A Look at the Law

Common Fact Patterns of Stockbroker Fraud and Misconduct

By Robert C. Port

Until recently, it seemed as though everyone had heard of a "friend of a friend" who made a "killing" in the stock market. The late 1990s were especially good to investors, with double digit returns seemingly the norm. Financial newspapers and magazines offering investment advice were everywhere, and Internet bulletin boards and chat rooms were filled with people claiming to have identified the next Microsoft, Yahoo or Cisco.

In this environment, investors easily fell prey to dishonest stockbrokers, investment advisors, financial planners, insurance agents and others claiming to have the knowledge and experience to offer investment advice. Certainly, no one has a crystal ball, and not every loss results from actionable activity by a broker. Even supposedly "rock-solid" blue-chip stocks experience significant declines from time to time. However, in many instances, the actions of a broker or investment advisor can form the factual basis for a variety of legal claims.

Federal and state securities statutes and state common-law typically govern civil liabilities arising out of the purchase and sale of securities.[1] This article first reviews the duties a broker owes to his client, and then provides an overview of reoccurring fact patterns and circumstances often found when an investment advisor has engaged in actionable activity.

STOCKBROKER AND BROKERAGE FIRM DUTIES TO THE CUSTOMER

Pursuant to Sections 15A and 19 of the Securities Exchange Act of 1934[2], Congress has authorized the establishment of "self-regulatory organizations" (SROs) such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX) and the National Association of Securities Dealers (NASD). Each of these SROs have promulgated rules which are, inter alia, "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. . . "[3] Rules promulgated by the various SROs are sent to the Securities and Exchange Commission for review and approval, following publication and an opportunity for public comment.[4]

The failure of a broker to comply with the SRO rules does not give rise to a private right of action.[5] However, a violation of the SRO rules can provide critical evidence that a broker or brokerage firm failed to exercise the requisite degree or standard of care owed their customer.[6]

The Duty to Know the Customer and to Recommend Suitable Investments. Among the most fundamental of SRO rules are the "Know Your Customer" and the "Suitability" rules. The "Know Your Customer Rule"[7] places a duty upon brokers to acquire an understanding of their customer's financial needs, investment objectives and other pertinent information before making a recommendation to purchase or sell a security.

Working hand-in-hand with the "Know Your Customer Rule," the "Suitability Rule"[8] requires that the broker have a reasonable basis for believing that a securities transaction recommended to a customer is suitable for the customer, in light of the customer's financial and other circumstances. NASD has made it clear that a "recommendation," and hence the applicability of the "suitability requirements," is a fact specific inquiry. In particular, the NASD has advised that "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."[9] The NYSE has adopted a similar approach. For purposes of these standards, the term "recommendation" includes any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a security. [10]

By regulation, the Georgia Securities Commissioner has promulgated rules that similarly obligate a broker operating in Georgia to investigate the client's circumstances and only recom-

mend investments suitable in light of those circumstances.[11] Violation of these rules is a violation of the Georgia Securities Act.[12]

The Duty of Good Faith, Fair Dealing and Loyalty. Various SRO and state regulatory pronouncements require brokers and brokerage firms to act with the utmost good faith, fair dealing and loyalty toward their customers.[13] These obligations mirror those imposed by Georgia common-law and statute upon parties to a contract.[14]

The Duty to Supervise Brokers. Brokerage firms have a statutory obligation, under both federal and state law,[15] to supervise their brokers to prevent violations of the securities laws. The SROs have imposed similar obligations by rule-making.[16]

Brokers Owe Their Customers a Fiduciary Duty. Under Georgia law, a confidential, fiduciary relationship exists between a broker and a client.[17] As a fiduciary, the broker has a legal obligation to act in the "utmost good faith."[18]

As set forth by the 11th Circuit, the fiduciary duties of an investment broker include: (1) the duty to recommend investments only after studying it sufficiently to become informed as to its nature, price and financial prognosis; (2) the duty to perform the customer's orders promptly in a manner best suited to serve the customer's interests; (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security; (4) the duty to refrain from self-dealing; (5) the duty not to misrepresent any material fact to the transaction; and (6) the duty to transact business only after receiving approval from the customer.[19]

COMMON PATTERNS OF MISCONDUCT

Although each case presents a different set of facts and circumstances, there are a number of common themes and fact patterns giving rise to claims against stockbrokers, brokerage firms and investment advisors. Most of these claims arise from the inherent conflicts created when a broker's income is commission based, and thus directly tied to the volume of transactions generated. Among the more common improper activities are the following:

Churning/Excessive Trading. Churning "occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, and for the purpose of generating commissions."[20] The broker churns an account by exercising control over it, either as a result of having been given express discretionary authority to trade, or by developing a relationship of trust and confidence with the client such that the client follows almost every recommendation the broker makes. Churning can be a violation of Section 10(b) of the Securities Act of 1934[21] and Rule 10b-5 promulgated thereunder.[22] It also is a violation of the Georgia Securities Act.[23] Churning may also provide a basis for claims based upon breach of fiduciary duty,[24] breach of contract,[25] negligence,[26] and respondent superior liability.[27]

Several objectively measurable factors may suggest that an account has been churned. One widely-accepted indicator is the turnover ratio. "Turnover rate is the ratio of the total cost of purchases made for the account during a given period of time to the amount invested."[28] The courts generally recognize an annual turnover rate in an investment account of 6, or a ratio of purchases to the amount invested of 6:1, excessive as a matter of law.[29] Whether a particular turnover rate is excessive depends upon the investment objectives of the customer. In long-term accounts with conservative objectives, a lower turnover ratio may be deemed excessive.[30] In trading accounts and accounts with options transactions, a higher turnover ratio is expected.[31]

Another factor to consider is the "account maintenance cost," also known as the "equity maintenance factor" or the "cost/equity ratio." This is the rate of return the customer must earn on the account to pay the commissions and other trading fees (such as margin interest). It is calculated by adding all fees and commissions and expressing the total as a percentage of average annual equity. A high account maintenance cost is indicative of an account that has been traded not for the customer's benefit, but for the benefit of the broker.

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Also considered is the period of time a security is held from purchase date to sale date. Short holding periods, with the proceeds immediately reinvested in other positions, may be indicative of churning.[32] Another indicator of churning is a comparison of the total commissions generated by the account as compared to total commissions earned by the broker and/or the branch.[33]

Fraud and Misrepresentation. A broker may induce a customer to buy or sell a stock by making statements or representations of material fact that are known by the broker to be untrue, or that are made with a reckless disregard for the truth, and that are relied upon by the customer following the broker's recommendation. Also, a broker can commit fraud by an "omission" — failing to reveal material facts that would have been important to the customer in making the investment decision. This conduct is prohibited by Section 10(b) of the Securities Exchange Act and Rule 10b-5 promulgated thereunder[34], as well as the Georgia Securities Act.[35] Such conduct also can serve as the basis for a claim of common-law fraud.[36]

Unsuitable Recommendations. A broker must only recommend investments that are appropriate for the customer's particular circumstances, in light of the customer's financial condition, level of sophistication, investment objectives, and risk tolerance. This is known as "suitability" or "knowing your customer."[37] A common fact pattern is the broker's recommendation to purchase excessive concentrations of low priced "penny" stocks[38] or other volatile shares, suggesting that a small price rise for each share will mean significant profits. Churning is also evidence of unsuitable activity, as is over concentration of the portfolio in one stock, group of stocks, or industry, recommendations to use excessive margin to purchase additional shares, and recommendations to purchase unregistered private placements. The broker's failure to recommend suitable investments may violate Section 10b of the Securities Exchange Act and Rule 10b-5,[39] the Georgia Securities Act,[40] as well as conduct rules promulgated by the SROs.[41] Unsuitable recommendations may also give rise to state law based causes of action under theories of breach of contract,[42] breach of fiduciary duty,[43] and negligence.[44]

Unauthorized Trading. A broker is prohibited from executing a trade in an account unless the client has approved and authorized the trade, before the trade has been made, either by written discretionary authority given to the broker (such as a Power of Attorney), or by oral "time and place" discretion granted to the broker.[45] Often, a disreputable broker will initiate trades in the account without the prior authorization of the client. Among other claims, unauthorized trading in an account may violate Section 10b of the Securities Exchange Act and Rule 10b-5[46], and is a violation of the Georgia Securities Act.[47]

Overconcentration/Failure to Diversify. It is generally accepted that risk can be reduced by diversifying investments among a number of different investments (such as investments in auto stocks, technology stocks, retail stocks), or by diversifying in different types of investments (such as stocks, bonds and mutual funds).[48] A broker who recommends that a client place all or substantial all of his investments in one or just a few securities may not only be ignoring sound investment theory, but may also be violating a number of legal and regulatory obligations owed to his customer. Indeed, as a fiduciary, the broker may be obligated to recommend a diversity of investments to his client.[49]

Excessive Margin. "Margin" refers to the situation where a customer borrows from the brokerage firm to purchase additional securities, using those securities (and perhaps others in the account) as collateral.[50] The Federal Reserve sets the initial ratio of margin debt to stock value at the time of purchase.[51] A broker cannot engage in margin trading in a customer's account unless the customer authorizes it in writing, and is provided with certain credit disclosures.[52] While many account opening agreements contain a provision authorizing and allowing margin

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trading, sometimes an account is improperly traded on margin without any prior agreement or authorization from the customer.

Even if a customer has authorized trades on margin, a broker may improperly induce the customer to carry an unreasonably large margin debt. Often, a dishonest broker will recommend that a customer borrow heavily to purchase low-priced, risky securities. Sometimes, the broker fails to clearly explain margin borrowing, including the fact that the margin balance cannot exceed a certain percentage of the account. The broker might also fail to explain that if the value of the account falls below the required percentage, a "margin call" will be made requiring the customer to place additional money in the account or risk liquidation of the account to satisfy the margin debt. As the SEC has observed:

> Trading on margin increases the risk of loss to a customer for two reasons. First, the customer is at risk to lose more than the amount invested if the value of the security depreciates sufficiently, giving rise to a margin call in the account. Second, the client is required to pay interest on the margin loan, adding to the investor's cost of maintaining the account and increasing the amount by which his investment must appreciate before the customer realizes a net gain. At the same time, using margin permit[s] the customers to purchase greater amounts of securities thereby generating increased commissions for [the salesperson].[53]

Failure or Refusal to Execute an Order. A broker also has an obligation to execute sell orders if given. An unscrupulous broker or firm sometimes refuses to do so, because a sale might push down the price of a security they are promoting.

Switching of Mutual Funds. Although mutual funds are often viewed as an appropriate investment option, a broker looking to improperly increase his commission may recommend that his customer sell a mutual fund they own, and purchase a fund offered by a different mutual fund company. Switching can generate significant commissions and sales charges benefiting the broker. Switching may not, however, place the investor in a better mutual fund, and may in fact place the investor in a lesser known, lower-quality fund.

Selling Away. "Selling Away" describes instances where a broker sells securities outside of the firm with which he or she is associated.[54] As described by the NASD,

> "[these] transactions present serious regulatory concerns because securities may be sold to public investors without the benefits of any supervision or oversight by a member firm and perhaps without adequate attention to various regulatory protections such as due diligence investigations and suitability determinations. In some cases, investors may be misled into believing that the associated person's firm has analyzed the security being offered and "stands behind" the product and transaction when in fact the firm may be totally unaware of the person's participation in the transaction."[55]

NASD Conduct Rules 3030 and 3040 prohibit, respectively, unapproved outside business activities and private securities transactions. The ability of a broker to engage in "selling away" may be indicative of the brokerage firm's failure to adequately supervise its brokers.

"Cold Calls." A cold call is a telephone call from a broker the customer has never met, trying to solicit business. The brokers making these calls are often very convincing, and portray the stock they are touting as no-risk opportunities for big profits. The stock is described as a "phenomenal opportunity," "the next Microsoft," or "a once in a lifetime opportunity." Often, such brokers claim they have "inside" information, claim they have made lots of money for other people, or claim that they are out to help the small investor, unlike the "big boys" on Wall Street. Sometimes, brokers will claim (usually falsely) that they believe in the investment so much, they sold some to their mother or other relatives. The NASD's Telemarketing Rule[56] limits the calling time to between 8 a.m. and 9 p.m. Brokers calling must identify themselves by providing their name, firm name, address or phone number.

The "Bait and Switch." The initial recommendations of a dishonest broker may be for the purchase of well known, widely traded blue chip stocks, or other securities consistent with the customer's investment objectives. After the customer has invested in such companies, the broker will then suggest that such companies have little growth potential, and pressure the customer to sell the blue chip stocks and invest in small, unknown companies, which the broker claims will bring spectacular profits.

Improper Marking of Confirmations as "Unsolicited" Orders. The broker may inaccurately state that purchases recom-

mended by the broker were "unsolicited." Mismarking order tickets is a violation of the Securities Exchange Act[57] and rules promulgated by the SROs.[58]

Blaming Errors on "Back Room" or "Administrative" Problems. Unauthorized transactions, improperly marked confirmations, and other difficulties a customer is having with a broker will often be dismissed by the broker as a problem with the "back room," the administrative and clerical support.

The Manager Who Promises to "Make it Right." Often, a customer who has lost substantial money as a result of a rouge broker gets a call from the "manager" of the firm, offering to make things right if the customer will let the "manager" handle the account. Frequently, the customer will be asked to send more money, "so we can have something to work with." The "manager" might claim that the other broker was young and inexperienced, or claim that the other broker has been fired. This "manager" is often not the manager of the office, but someone working in tandem with the first broker. More often than not, this "manager" will lose any new funds sent in, as well as what was left in the account.

CONCLUSION

Unscrupulous investment advisors are always devising new and innovative methods to part investors from their hard earned money. Many of the patterns of illicit activity summarized in this article are motivated by the economic incentives under which brokers operate: commissions based on trading activity. When presented with a possible claim of inappropriate or perhaps fraudulent investment activity, the practitioner should carefully review the facts not only in light of the legal and regulatory obligations imposed upon those in the brokerage community, but also to understand the economic motivations that encouraged and facilitated the broker to breach the legal and regulatory duties owed to the customer.

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ENDNOTES

1. A number of theories of liability are available to a plaintiff, including claims based upon the anti-fraud provisions of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5; the anti-fraud provisions of the Georgia Securities Act of 1973, O.C.G.A. § 10-5-14; common law fraud; breach of fiduciary duty; breach of contract; negligence; control person liability under the Securities Exchange Act, 15 U.S.C. § 78t(a) or the Georgia Securities Act 0f 1973, O.C.G.A. § 10-5-14(c); respondent superior liability; agency; and the Georgia Racketeer Influenced and Corrupt Organizations Act ("RICO"), O.C.G.A. § 16-14-4. Other federal statutes, such as the Employee Retirement Income Security Act ("ERISA") may come into play. Self-regulatory organization rules, such as the NASD rules or NYSE rules, also are relevant to the question of whether the broker has breached a duty owed to a customer.
2. 15 U.S.C. § 78o-3 and § 78s.
3. 15 U.S.C. § 78o-3(b)(6).
4. 15 U.S.C. § 78s(b)(1), (b)(2).
5. Spicer v. Chicago Bd. of Options Exch., Inc., 977 F.2d 255 (7th Cir. 1992); Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 200 (3d Cir. 1990); Shahmirzadi v. Smith Barney, Harris Upham & Co., 636 F. Supp. 49 (D. D.C. 1985); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983); Jablon v. Dean Witter & Co., 614 F.2d 677 (9th Cir. 1980); Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 160 (8th Cir. 1977).
6. Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981) (industry rules are "excellent tools against which to assess in part the reasonableness or excessiveness of a broker's handling of an investor's account"); Lang v. H. Hentz & Co., 418 F. Supp. 1376, 1383-84 (N.D. Tex. 1976) (NASD Rules provide evidence of the standard of care a member should have); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983). *See also*, Allen v. Lefkoff, Duncan, Grimes & Dermer, P.C., 265 Ga. 374, 453 S.E.2d 719 (1995)(violation of a Bar Rule is not determinative of the standard of care applicable in a legal malpractice action, but it may be circumstance that can be considered, along with other facts and circumstances, in determining negligence.)
7. *See* NASD Conduct Rule 2310(b); NYSE Rule 405(1); AMEX Rule 411. NASD Conduct Rule 2310(b) provides as follows:
   Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:
   (1) the customer's financial status;
   (2) the customer's tax status;
   (3) the customer's investment objectives; and
   (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.
8. NASD Conduct Rule 2310(a). This Rule provides as follows:
   In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

9. NASD Notice To Members 96-60 (Sept. 1996) (emphasis added).
10. NYSE Supplementary Material to Rule 472, Communications With The Public No. 90-5.
11. Ga. Comp. R. & Regs. r. 590-4-2-.14 (1)(a)(3) of the Georgia Securities Commission, entitled *Dishonest or Unethical Business Practices*, authorizes the Securities Commissioner to take action against brokers who: recommend[ ] to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the dealer, limited dealer, salesman, or limited salesman.
12. O.C.G.A. §§ 10-5-12(a)(1).
13. *See*, *e.g.*, NASD Conduct Rule 2110 (Members "shall observe high standards of commercial honor and just and equitable principles of trade."); NYSE Rule 401 ("Every member, allied member and member organization shall at all times adhere to the principals of good business practice in the conduct of his or its business affairs."); Rule 590-4-2.14(1) of the Georgia Securities Commission ("Every dealer, limited dealer, salesman and limited salesman shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of business").
14. O.C.G.A. 11-1-203; Jackson Elec. Membership Corp. v. Ga. Power Co., 257 Ga. 772, 364 S.E.2d 556 (1988); *see also* Restatement (Second) Contracts, § 231 (1986 App.) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). *But see*, Lake Tightsqueeze, Inc. v. Chrysler First Fin. Servs. Corp., 210 Ga. App. 178, 435 S.E.2d 486 (1993)("the failure to act in good faith in the performance of contracts or duties under the Uniform Commercial Code does not state an independent claim for which relief may be granted.")
15. Rule 590-4-2-.08 of the Georgia Securities Commission, entitled *Supervision of Salesmen, Limited Salesmen, and Employees*, provides that "(1) Every dealer and limited dealer registered or required to be registered under the Act shall exercise diligent supervision over the securities activities of all of its salesmen and employees." The Rule sets forth various procedures by which proper supervision can be accomplished.
16. NASD Conduct Rule 3010 provides:
 (a) Supervisory System.
 Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association. Final responsibility for proper supervision shall rest with the member.
 . . .
 (b)Written Procedures.
 Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association.
 NYSE Rule 405(2) provides:
 Every NYSE member shall "supervise diligently all accounts handled by registered representatives of the organization."
17. E. F. Hutton & Co. v. Weeks, 166 Ga. App. 443, 445, 304 S.E.2d 420, 422 (1983) ("The broker's duty to account to its customer is fiduciary in nature, resulting in an obligation to exercise the utmost good faith."); Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) ("The law is clear that a broker owes a fiduciary duty of care and loyalty to a securities investor."); *accord* RESTATEMENT (SECOND) OF AGENCY § 425 (1957) (agents who are employed to make, manage, or advise on investments have fiduciary obligations).
18. O.C.G.A. § 23-2-58.
19. Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) (quoting Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) *aff'd*, 647 F.2d 165 (6th Cir. 1981)).
20. Thompson v. Smith Barney, Harris Upham & Co., 709 F. 2d 1413, 1416 (11th Cir. 1983); Costello v. Oppenheimer & Co., 711 F.2d 1361 (7th Cir. 1983).
21. Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b), provides, in pertinent part that:
 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange…
 (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
22. *See* Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1206-07 (9th Cir. 1970); Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983)(churning may be a deceptive and manipulative action under 10b-5). Rule 10b-5, promulgated by the Securities and Exchange Commission pursuant to the authority granted to it by Section 10b of the Securities Exchange Act, provides:
 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
 (a) To employ any device, scheme, or artifice to defraud,
 (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
23. Rule 590-4-2-.14(1)(a)(2) of the Georgia Securities Commission, entitled *Dishonest or Unethical Business Practices*, authorizes the Securities Commissioner to take action against brokers who "induc[e] trading in a customer's account which is excessive in size or frequency in view of the financial resources and character of the account." Violation of the Rule is a violation of the Georgia Securities Act, § 10-5-12(a)(1).
24. *See* nn. 19-21, *supra*
25. Most customer agreements and trade confirmations incorporate industry rules and regulations into the contract with the customer. For

example, a Bear Stearns Customer Agreement provides:

APPLICABLE LAW, RULES AND REGULATIONS. All transactions shall be subject to the applicable laws, rules and regulations of all federal state and self-regulatory authorities, including, but not limited to, the rules and regulations of the Board of Governors of the Federal Reserve System and the constitution, rules and customs of the exchange or market (and clearing house) where such transactions are executed.

Violations of industry rules and regulations by a broker/dealer or registered representative give rise to breach of contract claims if damages result.

26. A broker's violation of regulatory duties, while generally recognized to not give rise to a private right of action, may provide evidence in evaluating whether the broker/dealer properly exercised the required degree of care in dealings with a customer. *See*, *e.g.,* Allen v. Lefkoff, Duncan, Grimes & Dermer P.C., 265 Ga. 374, 453 S.E.2d 719 (1995)(violation of a Bar Rule is not determinative of the standard of care applicable in a legal malpractice action, but it may be circumstance that can be considered, along with other facts and circumstances, in determining negligence.).
A number of courts have held that a violation of regulatory rules may be the basis of a claim sounding in negligence. Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981) (industry rules are "excellent tools against which to assess in part the reasonableness or excessiveness of a broker's handling of an investor's account"); Lang v. H. Hentz & Co., 418 F. Supp. 1376, 1383-84 (N.D. Tex. 1976) (NASD Rules provide evidence of the standard of care a member should have); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427 (E.D. Mich. 1983). *See also*, NASD Conduct Rule 2120 ("No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.")
27. Under common law agency principles, the principal (the broker/dealer) is liable for the torts of its agents (its registered representatives) done within the scope of the principals business. O.C.G.A. § 51-2-2. Further, under both federal and state law, "control persons" may be held liable for the acts and omissions of those over whom they hold the ability to discipline or influence. *See*, Section 20(a) of the Securities and Exchange Act, 15 U.S.C. § 78t(a); Harrison v. Dean Witter Reynolds, Inc., 79 F.3d 609 (7th Cir. 1996); Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (en banc)(control found where primary violator was a registered representative of the firm and had some direct means of discipline or influence over them). The Georgia Securities Act similarly provides for liability of "control persons," subject to a "good faith" defense. O.C.G.A. § 10-5-14(c).
28. Levin v. Shearson Lehman/ American Express, Inc., [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,080 (S.D.N.Y. June 14, 1985). To calculate the annual rate of turnover in an account, divide the total purchases in the account by the average amount invested in the account. Then divide that figure by the number of months in the time period the account has been open to determine the monthly rate of turnover. Multiply that figure by twelve (12) to determine the annual turnover.
29. Freundt-Alberti v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 134 F.3d 1031, 1032 (11th Cir. 1998)(referring to benchmark annual turnover ratio of six); Craighead v. E.F. Hutton & Co., 899 F.2d 485, 490 (6th Cir. 1990); Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1502 (11th Cir. 1985); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); Moran v. Kidder Peabody & Co., 609 F. Supp. 661 (S.D.N.Y. 1985), *aff'd*, 788 F.2d 3 (2d Cir. 1986).
30. *See* In re Thomson McKinnon Sec., Inc., 191 B.R. 976 (Bankr. S.D.N.Y. 1996)(turnover rate of 2.2 creates question of fact for jury to decide if activity was excessive).
31. *See* Thompson v. Smith Barney, Harris, Upham & Co., 539 F. Supp. 859 (N.D. Ga. 1982), *aff'd*, 709 F. 2d 1413 (11th Cir. 1983) (plaintiff who knew his account was being constantly traded, who had financial acumen to determine his own best interests and who desired frequent trading, could not establish excessive trading).
32. *See* Mihara v. Dean Witter & Co., 619 F.2d 814, 819 (9th Cir. 1980) (excessive trading established where 50% of securities held for less than 15 days).
33. *See*, *e.g.,* Smith v. Petrou, 705 F. Supp. 183 (S.D.N.Y 1989)(commissions generated by account was substantial portion of broker' s income). Accord, Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836 (E.D. Va. 1968); Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970).
34. The elements of a securities fraud action under of the 1934 Act are: (1) false representation or omission of a material fact; (2) made with scienter - a mental state embracing an attempt to deceive, manipulate or defraud; (3) in connection with the purchase or sale of a security; (4) upon which the claimant reasonably relied; (5) that proximately causes damage. *See* Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1046-47 (11th Cir. 1987); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413 (11th Cir. 1983); Diamond v. Lamotte, 709 F.2d 1419 (11th Cir. 1983). The standard for determining materiality is whether "there is a substantial likelihood that a reasonable shareholder would consider it important" or "a substantial likelihood that the disclosure…would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TCS Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); SEC v. Carriba Air, Inc., 681 F.2d 1318, (11th Cir. 1982) (The test for determining materiality is whether a reasonable man would attach importance to the fact misrepresented or omitted in determining his course of action).
35. Georgia Code Section 10-5-14 provides a cause of action against a seller of securities for violating Section 10-5-12 for making an untrue statement of a material fact or omiting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading. Liability will not be found however, if (1) the purchaser knew of the untrue statement of a material fact or omission of a statement of a material fact; or (2) the seller did not know and in the exercise of reasonable care could not have known of the untrue statement or misleading omission. O.C.G.A. § 10-5-14. There is very little case law interpreting the Georgia Securities Act. Its civil liability provisions are analogous to the federal statutes. Although the language

of the Georgia statute does not appear to require scienter, courts have construed the section in accordance with 10b-5 as requiring proof of scienter. Currie v. Cayman Resources Corp, 595 F. Supp. 1364 (N.D. Ga. 1984), GCA Strategic Inv. Fund, Ltd. v. Joseph Charles & Assocs., Inc., 245 Ga. App. 460, 464, 537 S.E.2d 677 (2000). Georgia blue sky law does not require proof of reliance. One advantage of a claimant proceeding under the Georgia Act is the provision for recovery of attorney's fees, interest, and court costs. O.C.G.A. § 10-5-14(a).

36. Elements of fraud in Georgia are: (1) false representation of an existing fact or past event; (2) scienter, (3) intention to induce plaintiff to act or refrain from acting, (4) justifiable reliance by plaintiff and (5) damage to plaintiff. *See*, *e.g.*, Fuller v. Perry, 223 Ga. App. 129, 476 S.E.2d 793, 795 (1996). Nondisclosure may provide the basis for constructive fraud where a party is under an obligation to communicate. O.C.G.A. § 23-2-53. The obligation to communicate may arise from the confidential relations of the parties or from the particular circumstances of the case. *See also* O.C.G.A. § 23-2-51(b). Under Georgia law, a confidential relationship imposes a greater duty on the parties to reveal what should be revealed, and a lessened duty to discover independently what could have been discovered through the exercise of ordinary care. Hunter, Maclean, Exley & Dunn, P.C. v. Frame, 269 Ga. 844, 847-48, 507 S.E.2d 411 (1998).
37. *See* nn. 8-11 *supra.*, "[T]he making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for such recommendations, which in turn, requires that, as a prerequisite, he shall have made a reasonable investigation." Distribution By Broker-Dealers of Unregistered Securities, Exchange Act Release No. 4445, 1962 WL 69442 (Feb. 2, 1962).
38. "Penny" stocks are generally considered to be those whose market price is less than $5.00.
39. *See* nn. 23-24, *supra.*
40. *See* n. 25, *supra.*
41. *See* n.28, *supra.*
42. *See* n. 27, *supra.*
43. *See* nn. 19-21, *supra.* As set forth by the Eleventh Circuit, the fiduciary duties of an investment broker include "the duty to recommend [investments] only after studying it sufficiently to become informed as to its nature, price, and financial prognosis." Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) (quoting Lieb v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) *aff'd*, 647 F.2d 165 (6th Cir. 1981).
44. *See* n. 7, *supra.*
45. *See*, *e.g.*, NYSE Rule 408; NASD Conduct Rule 2510, IM 2310-2(4)(iii). Glisson v. Freeman, 243 Ga. App. 92, 99 532 S.E.2d 442, 449 (2000)("With respect to a nondiscretionary account, . . . the broker owes a number of duties to the client, including the duty to transact business only after receiving prior authorization from the client. . . ."). At least one court has held that basic principles of agency law required the broker to inform the customer of his right to reject unauthorized purchases. Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128 (D.C. Cir. 1990).
46. *See* n. 23, supra. *See*, *e.g.*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1212 (8th Cir. 1990).
47. Rule 590-4-2-.14(1)(a)(4) of the Georgia Securities Commission, *Dishonest or Unethical Business practices*, authorizes the Securities Commissioner to take action against brokers who "executing a transaction on behalf of a customer without authorization to do so." Ga. Comp. R. & Regs. r. 590-4-2-14. Violation of the Rule is a violation of the Georgia Securities Act, § 10-5-12(a)(1).
48. *See*, *e.g.*, Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599 (1999) "One of the time-honored investment maxims is that risk can be reduced by diversification." Burton Malkiel & William Baumol, *Redundant Regulation of Foreign Security Trading and U.S. Competitiveness*, in MODERNIZING U.S. SECURITIES REGULATION, 39, 45 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992). "The single most important step most investors can take to immediately improve the long range performance of their portfolios … is to properly diversify their common stock investments." Norman G. Fosback, STOCK MARKET LOGIC: A SOPHISTICATED APPROACH TO PROFITS ON WALL STREET 252 (1985). There is general agreement that it takes at least 10, and usually 15-20, non-correlated stocks to achieve adequate diversification and thereby reduce nonsystematic risk. *See* Edwin J. Elton & Martin J. Gruber, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS 31 (3d ed., 1987).
49. "Diversification is a uniformly recognized characteristic of prudent investment." Robertson v. Cent. Jersey Bank & Trust Co., 47 F.3d 1268, 1275 n. 4 (3d Cir. 1995), citing RESTATEMENT (THIRD) OF TRUSTS § 229(d) (1992).
50. As explained by the court in Walck v. Am. Stock Exch., Inc., 687 F.2d 778, 780 (3d Cir. 1982), "[t]he margin device permits a broker to extend credit to his customer to finance the customer's transactions, with the broker holding a security interest in the securities purchased as collateral for the loan. The customer pays an agreed percentage of the purchase price by depositing cash or other securities, and the broker holds the stock purchased as collateral for the balance. The broker in turn often finances the purchase by using the securities purchased as collateral for a bank loan."
51. Regulation T of the Federal Reserve Board, 12 C.F.R. § 220.1-18. A customer purchasing stock on margin generally must advance a minimum of 50% of the purchase price in cash or in securities. In addition, the NASD, NYSE, and brokerage firms set their own "margin maintenance" requirements, and in some instances, do not permit certain securities to be used as collateral for margin borrowing. Currently, NASD and stock exchange rules require 25 percent margin maintenance, and many firms require 30 percent to 35 percent maintenance.
52. 17 C.F.R. § 240.17a-3(a)(9)(iii); 17 C.F.R. § 240.10b
53. In the Matter of Laurie Jones Canady, Exchange Act Release No. 41250, (Apr. 5, 1999).
54. *See*, *e.g.*, Martin v. Shearson Lehman Hutton, Inc., 986 F.2d 242 (8th Cir. 1993).
55. NASD Notice to Members 85-21.
56. NASD Conduct Rule 2211.
57. Securities Exchange Act, Sec. 17(a) and Rule 17a-3(a)(6).
58. NYSE Rule 440.