GLASSER LEGALWORKS
Broker-Dealer Litigation
New York, New York

CUSTOMER DISPUTES AND UNFAIR COMPETITION ISSUES

BROKER-DEALER CUSTOMER AND RECRUITING DISPUTES

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by

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BROKER-DEALER CUSTOMER AND RECRUITING DISPUTES

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I. INTRODUCTION.

This outline focuses on selected customer litigation issues that are arising or have arisen in customer litigation. The areas covered in this outline are the following:

(1) The controversies dealing with arbitrator selection;

(2) Discovery in arbitration;

(3) Emerging on-line brokerage litigation issues;

(4) Clearing firm liability; and

(5) Correspondent arbitration agreement coverage under clearing firm customer agreements.

The outline attempts to provide the procedural or substantive rules and law as a background for a further discussion of emerging or current issues and controversies.

II. ARBITRATOR SELECTION.

A. NASD Rule 10300.

1. Single Arbitrator Proceeding.

a. One list furnished – all public arbitrators as defined.

2. Three Arbitrator Panel.

a. Two lists furnished; one list of public arbitrators and one list of non-public arbitrators in ratio of two public to one non-public arbitrator.

3. Preparation of Lists.

a. Lists selected by the NASD Dispute Resolution, Inc. ("NASD") Neutral List Selection System ("NASD System").

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b. Rotates within geographic hearing area (excluding arbitrator's having conflicts).

c. Party may request arbitrator with particular expertise and list "may" include some arbitrators with expertise.

d. Lists provided 30 days after last answer is due.

4. Ranking and Striking Arbitrators from the List.

a. May strike one or more.

b. "Shall" rank remaining arbitrators in order of choice.

c. Three arbitrator panel – rank public and non-public arbitrators separately.

d. Time period: 20 days.

5. Appointment.

a. Director of Arbitration consolidates rankings and appoints.

b. If arbitrators on list are not sufficient to fill panel, Director of Arbitration appoints.

6. Chairpersons.

a. Parties may agree within 15 days.

b. If not appointed by NASD:

(i) Public arbitrators ranked highest but not if 50% of time spent advising or representing public customs.

(ii) If not, Director appoints next public arbitrator if not disqualified by (i).

(iii) If no public arbitrator under (i) or (ii) Director appoints highest ranking arbitrator.

7. Disqualification or Removal.

a. For cause or conflict.

8. Preemptory Challenges – Rule 10311.

a. One per party as matter of right.

B. NYSE.

1. Current Rules.

a. NYSE Rules 607-611.

b. Customer claims over $10,000

3 arbitrators: 1 industry, 2 non-industry, as defined.

c. Appointed by Director.

(i) Information regarding each is supplied.

(ii) May request additional information.

d. Preemptory Challenge.

(i) One per party.

e. Disqualification or Disability.

(i) Any party may request replacement or proceed without the disqualified or disabled arbitrator.

2. Alternative Method One.

a. Available as a pilot program with consent of parties. See '34 Act Release No. 34-43214.

b. 15 names on list selected by Director.

(i) Parties may choose panel.

(ii) Conflicted arbitrators will be eliminated.

(iii) Challenge for cause will be eliminated from list if sustained.

(iv) Replacement for (ii) and (iii).

c. If no Panel selected by list, replacements in groups of three will be provided.

3. Alternative Method Two.

a. Staff selects nine (9) names.

(i) Each party may strike three.

(ii) One preemptory challenge.

C. NFA Appointments.

The NFA Code of Arbitration Section 4 provides that all panels shall be appointed by the Association with one arbitrator for amounts that do not exceed $10,000 (proposed raise to $50,000) and three for any other panel. The majority of the panel will be non-NFA connected arbitrators within the meaning of the Code if the customer so requests. Arbitrators are removed for conflict.

D. Discussion.

To the staff of the NASD, it appears that no one seems to appreciate their system of arbitrator selection. Neither claimant's counsel nor respondent's counsel are happy with the situation. There is little question that the NASD's list system has created additional expense for both claimants and respondents. Furthermore, the list method appears to increase the time of the arbitration process. The question is whether the list method increases fairness or the appearance of fairness.

Claimants' attorneys are unhappy with the NASD list method because they do not understand how the NASD System generates the list through its "black box". To a certain extent, their complaints may be well taken. The NASD itself has not articulated clearly how its lists are selected and matched in its NASD System software. The question remains though, if the NASD does disclose the methodology, does this present an opportunity for gamesmanship with sophisticated software?

The idea behind the self-regulatory organizations arbitration programs is to provide panels with industry expertise. Expertise in particular areas like repos, government securities, variable annuities, should provide assistance to claimants if they have a strong case and it should reduce the cost of the arbitration. Claimants' lawyers have objected to the provision that provides parties may request arbitrators with expertise. Claimants' lawyers are of the view that this undermines random selection because in certain areas, even in large metropolitan areas, there will be very few arbitrators with certain expertise. Claimants' objections to expertise probably may have more to do with wanting to play to the emotions of a panel.

Claimants and respondents find the NASD's random list method of selection unsatisfactory because of the case delays and because many arbitrators lack securities expertise. We have all seen employment lawyers who have no knowledge of the securities laws serving on panels dealing with repos, NASDAQ trading, and a variety of other complicated issues. To educate such a panel requires an enormous expense with experts. Further, it is virtually impossible to truly educate them. This necessarily increases costs to both parties and in the end may limit claimants' access to arbitration.

The NYSE's proposed list system, which is being tried on a pilot basis, streamlines the NASD system and may turn out to be a better system. Again, the issue of expertise remains. In all cases, the parties should be permitted to agree on the expertise of the panel and in most cases at least one of the panel members should have expertise if requested by one party even if not requested by another party.

The NFA continues to use the appointment of arbitrators selected by its staff with considerable success. The Commodity Futures Trading Commission ("CFTC"), in their review of the NFA's arbitration system, suggested that the NFA consider a list system like the NASD. However, after studying the results of the NASD list method, the NFA has concluded not to pursue a list system at the present time because of the delays and the costs involved to claimants and respondents. Further, in many geographic areas a list system would be impractical for the NFA because there are not enough arbitrators with futures and commodities expertise in some areas. The NFA has had difficulty finding experienced arbitrators with futures experience in areas outside the major metropolitan areas of Chicago, New York, Washington, and several other major cities.

III. DISCOVERY IN ARBITRATION.

A. NASD Discovery Provisions.

1. In General.

a. Rule 10321 permits requests for documents and requests for information. Rule 10321(b) provides that either party may request information or documents upon another party 45 calendar days or more after service of the Statement of Claim by the Director or upon filing of the answer whichever is earlier.

b. Each party shall have 30 days to respond with the information and 10 days to respond with any objection.

c. Rule 10321(c) provides for the exchange of documents that are going to be used or intend to be used with witnesses at the hearing and identification of witnesses to be presented at least 20 days before the hearing.

d. Under Rule 10322, subpoenas may be issued as provided by law (meaning by state law in the particular jurisdiction).

e. Rule 10322(b) allows an arbitrator to order without resort to subpoena the appearance of any person employed or associated with any member of the Association or production of the records of any such person or member.

f. Notwithstanding these provisions above, the provisions of state law provide for subpoenas to be issued in arbitration upon showing of good cause by a state court.

2. NASD Notice to Members 99-90 and the "Discovery Guide".

a. General. In Notice to Members 99-90 (November 1999) ("NTM 99-90"), the NASD announced the "discovery guide" to be used in arbitration proceedings. The guide

is far more than a guide because in many places it is mandatory by its very terms. The guide is stated to be a supplement or an addendum to the guidance regarding discovery provided by the arbitrator's manual published by the Securities Industry Conference on Arbitration ("SICA"), pages 11-16. NTM 99-90 is attached as Appendix 1.

b. Documents to be Produced.

(i) NTM 99-90 has attached a list of 14 lists of documents to be produced in arbitrations. Documents on lists 1 and 2 are required to be produced in all customer cases. List 1 documents are to be produced by the member and associated persons. List 2 documents are to be produced by the customer. The other lists deal with specific types of claims that might be asserted in an arbitration in addition to those covered by the general lists 1 and 2. Lists 3 and 4 deal with churning. Lists 5 and 6 deal with failure to supervise. Lists 7 and 8 deal with misrepresentations and omissions. Lists 9 and 10 deal with negligence and breach of fiduciary duty. Lists 11 and 12 deal with unauthorized trading. Lists 13 and 14 deal with unsuitability.

(ii) Although the guide is stated to be a guide, the NASD states that the documents required are presumptively discoverable and "shall be exchanged". NTM 99-90 at p. 3. However, nothing precludes parties from agreeing to less or more production. The rules provide for confidentiality of documents pursuant to stipulation between the parties or upon an arbitrator's order of confidentiality. The rules further require that there be an affirmation that there are no responsive documents or information.

(iii) The time frames for production are 30 days.

c. Information Requests. NTM 99-90 is quite specific that information requests should be "generally limited to identification of individuals, entities and time periods related to the dispute." It further states "such requests should be reasonable in number and not require exhaustive answers or fact finding." NTM 99-90 at p. 4.

d. Depositions. NTM 99-90 at p. 4 states that depositions are "strongly discouraged" in arbitration and it lists instances where arbitrators may permit depositions as follows:

(1) To preserve the testimony of the ill or dying witness.

(2) To accommodate essential witness who are unable to unwilling to travel to the hearing and may not be required to participate in the hearing.

(3) To expedite large or complex cases.

(4) Any other unusual circumstances.

e. Sanctions. NTM 99-90 specifically authorizes arbitrators to impose sanctions for failure to respond to discovery.

B. New York Stock Exchange Rules.

1. General.

New York Stock Exchange Rule 619 provides general provisions on subpoenas and production of documents and information in arbitration proceedings.

2. Production of Documents and Information.

Information or document requests may be served upon another party 20 days or more after service of the Statement of Claim or upon filing an answer, whichever is earlier. It has the same provisions as the NASD Rules with respect to objections and production times. It has similar provisions with respect to subpoenas and power to direct production of documents or appearance of employees associated with the members of the New York Stock Exchange.

3. Impact of Notice to Members 99-90 on the New York Stock Exchange.

Notice to Members 99-90 has been to some extent informally adopted by the New York Stock Exchange to govern disputes under the New York Stock Exchange Rules of Arbitration.

C. NFA Discovery Procedures.

1. Section 7 of the NFA Rules require the parties to cooperate in connection with voluntary exchange of material, relevant documents and written information.

2. The NFA has issued two interpretations which list potential documents to be exchanged in connection with arbitrations. NFA interpretive notice December 1, 1997 sets forth a list of documents to be considered for production in member arbitrations and a companion interpretation entitled "Standard List of Documents to be Exchange Under Section 8 of NFA's Code of Arbitration" (December 1, 1997) which applies to customer arbitrations. These lists of documents are not mandatory but are for use by the NFA staff. In each arbitration, the NFA staff identifies from the lists the initial documents that are to be produced by each party based upon the pleadings. The list is provided by the NFA arbitration department to counsel for the parties. The two NFA standard lists of documents to be exchanged are attached hereto as Appendix 2.

3. Additional documents and information may be requested within 30 days after the last pleading is due. Any objections are due at the same time.

4. Request to compel production are required 10 days after the objections are due.

5. Rule 7(b) requires that the documents to be introduced at hearing shall be exchanged between the parties at least 35 days prior to the first hearing date unless it is a summary proceeding.

6. There is no provision for depositions, although in practice depositions are permitted for the same reasons as set forth in the NASD guide mentioned above.

D. Discussion.

Discovery in arbitration has always been an enigma. On one hand, arbitration should be fast, efficient, accessible and fair. On the other hand, discovery can undermine all of these objectives. Lengthy discovery is inefficient and costly and may undermine reasonable access and fairness. The question is whether the recent changes in the NASD's discovery guidelines and their adoption by other forums will effect the fairness of arbitration by lengthening the time period and reducing accessibility because of the cost.

Prior to the guidelines, discovery in NASD and NYSE arbitrations were problematic. Numerous disputes regarding discovery arose and were unresolved until close to hearing because the provisions regarding discovery were vague and unclear and because arbitrators were not appointed until late in the process. The disputes some times were costly, but more importantly, parties often gave up their requests or received information too late to effectively use the materials received. The question is, are the new guidelines better?

The lists are certainly clearer with respect to what is presumptively to be produced. However, the cost of the guidelines to the broker-dealer or the industry is much higher than that of the claimant because of the number of records that must be searched and produced, many of which are not relevant. Furthermore, many claimants' attorneys appear not to produce the required customer documents resulting in additional discovery requests and demands.

NTM 99-90 stated that one of the goals of the guidelines was to reduce disputes regarding discovery and the associated costs. In fact, the experience of most counsel for both claimants and respondents is that more disputes arise under the discovery guidelines. However, many disputes appear to be disposed of more promptly than in the past because of the guidelines and early arbitrator appointment. But the continuing discovery disputes under the guidelines have also without question made arbitration more costly for both the claimant and the respondent.

Broker-dealers also have concerns with the scope of the requests and information, particularly for internal audit reports and similar regulatory examinations which lose some of their effectiveness and their candid ability to point out areas that have been found to be deficient. As a result, many internal audit and other similar documents are now being written in a way that makes them far less effective as a communication tool thereby increasing the opportunities for them to be misunderstood and deficiencies to continue unabated.

Complaints about a broker-dealer employee or the broker-dealer itself even if not related directly to the dispute are presumptively discoverable. For large firms that receive a number of complaints, although on a percentage basis very small but numerically large, this can present a significant and troublesome cost.

Another area that has created issues deals with the application of the procedures to electronic trading. Electronic trading is not specifically addressed and consequently some of the requirements of the guidelines do not fit from either the claimant's or respondent's perspective the information that should be exchanged in disputes about on-line trades. Hopefully this will be remedied in the not too distant future. See below in Section IV for a discussion of these issues.

In contrast to the NASD and NYSE procedures, claimants and respondents appear reasonably satisfied with the NFA process. The NFA procedure of tailoring the list has reduced costs, disputes and delay while providing fairness to both parties. It is a method that the NASD and NYSE should consider.

IV. CLEARING FIRM LIABILITY.

A. Introduction.

With the expansion of the number of securities firms over the past several years, the role of clearing firms in the securities industry has expanded as well. One commentator recently noted that the number of introducing firms has increased nearly 900% since 1975 – from 564 firms to 5,030 firms in 2000. *See* Henry F. Minnerop, Recent Developments in the Regulation of Clearing Brokers, 1 Journal of Investment Compliance 27, 32 (2000). The increase in the number of introducing broker-dealers have spawned a concomitant increase in arbitration involving those broker-dealers and, frequently, their clearing firms. This section will review the basic relationship between clearing firms and introducing firms, traditional notions of liability of clearing firms, recent developments concerning the liability of clearing firms, and the recent NASD arbitration decision in Koruga v. Wang et al.

B. Law, Rules and Regulations Governing the Relationship Between Introducing Brokers and Clearing Brokers.

The typical securities transaction and account relationship between a securities customer and brokerage firm include the following steps:

(1) opening, approving and monitoring customer accounts;

(2) extension of credit;

(3) maintenance of books and records;

(4) receipt and delivery of funds and securities;

(5) safeguarding of funds and securities;

(6) confirmations and statements; and

(7) acceptance of orders and execution of transactions.

See NYSE Rule 382, 2 NYSE Guide (CCH) ¶2382; NASD Rule 3230, NASD Manual (CCH) Rule 3230; Henry F. Minnerop, The Role and Regulation of Clearing Brokers, 48 Bus. Law. 841, 842 (1993) (hereinafter "Minnerop"). Brokerage firms that perform all of these tasks are known as "self-clearing" firms.

Other firms, typically smaller in size, enter into a clearing agreements and "introduce" their customer accounts to clearing firms to perform "back-office" operations. *See* Minnerop, at 842-43. Generally, an introducing firm obtains customers and customer accounts, then submits its customer

accounts and customer orders to a carrying firm for execution. *See* Exchange Act Release No. 31,511, Fed.Sec.L.Rep (CCH) ¶85,064 at 83,569 (Nov. 24, 1992). At the same time, the introducing broker maintains the personal contact with the client. A customer places its order through the introducing broker, which monitors the transaction and insures its own compliance with NASD and/or NYSE rules and regulations. Introducing brokers are thus able to engage in securities brokerage business without investing large amounts of capital. *See* John M. Bellwoar, Bar Baron at the Gate: An Argument for Expanding the Liability of Securities Clearing Brokers for the Fraud of Introducing Brokers, 74 N.Y.U.L.Rev., 1014, 1019 (1999).

By contrast, clearing brokers are usually full-service brokerage houses with their own customers who have the capacity to execute more trades. Although establishing clearing operations remains costly, the cost of each incremental transaction is minimal. Thus, clearing brokers that have an incentive to use their excess capacity to clear trades of introducing brokers.

Clearing firms provide back-office services to process the introduced transactions, including:

(a) provision of written confirmations of the executed order to the customer;

(b) receipt and delivery of funds or securities from or to the customer;

(c) maintenance of books and records that reflect the transactions, including the rendering of periodic account statements;

(d) safeguarding of customer funds and securities in the customer's account; and

(e) the clearing and settling of the transaction in the clearing house.

See Minnerop at 842.

C. Relationship Between Introducing Brokers and Clearing Firms.

In February 1982, the SEC approved amendments to NYSE Rule 382 and 405. As amended, Rule 382 required each clearing firm and introducing broker to fully disclose the matters of their relationship, and in each clearing agreement between an introducing broker and clearing firm, to designate between them which broker was responsible for which specific brokering functions. *See* NYSE Rule 382(b), 2 NYSE Guide (CCH) ¶2382; Bellwoar, at 1020-1021. Further, Rule 382(c) requires that the firms to notify each customer in writing upon the opening of the account of the existence of the clearing agreement and the relationship between the introducing and clearing broker. 2 NYSE Guide (CCH) ¶2382.

In addition, the NYSE amendments to Rule 405 removed any "know your customers" responsibilities set forth in Rule 405 from clearing firms. *See* Bellwoar at 1021. Under amended Rule 382, the obligation to "know your customer" rests exclusively with the introducing firm. *See also* NASD Rules of Fair Practice, NASD Manual (CCH) Rule 2310. Clearing agreements between introducing brokers and clearing firms generally set forth the introducing broker's responsibility for monitoring investors' account activities, and that the investors themselves must agree to this arrangements.

In 1999, the SEC again amended regulations governing the relationship between introducing and clearing brokers. Although the amendments require clearing firms to (1) report and forward customer complaints to an introducing firm's Designated Examining Authority (generally, the NASD), and (2) furnish introducing firms a list of all reports, including exception, reports, available to the introducing to monitor account trading, the 1999 amendments do not significantly affect the relationship between introducing and clearing firms. S*ee* Bellwoar at 1022; NYSE Rule 382(e), 2 NYSE Guide ¶2382(e), and NASD Rule 3230(b), NASD Manual Rule 3230. Both the NASD and the NYSE, in their promulgation of the amendments to their membership, confirmed that the 1999 amendments were not intended to impose any additional responsibilities on clearing firms to supervise customers' account, and were not intended to alter the fundamental relationship between clearing and introducing brokers. *See* NASD Notice to Members No. 99-57 (July 1999); NYSE Information Memo No. 99-33 (July 1, 1999).

D. Claims Against Clearing Firm.

With an increase in the number of introducing firms has come an increased number of arbitration claims against both introducing firms and the clearing firms. Claims have been divided into three main causes of action: (1) primary liability for fraud pursuant to Rule 10b-5, 17 C.F.R. §240.10b-5; (2) control person liability under Section 20 of the Exchange Act, 15 U.S.C. §78t(a); (3) state law liability claims under theories of agency, contract or state securities law. *See* Part IV.E.1, infra.

1. Primary Liability.

Courts have consistently held that a clearing broker who performs merely ministerial duties is not liable to the introducing broker's customer for losses suffered by the introducing broker's actions. *See* Carlson v. Bear Stearns & Co., 906 F.2d. 315 (7th Cir. 1990); Ross v. Bolton, 904 F.2d. 819 (2d Cir. 1989); Edwards & Hanly v. Wells Fargo Securities, Inc., 602 F.2d. 478, 484 (2d.Cir. 1979), cert. denied, 444 U.S. 1045 (1980); Dillon v. Milatano, 731 F.Supp. 634 (S.D.N.Y. 1990); Connolly v. Havens, 763 F.Supp. 6 (S.D.N.Y. 1991). Similarly, courts have concluded that there is no fiduciary relationship between a clearing firm and introducing broker or the clearing firm and a customer of an introducing broker. *See* Edwards & Hanly, 602 F.2d. 484; Connolly, 763 F.Supp. at 9.

As a clearing broker owes no fiduciary duty to the customer of the introducing broker, the clearing firm has no duty to disclose a material fact to that securities customer. Accordingly, a clearing firm cannot be liable under Rule 10b-5 for failure to disclose a material fact to an introducing broker's customer. *See* In re Blech Securities Litigation, 928 F.Supp. 1279, 1295-96 (S.D.N.Y. 1996) ("Blech I"); Connolly, 763 F.Supp. at 10.

2. Control Personal Liability Under § 20(a).

A second theory of recovery stems from "control person" liability under §20(a) of the Exchange Act. Section 20(a) extends liability to "every person who, directly or indirectly, controls any person liable under any provision of this chapter…." *See* 15 U.S.C. §78t(a). A plaintiff making a claim under Section 20 must prove that the clearing firm directly or indirectly controlled the introducing broker that had, in turn, committed a violation of Rule 10b-5. Courts

have generally found that clearing brokers do not control their introducing broker. *See* Carlson v. Bear Stearns & Co., 906 F.2d. 315, 318 (7th Cir. 1990); Damato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 878 F.Supp. 1156, 1159 (N.D.Ill. 1995); Blech I, 928 F.Supp. at 1299.

3. State Law Claims.

Historically, claimants assert one of two types of common law causes of action: agency claims or contract claims. Under the agency law theory, claimants have asserted that an introducing broker acts as the agent for the clearing firm, and thus the clearing firm is vicariously liable for the negligent or tortious actions of the introducing firm. *See, e.g.*, Riggs v. Schappell, 939 F.Supp. 321 (D.N.J. 1996); Katz v. Financial & Clearing Services Corp., 794 F.Supp. 88, 94, (S.D.N.Y. 1992). In fact, courts have found that the opposite to be true; it is the clearing broker who is the agent of the introducing broker.

A second common law cause of action asserts breach of contract between the customer and the clearing firm. Virtually all clearing firms have customers sign agreements by which the customers acknowledge the relationship with the introducing and clearing broker. In some circumstances claimants have asserted a breach of the agreement between the clearing broker and customer. *See,* e.g., Fine v. Bear Stearns & Co., 765 F.Supp. 824 (S.D.N.Y. 1991), In re Lloyds Securities, 1992 WL 318588 (Bankr. E.D. Pa. October 29, 1992). In both Fine and Lloyd, plaintiffs asserted that the clearing broker had breached the clearing broker-customer agreement to properly safeguard their funds. The court in Fine held that the complaints failed to state a cause of action 765 F.Supp. at 828; the court in Lloyd found liability. *See* 1992 WL 318588 at 9-10.

E. Recent Developments in Theories of Clearing Firm Liability.

Despite relatively consistent cases finding no liability on the part of clearing firms, certain recent cases suggest some inroads are being made into theories of liability.

1. Blech III.

As noted previously, in Blech I, the District Court dismissed claims of Section 10(b) and Section 20 violations against Bear Sterns on the grounds of its activities as a clearing broker. *See* Blech I, 928 F.Supp. at 1295-96, 1299. After dismissal, the class plaintiffs amended their class action complaint and reasserted their claims against Bear Stearns & Co., Inc., the clearing broker, Bear Stearns, in turn, renewed its motion to dismiss.

In denying Bear Stearns' motion to dismiss, the District Court found that the plaintiff had sufficiently alleged that Bear Stearns "directly and knowingly participated in deceptive or manipulative conduct that caused damage to the plaintiffs." 961 F.Supp. 569, 582 (S.D.N.Y. 1997) ("Blech III"). The court concluded that the amended complaint contained allegations that Bear Stearns caused or directed trading by the introducing broker. In refusing to dismiss the claim, the court held:

> [T]he complaint does contain certain allegations that, when read most favorably to the plaintiffs, indicate that Bear Stearns caused Blech or his confederates to fraudulently trade, and that Bear Stearns *itself* engaged in

> conduct aimed at artificially inflating or maintaining the price of the Blech securities. These allegations, at this stage, are sufficient.

Blech III, 961 F.Supp. at 583. *See, also* Berwecky v. Bear Stearns & Co., Inc., 197 F.R.D. 65, 67 (S.D.N.Y. 2000) (finding that plaintiff had asserted that Bear Stearns had shed the role as a clearing broker and directly participated in the introducing broker's fraudulent scheme).

More recently, a separate court in the Southern District of New York refused to expand liability to a clearing firm under facts similar to those asserted in Blech III. *See* Goldberger v. Bear Stearns & Co., Inc., Fed.Sec.L.Rep. (CCH) ¶ 91,287 (S.D.N.Y. (2000) (Martin, J.). The court acknowledged that the complaint contained many of the allegations of scienter, generally, that the court in Blech III had found sufficient to establish liability against Bear Stearns; yet, there were no similar allegations of scienter with respect to the specific securities at issue in Goldberger. Goldberger at 93,620. The Court held that the complaint failed to allege that Bear Stearns had direct primary liability with respect to the securities at issue. Moreover, the court noted, the complaint did no more than allege that Bear Stearns performed the normal function of a clearing broker. "Even if one accepts that the complaint sufficiently alleges that Bear Stearns did this with knowledge that these brokers were manipulating the securities at issue, the complaint does not establish Bear Stearns primary liability under § 10(b)." Id. at 95,620.

2. Koruga, et al. v. Wang, et al.

A recent decision by a NASD arbitration panel in Portland, Oregon in the matter entitled Koruga et al. v. Wang, et al., NASD Arbitration No. 98-04276 ("Award"), suggests a further, potential expansion of clearing firm liability.

In the 39-page Award entered on October 5, 2000, a three member NASD arbitration panel assessed liability against Hanifen, Imhoff Clearing Corp., the clearing firm for Duke & Company, Inc., the introducing brokerage firm. The arbitration panel found that Hanifen had "materially aided in the sale" of securities by Duke to the claimants within the meaning of §410(B) of the Uniform Securities Act of 1956, as enacted at and incorporated by Washington and California in their securities laws. *See* RCW 21. 21. 430(3) and Cal. Corp. Code §25504.

In its Findings of Fact, the arbitration panel found that "Hanifen had substantial reasons to suspect that Duke was highly likely to engage in microcap stock fraud… Hanifen not only with reasonable care could have known, but in fact, did know the existence of facts concerning Duke's systematic violations of Washington securities laws, with respect to the Koruga and Steelhammer, and of Duke's systematic violation of California securities laws, with respect to Spitzka and Artz." Award, at 10. The panel concluded that Hanifen was jointly and severally liable under the Washington and California securities laws to each of the claimants for the full amount of damages.

In addition to its findings with respect to the case, however, the arbitration panel authored a detailed Explanation of Award. In its "Explanation," the arbitrators specifically criticized and rejected the Seventh Circuit decision in Carlson v. Bear Stearns. "This panel was totally unpersuaded by the reasoning of the court in Carlson. We question whether the Illinois courts would apply Carlson to the Illinois statute, if it ever gets the chance. In any event, this panel will not apply Carlson to the significantly different wording of the Washington and California

statutes." Award at 19. Moreover, the arbitrators encouraged other arbitration panels to join in the writing of detailed award decisions, "so that a body of meaningful precedents, interpreting the securities laws of the various states, may become available, absent the ability of the various state courts to develop their respective state laws." *See* Award at 15.

Subsequent to the panel's decision, the successful claimants brought an action in the United States District Court for the District of Oregon to confirm the Award; Hanifen's successor, Fiserv Correspondent Services, Inc., moved to vacate the Award as being "in manifest disregard of law." In a decision dated February 7, 2001, the U.S. District Court for the District of Oregon, concluded that the arbitration Award was not in manifest disregard of the law, and granted the claimant's motion to confirm and denied Fiserv's motion to vacate.

The court held that the arbitration panel's application of the Washington and California statutes was not contrary to the plain meaning of the statutes, and that review of the factual determination of the arbitration panel was beyond the scope of the court's jurisdiction. *See* Koruga v. Fiserv Correspondence Services, Inc., et al., slip opinion, CV00-1415-MA (D. Or. February. 7, 2001). The court specifically noted that the Seventh Circuit decision in Carlson v. Bear Stearns, 906 F.2d. 315 (7th Cir. 1990) was not binding upon the arbitration panel nor upon District Court.

Koruga is now on appeal to the Ninth Circuit Court of Appeals.

F. Affect on Arbitration Proceedings.

Although the decision of Blech III might suggest, at first blush, an expansion of the standard for finding liability against clearing brokers, courts applying that case have not viewed the case as intending clearing firm liability. In Blech III, Judge Sweet found that Bear Stearns' knowledge and participation allegedly came to the point of creating direct liability under 10b-5. Courts applying Blech III have found liability not only where the parties pleaded or established that the clearing firm was directly and materially involved in violation of Rule 10b-5. *See* Goldberger, slip opinion, at 7-9.

It is too soon to tell whether the finding in Koruga is indicative of a long-term trend or is aberrant. In upholding the Award, the Court emphasized that its decisions was based not on federal securities law or common law, but upon the panel's interpretation of California's and Washington's securities laws.

When named in arbitration suits, most clearing firms will seek early dismissal of the claim. Although neither the NASD Code of Arbitration in the NYSE Arbitration Rule explicitly provide for summary dismissal of claims against clearing firms, with some frequency, respondents have brought and arbitration panels have granted pre-hearing motions to dismiss of clearing firm claims. *See, e.g.,* Olson v. Kushnir, (NASD 98-02762) (2001); Beitner v. Hertzog, Heine, Geduld, Inc., (NASD 96-04567) (1998); Seagal v. Corlandt (NASD 96-00706) (1998); Razouvaev v. Schroeder, Wertheim & Co., Inc., (NASD 96-04398) (1997); and Hegarty v. Messenger, (NASD 93-00276) (1995). *See also* Koruga, Award, Page 15 (identifying 11 NASD panel decisions during claim against which clearing brokers).

IV. ON-LINE BROKERAGE ISSUES

A. Introduction.

Broker-dealers are facing more and more litigation and disputes from customers trading on-line, some of which have novel issues. The SEC, the NASD, the CFTC and the NFA have promulgated a number of rules, releases and interpretations with respect to the use of electronic communication, websites and on-line trading by customers. Some of these releases and interpretations raise new and challenging issues for broker-dealers. A litigator dealing with customer litigation should be familiar with those rules, releases and interpretations. Attached as Appendix 3 is a general outline of those rules, releases and interpretations (updated from a presentation at the American Bar Association 2000 Annual Meeting by the author).

B. The OCIE Report.

The SEC recently completed a sweep of broker-dealers offering on-line trading. Litigators should also be familiar with the report of the Office of Compliance, Inspections and Examinations entitled "Examinations of Broker-Dealers Offering On-line Trading: Summary of Findings and Recommendations" (January 25, 2001) ("Report"), which can be found at the SEC website http:\\www.secgov\news\studies\online.htm. This Report provides an excellent insight into areas in which there have been litigation and will be litigation. It also provides a series of recommendations for broker-dealers to improve their procedures. The findings of the Report are interesting and are summarized below:

1. General Disclosure to On-Line Customers.

a. The SEC recommended that broker-dealers have a glossary of all terms used on their website with easy access and explanations in simple English.

b. The SEC recommends that a broker-dealer's website disclose the following types of matters:

(i) Differences between the various types of orders that may be placed – market order, limit order, stop order.

(ii) Notice that a market order may be executed at a price higher or lower than the quote displayed at the time of order entry.

(iii) An explanation as to how customer orders are executed by the firm.

(iv) Situations where a customer may not receive an execution.

(v) Restrictions by the firm on the types of orders that customers can place.

(vi) The possibility of delays and outages and alternative means of placing orders.

(vii) Market volatility and customer orders.

(viii) Cancellations – how orders may be cancelled by the customers and the consequence if the customer does not cancel.

2. Margin Sell-Out Disclosures.

a. The SEC in its survey found that no broker-dealers provided investor disclosures about margin and sell-outs.

b. The SEC recommended that the following be disclosed.

(i) A customer can lose more funds than he or she deposits in the account.

(ii) The firm has a right to sell securities in any of client's accounts and may sell any securities if the margin falls below the maintenance requirement or the house requirement.

(iii) The firm can sell customer's securities without contacting the customer.

(iv) The customer is not permitted to choose the securities in his or her account that are liquidated or sold to meet a margin call.

(v) The house can increase its maintenance calls at any time and is not required to provide the customer advance notice.

(vi) The customer is not entitled to an extension of time on a margin call.

c. The NASD has proposed a rule, NASD Rule 2341, which will require a margin disclosure for all customers, particularly on-line customers which would explain the above risks. See NTM 00-55 (September 21, 2000).

3. On-Line Public Offering Process.

The SEC found that the broker-dealer instruction to customers of on-line public offering websites were unclear. Furthermore, the initial public offering allocation process described on the websites was often unclear or misleading.

4. Cash Accounts.

The study found that many customers believed that if they had cash in the account that was the limit of their liability.

5. Chat Rooms and Bulletin Boards.

The staff found that investors apparently believed that the discussions or recommendations on chat rooms sponsored by a broker-dealer were recommendations by the broker-dealer. The staff made it clear, as demonstrated in the attached article, that chat rooms and bulletin boards must have clear disclaimers that the discussion is not that of the firm and there are no recommendations.

6. Best Execution.

The Report found that many broker-dealers make no on-line or other disclosure with respect to execution, methods of execution, order routing, choice of order routing and opportunities for price improvement. Furthermore, many of the broker-dealers participating in on-line systems used the execution systems of their clearing firm and made no best execution evaluation of on-line executions. The Report found that the websites for on-line trading generally provide little or no disclosure as to how the firm routes orders or their methodology for determining order routing. Likewise, there was little or no disclosure regarding order flow payments and how they may effect execution quality.

The NASD recently released NTM 01-22 (April 2001) to rectify these perceived problems. NTM 01-22, quoting the SEC states that a broker-dealer has an obligation to "regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security." This notice requires all broker-dealers to have procedures to meet this standard. The type of procedures depend upon whether the broker-dealer is an executing broker-dealer or an introducing broker-dealer. An introducing broker-dealer that transmits all of its orders for execution by its clearing firm or another executing broker is not excused from complying with the requirements of the rule but must examine reports of execution furnished by its executing brokers. In all cases, the broker-dealer must on a regular basis examine the quality of executions and the opportunities for price reporting even for automated systems that automatically execute orders. The NASD in NTM 01-22 stated that a member must "regularly and rigorously examine execution quality likely to be obtained from different markets or market makers trading as security."

7. Operation Capacity and Capability.

The Report explains SEC Division of Market Regulation Bulletin Number 8 (Release No. 34-29185 56 F.R. 22490 (May 9, 1991) and NASD NTM 99-1 (February, 1999)), require broker-dealers to have an on-line capacity or operational capability to prevent disruptions of on-line trading. The Report construes Staff Interpretation Number 8 in essence to require broker-dealers to maintain and to develop systems to evaluate the capacity of their on-line trading and their operational capacity, including the following:

(a) evaluating capacity of electronic systems;

(b) telephone or electronic hold times;

(c) maintaining records of systems capacity;

(d) evaluating adequacy of back-up systems and dual systems or a back-up site that can be switched to in a short period of time;

(e) evaluating the ability to increase phone representatives at an outage;

(f) employing multiple internet service providers;

(g) improving server capacity;

(h) giving priority at the time of peak usage to customers who wish to enter orders;

(i) educating customers about internet access issues; and

(j) providing alternative means to place orders when internet access is slow or unavailable.

The Report found that many firms have developed back-up systems and dual systems. Many firms test capacity and capability on an on-going basis through either computer software or by other tests. However, approximately one-third of the firms surveyed did no capacity or capability testing.

8. Security Measures.

The SEC adopted Regulation SP in November 2000 which is operational effective July 1, 2001 requiring firms to keep secure the privacy of customer and consumer personal financial information. In the Report on on-line trading, the SEC raised a number of security and privacy issues. It noted that most broker-dealers do not use encryption technology. The staff noted that only a few firms have fire walls between their on-line trading systems and other computer systems to prevent intrusions. While passwords are generally used for on-line trading access, there was no time out mechanism in most systems if a customer's computer is not shut down. Other deficiencies were noted.

C. Areas of On-Line Trading Litigation.

1. Capacity and Capability.

Capacity and capability have been the subject of much litigation as a result of outages. A number of well publicized outages have resulted in litigation against on-line trading firms, some of which resulted in fairly large settlements. Most of these cases have been class action cases for all persons injured during the outage. In some cases, the broker-dealers have provided recompense to the customers who were unable to execute their orders. In other cases, the customers were not compensated and litigation has resulted. The SEC Staff Bulletin No. 8 dealing

with capacity and discussed above in Section IV.A.7, is not even an SEC Rule and by its nature should not be actionable as an implied cause of action. However, claimants' lawyers have alleged lack of due care using the Staff Bulletin No. 8 as the basis for a duty of due care. In some cases, fraud and deceit have been alleged based upon failure to disclose the possibility or likelihood of outages because no capacity testing was done by the broker-dealer. *See* Akhtar v. E-Trade Securities, Inc., NASD Arbitration 98-00858 (April 1, 1999).

2. Suitability.

A number of recently publicized customer arbitration cases have raised the issue of suitability obligations of broker-dealers in connection with on-line trading. Many on-line firms expressly disclaim on their website any suitability obligations to on-line customers and disclaim any recommendations of specific securities to customers. However, in some of these cases, it appears that the customers have succeeded in establishing liability and damages.

The position of the SEC and the NASD is that suitability on-line is a question of facts and circumstances. NTM 01-23 sets forth a number of examples and is very helpful in clarifying the suitability obligation of broker-dealers in connection with various on-line activities. The question is, what is a recommendation? As explained below, certain on-line activities will constitute a recommendation generating a suitability obligation to particular customers. NTM 01-23, however, clarifies that there are a number of situations where on-line execution transactions will not carry a suitability obligation. NTM 01-23 attempts to strike a balance between permitting firms to provide information regarding securities and asset allocation to customers on its website or otherwise so long as the information is not tailored to a specific customer. The notice clearly states that a member may provide a website with a research engine that enables customers to sort through data available about performance of a broad range of securities, company fundamentals and industry sectors as long as the data does not favor securities in which the member makes a market or makes buy recommendations. As long as the customers use and direct the research tool on their own, there would be no recommendation. Likewise, search engines that allow a customer to design a search program to list securities based upon various criteria would be permitted. Another example of permitted material is a customer-generated watch list which electronically will generate information about the companies and stocks that are on the watch list so long as the customer selects the list and scope of information that will be sent. NTM 01-23 (April 2001). It is clear that an on-line broker-dealer, by posting on its website its own research and recommendations or that of third parties, does not incur a suitability obligation for a particular customer as long as the recommendations are general in nature, particularly if a disclosure to that effect is clearly posted. However, if the on-line firm targets specific investors and provides to them specific types of research, a suitability obligation may arise.

Some firms provide on-line customers with a financial plan and asset allocation recommendations based upon a financial information profile provided on-line by the customers. This probably does not give rise to a suitability obligation. However, some securities firms go further and provide recommended securities for the asset allocation program based on the profiles prepared by the on-line customer. NTM 01-23 imposes a suitability obligation based on the recommendations provided to the customer. Furthermore, some firms by analyzing the past trading patterns of on-line trading of a particular customer can recognize that the customer has an interest in particular securities and targets electronic e-mail recommendations to the customer in the form of research. These again, raise suitability obligations under NTM 01-23. NTM 01-22 finds that

firms are subject to a suitability obligation when the firm uses data mining tactics or similar techniques to bring particular securities to the attention of on-line investors.

Suitability obligations may arise under different rules and interpretations. The SEC shingle theory has been expanded to include suitability concepts. Under the shingle theory, a broker, when recommending securities, impliedly represents that he has a reasonable basis for that recommendation based upon the customer's circumstance. *See* e.g. Honly v. SEC, 415 F.2d 589 (2nd Cir. 1969). Likewise, NASD Rule 2310(a) provides that recommendations to a customer shall be based upon reasonable grounds for believing that the recommendation is suitable for the customer upon all of the facts disclosed by such customer about his financial situation and needs. Understandably, the NASD has been reluctant to define the term "recommendation", primarily because it would restrain its flexibility in interpreting and enforcing the rule. The NASD has taken the position, however, that transactions are deemed to be recommended where a member or its associated person brings specific securities to the attention of a customer through any means, including telephone communication, promotional material or electronic messages. *See* NASD NTM 96-90, September 1996. In contrast, the NASD has stated unequivocally that order takers are not making a recommendation if that is all they do.

The NYSE Rule 405 (Know Your Customer) provides that a broker is obligated "to use due diligence to learn the essential facts to every customer, every order, every cash and margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization." This Rule is not necessarily triggered by a recommendation, but in certain context it may in fact amount to a suitability rule.

3. Margin and Sell-Out Disputes.

Margin and sell-out disputes with on-line customers have become more significant over the last year as firms have sold out on-line customer positions because of the volatile market. *See, e.g.,* Camacho v. E-Trade Securities, Inc., NASD Arbitration 98-01595 (August 9, 1999); Monte v. Ameritrade, Inc., NASD Arbitration 99-141 (February 1, 2000). In such disputes, on-line trade customers contend, as have other customers for years, that they had no idea that they could be sold out under a number of different circumstances. Some claim fraud because of non-disclosure of sell-out procedures. The proposed NASD disclosure statement that will be provided to all customers on-line should provide an excellent potential defense to margin sell-out cases. The disclosure covers all of the areas normally raised by claimants' counsel in attempting to assert a non-disclosure or fraud in connection with sell-outs. With a customer's signature and an acknowledgement that the customer has read and understands the margin disclosure, it should make it much more difficult for claimants to assert claims in this area to avoid margin and sell-out liability.

4. Trading Disclosures.

The recent SEC Report concluded that firms provide on-line specific disclosure including the differences between the various types of orders, executions, methodology, outages, cancellations and the mechanics of the on-line order execution system for public offerings, which is different than for executing other orders, including the allocation procedures of the firm. Customers in arbitration proceedings involving on-line customers have already raised and will continue to attempt to use the lack of any of these as a basis for damage claims. See also Section

IV.B. *See, e.g.,* Varshavchik v. E-Trade Securities, Inc., NASD Arbitration 99-04325 (September 20, 2000); Wolff v. Fidelity Brokerage Services, Inc., NASD Arbitration 99-02674 (November 30, 2000).

5. Best Execution Litigation.

Several recent celebrated class actions have involved best execution. Best execution on-line is starting to become an area of interest to class action plaintiffs' attorneys. The Report noted that most broker-dealers provide no on-line disclosure concerning best execution, evaluation of best execution and how the firm periodically assesses the quality of competing markets. The Report also noted that many broker-dealers were not meeting best execution because they send all order flow to their clearing firm and conduct no independent review of execution. Some firms, in order to avoid having to make best execution decisions, allow their customers to chose electronic routing of their orders, which probably provides some relief.

Best execution appears to be an area that will have continuing class or mass actions because the obligations of broker-dealers are unclear. Claims in current cases are based upon an obligation of an agent to use due care. The SEC and courts are defining best execution as an obligation to use due care to try to obtain price improvement if reasonably possible. Furthermore, under the common law, an agent has a duty of care and of loyalty to his client. Under the duty, an agent must disclose conflicts when he is self-dealing. Using that duty, claimants' lawyers argue that broker-dealers have a duty to disclose if they receive order flow payments or if they are not testing order routing price improvement. They also argue that the duty to use due care in execution requires testing execution systems for price improvement. The failure to disclose meeting that obligation, in claimants' view, also raises a 10b-5 or fraud issue.

The recent NTM 01-22 articulates in great detail the rigorous examination that is required and the methodologies for doing the same. NTM 01-22 appears to provide claimant's lawyers and plaintiff's class action lawyers ammunition not only in the current class action cases but in other cases. Meeting the standard of NTM 01-22 is fact intensive. Consequently, it will be difficult for defendants and respondents to prevail on a motion for summary judgment or summary disposition in view of the factually intense facts and circumstance test set forth in NTM 01-22.

6. Advertising and Websites.

Websites are in fact advertising and sales promotional material that must meet the SEC, NASD and New York Stock Exchange advertising rules and regulations. At the beginning of on-line trading, some of the websites presented information which was in the SEC's view and the NASD's view misleading, particularly with respect to the speed of execution and other problems. The most controversial litigation issue today is with respect to advertising and promotion relating to hyperlinks to other parties' websites. Hyperlinks to issuers' websites, third party research and other information presents interesting liability issues. All of these issues have been presented in customer litigation.

The NASD has taken the position that any information that a broker-dealer displays on its website is subject to its advertising and sales literature provisions. Thus, if the broker-dealer displays recent press releases or articles regarding a completed IPO or a security it is recommending, those materials would be required to comply with the NASD standards and, if

applicable, filing requirements. Report of NASDR Concerning the Advertisement of On-Line Brokerage (September 21, 1999). Hyperlinks to research also raise a host of unanswered questions discussed below. The SEC and the NASD have been reviewing broker-dealer's websites and banner advertisements. The SEC's and the NASD's review has focused on the following:

a. Misleading statements that a customer has direct access to a particular exchange or marketplace without recognizing the transaction must go through a broker-dealer.

b. Implication that active trading results in high profits.

c. Implication that third-party research is in fact the research of the broker-dealer.

d. Misleading information that an advertised single discount commission would apply to all types of transactions where there are various types of commissions for different types of transactions.

As noted above, the NASD NTM 99-11 cautions members that statements in advertising or sales literature about speed and reliability of their services may not be exaggerated. Further, risk involved with on-line trading, including outages and capacity and alternative execution methods, should be disclosed and it applies equally to websites.

Many broker-dealers have arrangements with Internet access providers, such as Compuserve and America On-Line to have a banner advertising the broker-dealer and its services (web portals). The banners, by their very nature, must be extremely short and can contain generally no more than a few words or a trade name at a maximum. This creates a conflict with the affirmative disclosure requirements mentioned above. While the NASD has been understanding in this regard, the broker-dealer's website to which the banner hyperlinks must clearly have the required disclosures. Another issue with respect to banners is the compensation of on-line service providers. On-line payment of transaction base compensation is not permissible. However, by SEC no-action letter, a nominal or flat rate per order may be provided to an on-line service provider. *See* Atkisson, Carter & Akers, 1998 SEC No-Act. LEXIS (Jun. 23, 1998); No Action Letter to Charles Schwab & Co., Inc., 1977 SEC No-Act. LEXIS 920 (Sept. 18, 1997); Charles Schwab & Co., Inc., 1996 SEC No-Act. LEXIS 976 (Nov. 27, 1996).

7. Responsibility for On-Line Data and Research.

As noted at Section IV.B.6 above, it is clear that a broker-dealer is responsible for its sponsored research and must have a reasonable basis for a recommendation of a security. Many firms provide not only their own internal research on-line, but research recommendations by means of hyperlinks to third party research. Hyperlinks to third party Internet sites for research and other information is problematic for broker-dealers.

The NASD has established certain other requirements for hyperlinks, including the following:

(a) The hyperlink must be continuously available.

(b) A broker-dealer cannot alter the information on a third-party site.

(c) A broker cannot deny access if it contains material unforeseeable to the broker-dealer or its recommendations.

NASD Interpretation Letter to Investment Company Institute from R. Clark Hooper NASD (November 11, 1997).

The NASD has recently stated in the interpretive letter cited above that a hyperlink to a third-party site, which is intended for use by the public for general reference purposes and which does not refer to a broker-dealer, would not be subject to the NASD advertising, sales literature or other constraints. *See* NASDR Interpretation Letter to Investment Company Institute from R. Clark Hooper NASDR (November 11, 1997).

The SEC in a recent release addressed the issue of hyperlinks on issuer websites. *See* Use of Electronic Media: Interpretation and Solicitation of Comments, Release Nos. 33-7856 and 34-42728, 65 F.R. 25843 (May 5, 2000). The release states that the issuer's responsibility for information on a hyperlinked site depends upon "adoption" of the hyperlink site. Adoption is a circumstances and facts test. The SEC states that three non-exclusive factors should be considered:

(a) The context of the link.

(b) The risk of investor confusion.

(c) The presentation of the information on the website.

(d) The presentation of the information on the website.

Although articulated differently, these tests parallel the NASD interpretation discussed above. If there is an on-going hyperlink, an issuer, by the very nature of the tests, would have to monitor the hyperlinked site and information on the site. The recent SEC release states: "We are not suggesting, however, that statements and disclaimers will insulate an issuer from liability for hyperlinked information when the relevant facts and circumstances otherwise indicate that the issuer has adopted the information." Release NO. 33-7856, 65 F.R. 25843 at 25849 (May 5, 2000).

If a broker-dealer is "involved" in preparation of material on a hyperlinked website, then broker-dealer would be liable for the content of the hyperlinked material under the "Entanglement" theory. Entanglement is a facts and circumstances test focusing on the amount of involvement with the information on the hyperlinked site.

The NASD and the SEC have taken the unequivocal position that pop-up disclaimers do not release a broker-dealer of the responsibility for hyperlinked material if the broker-dealer knows or has reason to know that the recommendations or third party information is inaccurate or false. This raises the question as to whether hyperlinks to third party research or other information sites, such as an issuer's website, must continually be monitored to determine if the information is false or misleading. If there is a duty to monitor them on an on-going basis, the

extent of the monitoring is unclear. If it is required, monitoring will reduce the information available to customers because many firms will not want to take the responsibility to hyperlink to an issuer or other third party research websites if they have to incur the cost of continually monitoring them. Many firms use a pop-up window that states to an on-line trader who is using a hyperlink to go to a third party research or other information site that the broker-dealer has not reviewed the information and is not responsible for it. As noted above, this may not be enough in the view of the SEC. This raises the interesting questions as to whether anyone could ever provide a hyperlink to EDGAR because, we all know that there is information in the EDGAR system that is false and misleading. In fact, in many cases, there is information in the EDGAR system that is false and misleading and remains false and misleading even though the SEC has brought civil and criminal proceedings because the information has not been deleted from the system.

Chat rooms, both sponsored and non-sponsored, as part of or hyperlinked to a broker-dealer's website, also presents potential for customer claims and in fact, there have been claims for both sponsored chat rooms and non-sponsored chat rooms. The NASD's position and the SEC's position with respect to sponsored chat rooms are somewhat unclear. However, the SEC and the NASD have made it clear that if a broker-dealer does sponsor a chat room, the broker-dealer must clearly indicate that the opinions and statements on the chat room are not the broker-dealer's, otherwise the broker-dealer may be adopting those and responsible for the statements. Likewise, with respect to hyperlinked chat rooms, whether disclaimers will be enough is unclear at the present time.

8. Day Trading.

Day trading through electronic execution has received an enormous amount of publicity and a fair amount of customer litigation. Most on-line firms have promoted active trading and some firms have actively promoted day trading by offering instruction on day trading, facilities for day traders and seminars. Some of the advertisements have been very aggressive in promoting day trading. A number of national television advertisements have, without explicitly mentioning day trading, implied that active trading can generate huge profits. The number of active day traders has skyrocketed along with complaints of loss to the SEC. On-line day traders have attempted by hindsight to argue for a suitability or disclosure obligations. In most cases, the broker-dealers have been successful in defeating these claims. However, some retired customers with limited assets who have lost all of their assets by day trading have been successful in arguing non-disclosure or misleading statement reporting day trades.

Congress, the state regulators, the SEC and the NASD have reacted as expected, calling for substantial additional regulation. Report of NASD Concerning the Advertisement of On-Line Brokerage (September 21, 1999). In a series of releases and statements relating to day trading, the SEC and the NASD have strictly interpreted various current rules applicable to on-line trading. In addition to interpretations of current rules and NTMs, the NASD has adopted two rules regarding day trading, Rules 2361 and 2361. *See* NASD NTM 00-62 (October 2000). The Rules characterize certain strategies as a day trading strategy. The Rules apply to broker-dealers that promote day trading. They apply to new accounts and any other accounts where activity in the account demonstrates a pattern of day trading. This necessarily means that a firm will have to monitor all accounts for pattern of day trading. Thus, if a firm promotes day trading strategies, the broker-dealer must approve non-institutional customer accounts for day trading based upon reasonable grounds to believe that day trading is appropriate for the customer in view of the

customer's circumstances. Firms are required to monitor accounts that are not opened as day trading accounts. If such an account shows a day trading pattern, the firm is required to determine whether day trading strategy is appropriate for the customer. The Rules require explicit risk disclosures to day trading accounts.

Day trading also has raised various margin issues. The SEC, NASD and state regulators have targeted a number of abuses involving arranging credit, cross guarantees and a variety of other issues involving day traders. The NASD has also reminded members of their obligations regarding short selling and related margin issues during periods of market volatility. *See* NASD NTM 99-11 (February 1999); NASD NTM 99-33 (April 1999). The NASD provided advice regarding the calculation of margin for day trading and cross-margined accounts. *See* NTM 98-102 (December 1998). The NASD has also proposed additional margin requirements for particular types of volatile stock. *See* NTM 99-33 (April 1999). The proposed NASD rule has been amended by the NASD as a result of SEC staff and public comments. *See* Release No. 34-42418, 65 F.R. 8461 (February 11, 2000). Further, the proposed rule defines day trading for margin purposes and imposes additional margin requirements on "pattern day traders" as defined in the rule, including a minimum equity requirement of $25,000. Pattern day traders cannot trade equity securities in excess of their "day trading buying power", which is account equity (minus any maintenance margin requirement) times four.