regulation is to protect investors.<sup>148</sup> Protecting investors boosts investor confidence in the securities market which, in turn, encourages investment and capital formation.<sup>149</sup> The online brokerage industry creates a challenge for

143. See Schulz, *supra* note 4, at 240-42 (explaining that brokers consider the sophistication level and life circumstances of a client when making recommendations).

144. See *id.* at 242 (describing how client knowledge and understanding impacts a broker's recommendation).

145. See *id.* (stating that naïve online investors may have very little understanding of Internet trading).

146. See *id.* at 241 (discussing the responsibilities that accompany advertising expansive services); see also Simon & Buckman, *supra* note 8, at C1 (noting that discount and utility brokers claim that, unlike full service brokers, they do not provide investment advice, either online or otherwise, and thus are not subject to suitability obligations).

147. Commissioner Unger notes that even though full service and discount brokers traditionally offered very different levels of service to their customers, in today's market they provide many of the same types of services. The differences between full service brokers and discount brokers is lessening now that full service firms have launched online broker sites. For example, Merrill Lynch says it will continue to meet suitability requirements online by monitoring customer accounts and stopping excessive or inappropriate trades when necessary. See *Customer Expectations Online*, *supra* note 3, at 1 (commenting on the similarity of services offered by discount and full service firms); Simon & Buckman, *supra* note 8, at C1 (noting that Merrill Lynch's approach to online trading, which includes monitoring customer trades, will provide consumers with more protection, but will subject Merrill Lynch to more liability because investors who lose money will be likely to hold the firm responsible).

148. See Arthur Levitt, *Meeting the Challenges of the 21st Century Marketplace*, Speech at the Securities Association Annual Meeting (Nov. 6, 1998) (explaining that one of the fundamental reasons to regulate securities markets is to protect investors), available at <http://www.sec.gov/news/speeches/spch225.htm>; *Regulating on Internet Time*, *supra* note 79 ("The Commission's regulatory mandate is to protect investors and to promote fair and efficient markets.").

149. See Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1081

regulators who want to adequately protect investors without stifling innovation and potentially creating additional costs that could diminish some of the benefits of online trading. Investor protection, however, is important for online investors particularly in light of online brokers' advertising and the proliferation of information on their Web pages, which appears to result in online investor overconfidence.<sup>150</sup> Currently it is unclear if NASD rules adequately protect online investors. First, the NASD does not define the term "recommendation" or outline what types of online activities constitute a recommendation.<sup>151</sup> Indeed the term "recommendation" is difficult to apply in the online environment, but regulators need to provide more finite guidance.<sup>152</sup> Second, the NASD should require brokers to perform suitability checks for unsophisticated investors who place trades online.<sup>153</sup> In addition, regulators should initiate a number of other initiatives such as investor education and warning labels to protect investors.<sup>154</sup>

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(1999) (discussing investor confidence in relation to the Securities Investor Protection Act).

150. See Barber & Odean, *supra* note 43, at 2-3 (discussing the development of overconfidence among online investors); see also *NASAA Task Force*, *supra* note 11, at 612 (reporting on aggressive advertising campaigns and the false sense of confidence they create in new investors).

Online trading has created a means to enable an increased number of individuals to participate in securities markets; regulators must protect investors in order for them to remain in the securities market. See Buckman & Lucchetti, *supra* note 13, at A1 (explaining that investors who lose large amounts of money trading stocks may decide to sell everything and exit the market, as was seen after the 1987 market crash).

151. See NASD Conduct Rule 2310, NASD Manual (CCH) 4261 (Apr. 1997) (referring to the term "recommendation" three times but failing to provide a definition); see also *Suitability Obligations in Internet Investing*, *supra* note 2, at 13 (stating that the NASD has refrained from defining "recommendation," and asking that the NASD provide further guidance to clarify what constitutes a recommendation for online brokers); *Cyberspace*, *supra* note 2, at 30 (concluding from a survey that firms would like guidance on applying suitability requirements online). See generally *Regulating on Internet Time*, *supra* note 79, at 5 (explaining that the best way to clarify suitability obligations online may be for regulators to provide guidance on what is not a recommendation online).

152. See *Suitability Obligations in Internet Investing*, *supra* note 2, at 3 (illustrating the confusion and danger of not defining "recommendation").

153. See generally *Electronic Commerce: Levitt Announces Increased Inspections, Enforcement for Internet Brokerage Firms*, 31 Sec. Reg. & L. Rep. 593, 593 (May 7, 1999) [hereinafter *Levitt Announces Increased Inspections*] (reporting that Levitt believes online brokerage firms should receive greater scrutiny because of the risks they can bring to investors and that new regulators may be necessary).

154. See James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision, and Regulation of Investor Education*, 49 CASE W. RES. L. REV. 105, 157 (1998) (arguing that the SEC should require more extensive disclosures and increase efforts to educate investors). See generally *Regulating on Internet Time*, *supra* note 79, at 1 (discussing that the SEC has a new investor education website at [www.sec.gov/invkhome.htm](http://www.sec.gov/invkhome.htm)).

*A. Order Monitoring: Suitability Checks for the Purchase and Sale of Stocks Online by Unsophisticated Investors*

In light of online brokers' advertising, Web pages, and the personalized information they provide to their often unsophisticated customers, regulators should require suitability checks for unsophisticated customers entering trades online.<sup>155</sup> A suitability check or suitability review is when an online broker monitors the trades customers place online and stops the execution of any trades that are unsuitable for a customer's financial situation.<sup>156</sup> Until recently, securities regulators in Canada required all Canadian brokers, both online and traditional, to monitor all orders placed by their customers and guarantee that the transaction is suitable for the investor.<sup>157</sup> For each order placed, a broker employee, known as an investment representative, would review the transaction in light of the investor's investment objectives and client profile.<sup>158</sup>

155. See Schulz, *supra* note 4, at 242 (advocating that online brokerages should pay more attention to the inexperienced, unsophisticated investor). See generally Michelle Clayton, *Schwab Nixes Net Suitability*, ON WALL ST., Mar. 1, 1999 (stating that regulators are thinking about imposing suitability obligations on online brokers because unsophisticated investors may be hurt by trading in volatile stocks), available at 1999 WL 7285280.

The regulation of online brokers is essential to online investor protection inasmuch as online brokerage firms have a financial interest in encouraging customers to trade securities frequently. See *infra* notes 83, 107 and accompanying text. Although this conflict is a concern for both online and traditional offline brokers, online brokers are encouraging customers to engage in frequent trading in an aggressive manner, while attempting to avoid suitability obligations. See *infra* Part II.B (discussing aggressive advertising that encourages frequent trading, even though this activity may not be appropriate for most investors).

156. See Clayton, *supra* note 155; *Suitability Obligations in Online Investing*, *supra* note 2, at 15 (addressing suitability checks and reviews); Allyson Vaughan, *Canadian IDA to Press Regulators For Online Suitability Exemption*, FIN. NET NEWS, July, 26, 1999 (discussing the Canadian laws that require online brokers to review orders for suitability), available at 1999 WL 8881900.

157. See Katherine Macklem, *Discount Brokers Push for New Trading Guidelines: Waive Vetting Rules: Looking to Make Online Trading Fast and Cheaper*, NAT'L POST, Apr. 8, 1999 (noting that both solicited and unsolicited orders must be reviewed in Canada), available at 1999 WL 13670026; see also Clayton, *supra* note 156 (stating that Canada requires online brokers to run a suitability check on all trades, unsolicited or recommended); Vaughan, *supra* note 156 (explaining that the Canadian rules require a manual review of every order entered on an online broker's website).

After much pressure from the brokerage industry, the Canadian Securities Administration is looking to relax the requirement that brokers must monitor all trades for suitability. See Maklem, *supra* note 157 (explaining that suitability review is required for each transaction in Canada).

The Canadian brokerage industry believes that the suitability rule must be dropped to compete with the U.S. market, which does not currently have the same type of regulator provision. See *id.* (reporting that brokers believe that dropping Canada's suitability rule will lower trading costs and improve execution speed).

158. See Maklem, *supra* note 157 (explaining that suitability review is required for each transaction in Canada).

Online brokers in the United States argue that suitability checks will cause an increase in the price of online trading.<sup>159</sup> Technology and competition, however, would encourage online firms to find ways to keep prices low while meeting a suitability review requirement. In fact, suitability review technology is already in existence.<sup>160</sup> E\*Trade has been looking for a vendor to provide the online broker with technology that would enable it to conduct suitability reviews of online trades.<sup>161</sup> Suitability review technology would use algorithms and mathematical formulas to determine whether a specific trade is appropriate for a particular customer.<sup>162</sup> With this type of review, online brokers could identify unsophisticated online investors attempting to purchase securities that are too risky for their financial position and notify the investors about their findings.<sup>163</sup> Some

159. See Vaughan, *supra* note 156 (reporting that online brokerage firms in Canada are lobbying for an exception to the suitability rule because they cannot compete with lower priced U.S. online brokers who are not required to run suitability checks); *Suitability Obligations in Internet Investing*, *supra* note 2, at 15 (arguing that a suitability review or check would destroy some benefits of online investing, such as low costs and fast execution of trades).

160. See Margaret McKegney, *E\*Trade Seeks Technology to Review Trade Suitability*, FIN. NET NEWS, Nov. 8, 1999 (noting that E\*Trade is looking for a vendor with an established track record to provide them with suitability review technology); *The New Millennium*, *supra* note 134, at 3 (noting that some brokerage firms have been developing algorithms to conduct a suitability analysis).

161. See McKegney, *supra* note 160 (discussing E\*Trade's belief that advice online will be required to stay competitive, and thus, suitability obligations will become applicable).

162. See *id.* (explaining that "securities could be ranked by risk and matched electronically against a client's annual income, objectives and net worth.").

163. Cf. Lisa M. Bertain, *"Economic Suicide" Claims: An Emerging Trend in Securities Arbitration*, in 2 SEC. ARB. 1996, at 191 (PLI Corp. L. & Practice Course, Handbook Series No. B-950, 1996) (noting the emerging trend in securities arbitration of economic suicide claims in which an investor alleges the broker had a duty to prevent the investor from making an unsuitable investment).

In economic suicide cases against a traditional broker, the customer essentially asks the broker to save the customer from himself. As online brokers, however, engage in a number of activities to encourage the purchase of certain stocks and the participation in certain types of trading strategies, the responsibility to stop investors from engaging in unsuitable investments or trading strategies is even more appropriate for online brokers. See *id.* (explaining the nature of economic suicide claims); see also *Leib v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 647 F.2d 165 (6th Cir. 1981) (holding that a broker must act in the customer's interest when transacting business for a non-discretionary account holder); *Duffy v. Cavalier*, 264 Cal. Rptr. 740, 752 (Cal. Ct. App. 1989) (holding that a fiduciary duty exists in every broker-customer relationship, but that the scope of this duty will depend on the facts of the case); *Oliver v. Charles Schwab & Co., Inc.*, NASD 93-00656 (1994) (awarding \$10,000 to the claimant after he alleged that Schwab, a discount broker, breached its fiduciary duty by permitting and failing to supervise the options trading in claimant's account); *Peterzell v. Dean Witter Reynolds*, AAA 32-136-0416-88-ID (1990) (holding that the law imposes a fiduciary duty on brokerages, even in non-discretionary accounts). But see *Wasnick v. Refco, Inc.*, 911 F.2d 345, 350 (9th Cir. 1990) ("[There is] no duty by brokers to prevent emotionally or financially unstable client from trading on non-discretionary accounts.").

industry participants believe that online technology enables brokers to assess customer suitability more easily than if a customer traded via a traditional broker.<sup>164</sup> Additionally, online brokers would only be required to run these suitability checks on a portion of their customers who are classified as unsophisticated.<sup>165</sup> This limitation will reduce the additional costs that online brokers anticipate as a result of running suitability checks.<sup>166</sup> Furthermore, it is arguably better for online investors and the economy as a whole to pay slightly higher prices in exchange for suitability checks, which provide investor protection and promote investor confidence.<sup>167</sup>

*B. Consumer Education: One Important Step Toward Promoting Smart Online Investing*

To make smart investment decisions for themselves, online investors must be educated about capital markets and investing strategies.<sup>168</sup> Accordingly, the SEC has initiated a campaign to educate consumers about investing.<sup>169</sup> Chairman Levitt remarks that there are common misconceptions surrounding online trading.<sup>170</sup> For example, online investors may believe that simply selecting stocks

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164. See *Cyberspace*, *supra* note 2, at 28 (discussing that technology facilitates suitability determinations).

165. See Schulz, *supra* note 4, at 240-42 (illustrating why unsophisticated investors need more guidance than sophisticated investors).

166. Another factor that will keep the cost of suitability checks down is the fact that online brokers already have information about their customers that will enable them to make a decision as to the customer's sophistication level. Securities rules already require online brokerage firms to collect information such as their net worth, trading history, and investment goals when a customer wants to open an online trading account. These requirements already enable brokerage firms to meet suitability requirements. Therefore, online firms will not have to expend additional resources to obtain customer information necessary to accomplish suitability checks. See generally Schulz, *supra* note 4, at 240 (explaining that online brokers are required to learn basic information about their investors before opening online accounts).

167. See Barber & Odean, *supra* note 43, at 2 (discussing that the growth of online trading has produced benefits to investors, such as lower fees, but that benefits are diminished by the fact that online investing encourages disadvantageous and inappropriate trading strategies). The Barber and Odean study found that lower commissions actually encouraged excessive, speculative trading. See *id.* (explaining that lower fees and faster service create an incentive to trade without forethought).

168. See *Cyberspace*, *supra* note 2, at 3 (stating that investor education is critical to investor protection); Fanto, *supra* note 154, at 107 (arguing that investor education is important given the increasingly predominant role investing plays in Americans' lives).

The goal of investor education should be to educate an investor to the point where they can understand how to invest to achieve an optimal portfolio. An educated consumer should be able to evaluate financial information and make intelligent financial decisions. See *id.* at 131-35.

169. See *id.* at 156 (evaluating the SEC's investor education initiatives).

170. See *Plain Talk About On-line Investing*, *supra* note 6, at 1095 (stating that the fundamentals of investing still apply to online investing).

online will make them money.<sup>171</sup> To combat online investing misconceptions, the SEC has created an Investor Education Web Page, which includes a variety of information pertaining to Internet investing.<sup>172</sup> In addition, Chairman Levitt has asked that all online brokers create a link from their Website to the SEC's Investor Education Web Page.<sup>173</sup> The NASD also provides investor information on its Website.<sup>174</sup> Investor education, however, is but one aspect of a comprehensive solution to online investor protection, especially in light of online brokers' powerful advertising campaigns.

### C. Adequate Warning Labels and Disclosure

Some online firms post disclaimers stating they are not recommending any of the securities discussed on their Website.<sup>175</sup> Typically, firms place these disclaimers somewhere on the broker's Website and/or attach them to account opening information.<sup>176</sup> The SEC, however, in a report to Congress in March of 1999, stated that online brokers place such disclaimers on their Web pages to insulate themselves from liability and not to inform customers of the potential risks and hazards of using online trading services.<sup>177</sup>

To alert online investors about the potential pitfalls associated with online trading, one solution would be for the NASD to require that online brokers place warning labels prominently on their Internet Websites.<sup>178</sup> Recognizing the benefits of warning labels, the NASD has included a warning label requirement in the recently approved day

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171. *See id.*; *see also supra* notes 103-09 and accompanying text (discussing that investors become overconfident and overly self-attributive when they began trading online).

172. *See id.* at 1101 n.6 (discussing the SEC's new Investor Education Web Page located at [www.sec.gov/invkhome.htm](http://www.sec.gov/invkhome.htm)).

173. *See id.*

174. *See* <http://www.investor.nasd.com/iresc/c-iresc07.html> (visited Nov. 14, 2000).

175. *See Levitt Announces Increased Inspections, supra* note 153, at 593 (explaining that in May of 1999 Levitt sent letter to all online brokers asking them to improve the quality of their disclosures). *See, e.g.,* E\*Trade homepage (visited Nov. 14, 2000), at [http://www.etrade.com/cgi-bin/gx.cgi/AppLogic+Home?gxml=hpa\\_useragreement.html](http://www.etrade.com/cgi-bin/gx.cgi/AppLogic+Home?gxml=hpa_useragreement.html); Ameritrade Homepage (visited Nov. 14, 2000), at [http://www.ameritrade.com/getting\\_started/apply\\_online.html](http://www.ameritrade.com/getting_started/apply_online.html).

176. *See id.* (providing examples of disclaimers).

177. *See* Todd Woody, *Time To Regulate Greed?*, *INDUSTRY STANDARD*, May 17-24, 1999, at 55 (discussing the need to regulate online brokers). The NASD has considered attaching a suitability notice to any customized research available on specific securities. *See* Charles Gasparino & Michael Schroeder, *SEC Steps Up Oversight of Online Brokerages*, *WALL ST. J.*, Mar. 11, 1999, at C1.

178. At a minimum, online brokers should better communicate what it means to trade on margin, an increasingly popular practice online, that may be inappropriate for many smaller, less sophisticated investors.

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trading rules.<sup>179</sup> The rule requires firms promoting a day-trading strategy to deliver a disclosure statement to customers before they open an account.<sup>180</sup> A similar rule requiring online brokers to provide a disclosure statement to customers, including an explanation of the allocation of broker and customer responsibility, would be useful.

## CONCLUSION

Online trading has enabled increased access to the securities market. Encouraging investment in securities can be good for both individual investors and the economy as a whole. Yet to preserve the benefits created by online trading, investor protection is imperative. One aspect of this protection is the clarification of suitability obligations online. The difficulty in determining what constitutes a recommendation online makes investor protection difficult. This difficulty is further complicated by online brokers' aggressive advertising campaigns.

Unsophisticated investors are particularly vulnerable to the potential pitfalls of online trading. Therefore, to encourage these investors to continue participating in the securities market for the long term, they should be protected now through the use of suitability checks for all the orders they place online. In addition to suitability checks, regulators should continue investor education initiatives and strongly encourage online brokers to better educate their customers.

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179. See NASD Rule 2361 (outlining the required "day-trading risk disclosure statement.").

180. See *id.* (explaining that the firm can deliver the statement electronically or in writing).