COMMON THEORIES OF STOCKBROKER AND BROKERAGE FIRM LIABILITY

Common fact patterns associated with broker misconduct[1] include churning,[2] unsuitable recommendations (including overconcentration/failure to diversify, use of excessive margin, failure to use hedge strategies, and mutual fund or annuity switching)[3], unauthorized trading,[4] and failure to supervise.[5] Federal and state securities statutes, and state common law typically govern civil liability in connection with such conduct. Other federal statutes, such as the Employee Retirement Income Security Act ("ERISA"), may come into play. Also relevant to the issue of whether a broker owed or breached a duty to the customer are the self-regulatory organization

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[1] See R.C. Port, "Common Fact Patterns of Stockbroker Fraud and Misconduct", *Georgia Bar Journal,* June 2002.

[2] "Churning occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions." Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416 (11th Cir. 1983).

[3] NASD Conduct Rules require that a broker recommend that a client engage in a securities transaction only if the broker has "reasonable grounds for believing that the recommendation is suitable for such customer" based on the customers financial circumstances, risk tolerance, and other circumstances. NASD Conduct Rule 2310(a).

[4] 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. 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. . . ."); Gochnauer v. A.G. Edwards-&-Sons, 810 F. 2d 1042, 1049 (11th Cir. 1987) (describing the broker's "duty to transact business only after receiving approval from the customer").

[5] Section 15(b)(4)(E) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(4)(E) requires brokers-dealers to reasonably supervise its associated persons "with a view to preventing violations . . . [of the securities law] . . ." See also, Rule 590-4-2-.08 of the Georgia Securities Commission, entitled *Supervision of Salesmen, Limited Salesmen, and Employees*; NASD Conduct Rule 3010(b); NYSE Rule 405(2):

rules, such as the NASD rules or NYSE rules. The following is a brief overview of common of legal theories of liability that apply to such conduct.

FEDERAL AND STATE LEGISLATION

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5; Georgia Securities Act O.C.G.A. § 10-5-1, et seq.

Section 10 of the Securities Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, are federal "anti-fraud" provisions. They prohibit "any manipulative or deceptive device or contrivance" or the use of "any device, scheme, or artifice to defraud" in "in connection with the purchase or sale of any security." The elements of a 10b-5 claim are similar to the elements of a common law fraud claim: (1) a misstatement or omission; (2) of a material fact; (3) made with scienter; (4) upon which the plaintiff relied; (5) that proximately caused the plaintiff's loss. See, Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1046-47 (11th Cir. 1987); McDonald v. Alan Bush Brokerage Co., 863 F.2d 809 (11th Cir. 1989). 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 Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); SEC v. Carriba Air, Inc., 681 F.2d 1318, (11th Cir. 1982).

Georgia's Securities Act contains a similar prohibition, but its remedies are available only to a buyer of securities. O.C.G.A. § 10-5-14; see, Kirk v. First National Bank, 439 F. Supp. 1141 (N.D. Ga. 1977); Collins v. Norton, 136 Ga. App. 105, 220 S.E.2d 279 (1975). O.C.G.A. § 10-5-14 provides a cause of action against a seller for making "an untrue statement of a material fact or omit[ing] 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.

Control Person Liability

Federal Law

Under Section 20(a) of the Securities and Exchange Act, 15 U.S.C. § 78t(a), any person who directly or indirectly controls any person who is liable for selling securities in violation of the act is liable to the same extent as the seller, unless he acted in good faith and did not directly or indirectly induce the act at issue. The brokerage firm, as well as supervisors of the stockbroker, may be liable as "controlling persons" for the acts of the broker. Liability is premised upon the ability of the firm and its supervisors to have "some direct means of discipline or influence" over the stockbroker. Harrison v. Dean Witter Reynolds, Inc., 79 F.3d 609 (7th Cir. 1996); see also, Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (en banc).

Georgia Law

The Georgia Securities Act also provides for liability of "control persons," subject to a "good faith defense." O.C.G.A. § 10-5-14(c) provides for joint and several liability unless the control person "sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known of the existence of the facts by reason of which liability is alleged to exist." A control person may escape liability by showing that "he did not take an active part in the violation, that he did not know of the violation and that as a reasonably prudent man he would not have discovered the violation." Gilbert v. Meason, 137 Ga. App. 1, 5

(1975); Hamilton Bank & Trust v. Holliday, 469 F. Supp. 1229, 1244 (N.D. Ga. 1979).

Federal RICO

As a result of the Private Securities Litigation Reform Act of 1995, conduct forming the basis for a 10b-5 claim cannot be used as predicate acts for federal RICO. 18 U.S.C. § 1964(c) was amended to provide that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962."

Georgia RICO

Georgia's RICO act was enacted after the federal RICO statute and contains substantially the same language, and is subject to essentially similar construction. Stiller v. Sumter Bank & Trust Co., 860 F. Supp. 835, 839 n. 3 (M.D. Ga. 1994); Mills v. Fitzgerald, 668 F. Supp. 1554, 1561 (N.D. Ga. 1987); Stanton v. Shearson Lehman/ American Express, Inc., 622 F. Supp. 293, 294 (N.D. Ga. 1985).

The Georgia RICO statute specifically provides that "racketeering activity" includes committing, attempting to commit, soliciting, coercing, or intimidating another person to commit a willful violation of the Georgia Securities Act of 1973, O.C.G.A. § 10-5-1. O.C.G.A. § 16-14-3(9)(A)(xxi).

Fair Business Practices Act

The Fair Business Practices Act, O.C.G.A. § 10-1-391 *et seq*. does not apply to securities or commodities transactions. Taylor v. Bear Stearns & Co., 572 F. Supp. 667, 675 (N.D. Ga. 1983)("where a consumer remedy exists, with no need to fill in a legal gap or create a consumer right, and where the industry which is the subject matter of the situation explicitly defines wrongful conduct or unfair and deceptive practices, the FBPA has no application.").

COMMON LAW THEORIES OF LIABILITY

Breach of Fiduciary Duty

Under Georgia law, a confidential, fiduciary relationship exists between a broker and his client. "[A] stockbroker's duty to account to its customer is fiduciary in nature, so that the broker is obligated to exercise the utmost good faith." Glisson v. Freeman, 243 Ga. App. 92, 98, 532 S.E.2d 442, 449 (2000), *quoting* Minor v. E. F. Hutton & Co., 200 Ga. App. 645, 409 S.E.2d 262 (1991) (citations and punctuation omitted); see also, E. F. Hutton & Co. v. Weeks, 166 Ga. App. 443, 445, 304 S.E.2d 420, 422 (1982).

As set forth by the Eleventh Circuit, the fiduciary duties of an investment broker include:

> (1) the duty to recommend [an investment] 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.

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)).

In considering whether a broker properly exercised his fiduciary duties to a customer, an evaluation of the broker's actions under the "prudent investor" rule would be appropriate. Georgia has codified the standards and obligations of a trustee in investing property held in trust at O.C.G.A. § 53-12-287(b) and (c).

Fraud.

Under Georgia law, fraud is shown when (i) a representation of material fact is made (or there is a failure to disclose a material fact); (ii) that was known or should have been known to be false (or should have been disclosed); (iii) that was made (or omitted) for the purpose of being relied upon by another; (iv) that was in fact relied upon; (v) that caused damage. See, e.g., Fuller v. Perry, 223 Ga. App. 129, 476 S.E.2d 793, 795 (1996); Oklejas v. Williams, 165 Ga. App. 585, 586, 302 S.E.2d 110, 111 (1983). Willful misrepresentation of a material fact, or reckless representation made with intent to deceive, is sufficient. O.C.G.A. § 51-6-2.

Nondisclosure may provide the basis for constructive fraud where a party is under an obligation to communicate. Where a confidential or fiduciary relationship exists -- as is the case with a broker and his/her client – the client is entitled to rely on representations made by the broker, and it may not be a defense to a fraud claim that they did not exercise ordinary diligence. See, e.g., Allen v. Sanders, 176 Ga. App. 647, 337 S.E.2d 428 (1985)(partner entitled to rely on representations made by another partner). See also O.C.G.A. § 23-2-51(b); O.C.G.A. § 23-2-53.

Negligence

A broker's violation of his regulatory duties, while generally recognized to not give rise to a private right of action, may provide evidence in evaluating whether the broker properly exercised the required degree of care in their 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 a circumstance that can be considered, along with other facts and circumstances, in determining negligence.). See also, 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").

Breach of Contract

Most customer agreements and trade confirmations incorporate applicable laws, rules and regulations into the contract with the customer. Therefore, violations of industry rules and regulations by the broker give rise to a breach of contract claim if damage results. See, e.g., Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971)

Respondent Superior/Agency Principles

Under common law agency principles, the principal (the brokerage firm) is liable for the torts of its agents (its stockbrokers) done within the scope of the firm's business. O.C.G.A. § 51-2-2. Under this theory, brokerage firms typically are held responsible for a stockbroker's unintentional acts in handling a customer account as well as some intentional misconduct taken within the scope of handling the account, such as churning and placing unauthorized trades.

CONCLUSION

When presented with a litigation matter involving the purchase or sale of securities, a practitioner should carefully investigate the availability of the various statutory and common law claims and defenses that such circumstances present. While the conduct at issue may form a basis for a variety of legal claims, the successful prosecution or defense of a case will in large measure rest upon the theories of recovery pursued.