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CHURNING IN SECURITIES: FULL COMPENSATION FOR THE INVESTOR

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I. INTRODUCTION

In the context of securities accounts, the relationship of broker and customer is generally one of trust.[1] The customer assumes that his or her portfolio will be managed to its best advantage and that the stocks comprising it will be retained or traded in a fiscally rational manner. However, the broker's dual roles as adviser with a fiduciary interest in the customer and salesman with a sometimes scheming interest in commissions suggest the potential for conflict. Brokers may be tempted to "churn up" accounts for the sole purpose of generating commissions.[2] Poetically labeled "churning," this offense consists in the broker's inducing of transactions in an account, excessive in size and frequency in light of the character of the customer's account.[3]

As recently as the 1960's, few customers brought civil actions against brokers for churning.[4] In prior years, the problem was addressed almost exclusively by the Securities and Exchange Commission in actions brought under the antifraud provisions of the federal securities acts.[5] In the last decade, however, an ever-increasing number of

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1. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. 1981); Mihara v. Dean Witter & Co., 619 F.2d 814, 821-22 (9th Cir. 1980); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970); Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 870 (1967). *But see infra* note 47.

2. *See Miley*, 637 F.2d at 326; Note, *supra* note 1, at 870.

3. *See Miley*, 637 F.2d at 324; *Mihara*, 619 F.2d at 820-21; *Rolf*, 570 F.2d at 44-45; Juster v. Rothschild, Unterberg & Towbin, 554 F. Supp. 331, 332-33 (S.D.N.Y. 1983).

4. *See* Note, *supra* note 1, at 869.

5. *See id.* The SEC was a creation of the Securities Exchange Act of 1934. Ch. 404, § 4, 48 Stat. 881, 885 (codified as amended at 15 U.S.C. § 78(d) (1976)). Two years later, the SEC was vested by statute with enforcement mechanisms specifically designed to aid it in the oversight of brokers and dealers. Act of May 27, 1936, Pub. L. No. 621, § 3, 49 Stat. 1375, 1378 (1936) (codified as amended at 15 U.S.C. § 78*o*(b) (1976)). In 1937, rules were enacted under which the first SEC actions against churners would be brought. 2 Fed. Reg. 1389 (1937) (codified as amended at 17 C.F.R. §§ 240.15c1-1 to .15c1-8 (1983)). These rules gave meaning to the federal

civil actions have been brought against brokers alleging churning.[6] The suits, usually brought in the federal courts,[7] have been waged under a variety of new theories of recovery.[8] This article will outline the causes of action that have been relied upon by customers, after a brief description of the elements of proof necessary in such a case. The damages allowed by the courts and possible defense tactics will be considered later. The article will conclude with some reasons for concern with the courts' current capacity to offer redress for the problem.

II. THE PRIMA FACIE CASE

A. The Offense

A broker's excessive trading of an account to generate commissions is an offense against both federal securities law and state common

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securities acts' prohibition of the use of "any manipulative, deceptive, or other fraudulent device or contrivance" in securities transactions. 15 U.S.C. § 78*o*(c)(1) (1976). The rules most pertinent to the offense of churning specifically define "device or contrivance" to include (1) "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," 17 C.F.R. § 240.15cl-2(a) (1983), and (2) "any transactions or purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account," 17 C.F.R. § 240.15c1-7(a) (1983). For a discussion of these rules, see L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 803-05 (1983).

A number of years after their adoption, this arsenal of rules began to be used by the SEC in actions against brokers and dealers charged with churning. However, the procedures and sanctions of an SEC administrative adjudication differ markedly from those of the typical private suit for churning. S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS § 7.08 (1977); N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.01, at 2-5 to 2-9 (1977). Moreover, the statutory foundation of the typical SEC action is often of limited applicability to the private right of action for churning *See supra* note 66 and accompanying text. This article will address only the *private right of action* for churning. For a sampling of the occasions when the SEC has addressed churning and the closely related doctrine of unsuitability, see *In re* Cipar, Sec. Exch. Act Release No. 19,633 (Mar. 28, 1983); *In re* Tennenbaum, Sec. Exch. Act Release No. 18,429 (Jan. 19, 1982); *In re* Donaldson, Lufkin & Jenrette Sec. Corp., Sec. Exch. Act Release No. 17,416 (Jan. 6, 1981); *In re* Bear, Stearns & Co., Sec. Exch. Act Release No. 16,023 (July 16, 1979); *In re* Kinderdick, Sec. Exch. Act Release No. 12,818 (Sept. 21, 1976); *In re* Batterman, 46 S.E.C. 304 (1976); *In re* Fenocchio, Sec. Exch. Act Release No. 12,194 (Mar. 11, 1976); *In re* Merrill Lynch, Pierce, Fenner & Smith Inc., Sec. Exch. Act Release No. 11,515 (July 2, 1975); *In re* Mississippi Valley Inv. Co., Sec. Exch. Act Release No. 12,683 (Aug. 2, 1972); *In re* Shearson, Hammill & Co., 42 S.E.C. 811 (1965); *In re* R.H. Johnson & Co., 36 S.E.C. 467 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); *In re* Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347 (1945).

6. *See Miley*, 637 F.2d at 323.

7. *See id.*

8. *See id.* at 326 (churning creates a private right of action under § 10(b) of the Securities Exchange Act of 1934, and common-law breach of fiduciary duty); *Rolf*, 570 F.2d at 43-44 (churning creates an action for aiding and abetting and may create vicarious liability under the controlling persons doctrine of § 20(a) of the Securities Exchange Act of 1934, and/or the common-law doctrine of respondeat superior); Brodsky, *Measuring Damages in Churning and Suitability Cases*, 6 SEC. REG. L.J. 157, 158-59 (1978) (variety of measures of damages).

law.[9] From this offense the broker's customer suffers two distinct harms.[10] First, the customer is charged *excessive commissions* irrespective of any increase or decrease in the value of the customer's portfolio.[11] Second, the customer's portfolio may suffer in value under a deluge of *unsuitable transactions* entered merely to generate fees for the broker.[12] Whether the transactions are unsuitable as well as excessive is determined by examining the customer's objectives and the market conditions at the time of the alleged offense.[13]

Churning has been characterized as a "unified offense": an offense not limited to any specific transaction or transactions.[14] Rather, the essence of churning is an aggregation of transactions.[15] That is, a broker's handling of an account is viewed in hindsight and compared to the customer's actual needs and wishes.[16] Because there are numerous legitimate ways for a broker to handle an account—and because even the best of faith by a broker can result in trading losses—we shall see that proof of damages in a churning cause of action is difficult indeed.[17]

B. Elements of the Case

Three elements are essential to establish churning: 1) excessive trading in light of the customer's investment objectives, 2) the broker's exercise of control over trading in the account, and 3) an intent to defraud by the broker or willful and reckless disregard for the customer's

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9. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 324-25 (5th Cir. 1981); Mihara v. Dean Witter & Co., 619 F.2d 814, 820-21 (9th Cir. 1980); Comment, *Private Actions for the Broker's Churning of a Securities Account*, 40 MO. L. REV. 281, 292-95 (1975).

10. *See Miley*, 637 F.2d at 326; Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 48-49 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Brodsky, *supra* note 8, at 159-61.

11. *See Miley*, 637 F.2d at 326; *Rolf*, 570 F.2d at 48, 50; Mauriber v. Shearson/Am. Express, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529 (S.D.N.Y. July 11, 1983); Brodsky, *supra* note 8, at 159.

12. *See* S. JAFFE, *supra* note 5, at 307 ("high trading activity is also high risk activity and, with the possible exception of trading by a highly skilled professional, unprofitable"). *See also Miley*, 637 F.2d at 326; Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFFALO L. REV. 435, 445 (1977); Brodsky, *supra* note 8, at 159.

13. *See Miley*, 637 F.2d at 327; *Mihara*, 619 F.2d at 820-21; Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975); Brodsky, *supra* note 8, at 158; Comment, *supra* note 9, at 281-82.

14. *See Miley*, 637 F.2d at 327.

15. *See id.*; Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970); *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 846-47 (E.D. Va. 1968).

16. *See Miley*, 637 F.2d at 327; *Mihara*, 619 F.2d at 821; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; *Stevens*, 288 F. Supp. at 846; Brodsky, *supra* note 8, at 158-59; Comment, *supra* note 9, at 284.

17. *See, e.g.*, *Miley*, 637 F.2d at 327; *Stevens*, 288 F. Supp. at 849-50. *See also* notes 135-38 and accompanying text.

interests.[18] Proof of these elements has been held to permit recovery under the federal securities laws' section 10(b)[19] and rule 10b-5.[20] Moreover, these same elements may at times be sufficient to prove pendent state claims such as common-law fraud[21] and breach of the broker's fiduciary duty to his or her customer.[22]

1. Excessive Trading

Issues of proof of excessive trading center on whether the size and frequency of the transactions engaged in by the broker were excessive in regard to the needs and objectives of the customer and the type of account involved.[23] Since churning is considered a unified offense, a review of the whole series of transactions entered by the broker for the customer is necessary to determine if the transactions were "excessive." Courts utilize a number of factors and techniques to analyze the issue of excessive trading.

The investment objectives of the customer are a primary factor.[24] If the customer is interested in short-term, speculative profits, more activity than average should be expected.[25] However, if the customer

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18. *See* Thompson v. Smith Barney, Harris, Upham & Co., 709 F.2d 1413, 1416-17 (11th Cir. 1983); *Miley*, 637 F.2d at 324; *Mihara*, 619 F.2d at 821; Rolf v. Blyth, Eastman Dillon & Co., 424 F. Supp. 1021, 1039-40 (S.D.N.Y. 1977), *aff'd in part and rev'd in part*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

Compare the elements of the offense as set out in the proposed Federal Securities Code:

> It is unlawful for a broker, dealer, municipal broker, or municipal dealer to effect with or for a customer with respect to whose account he or his agent exercises investment discretion, or is in a position to determine the volume and frequency of transactions by reason of the customer's willingness to follow his or his agent's suggestions, transactions that are excessive in volume or frequency on consideration, of the amount of profits or commissions of the broker, dealer, municipal broker, municipal dealer, or his agent in relation to the size of the account and such other factors as the size and character of the account, the needs and objectives of the customer as ascertained on reasonable inquiry, and the pattern of trading in the account.

FEDERAL SEC. CODE § 1606 (Proposed Official Draft 1978).

19. 15 U.S.C. § 78j(b) (1976).

20. 17 C.F.R. § 240.10b-5 (1983). *See Miley*, 637 F.2d at 324; *Mihara*, 619 F.2d at 820; McNeal v. Paine, Webber, Jackson & Curtis, Inc., 598 F.2d 888, 890 n.1 (5th Cir. 1979); *Hecht*, 430 F.2d at 1206-07; *Carras*, 516 F.2d at 281.

21. *Cf.* Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1024 (6th Cir. 1979) (claim for relief under § 10(b) and rule 10b-5 essentially counterpart to common-law fraud). *But see Stevens*, 288 F. Supp. at 847-48.

22. *See Miley*, 637 F.2d at 324-25.

23. *See Thompson*, 709 F.2d at 1416-17; *Miley*, 637 F.2d at 324-25; *Mihara*, 619 F.2d at 820-21; *Carras*, 516 F.2d at 258; *Hecht*, 430 F.2d at 1206-07; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; *Stevens*, 288 F. Supp. at 845-47; Comment, *supra* note 9, at 284-86.

24. *See Miley*, 637 F.2d at 333-34; *Mihara*, 619 F.2d at 820-21; *Hecht*, 430 F.2d at 1206-07; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; *Stevens*, 288 F. Supp. at 845-47; Comment, *supra* note 9, at 284-85.

25. *See Thompson*, 709 F.2d at 1417 (no churning found when investor desired to "play the

desires conservative investments to generate profits from dividends and long-term growth, less than average activity should occur.[26] Problems arise when the customer's investment policies are unclear or have internal inconsistencies.[27] The broker, because of his experience and knowledge, has the duty to clarify the customer's objectives and to explain the inconsistencies.[28] Fulfilling this duty will not only allow the broker to meet his or her contractual obligations to the customer, but will also protect the broker from later, unjustified claims that the customer's objectives were compromised by excessive trading.[29]

In establishing excessive trading, many courts also employ "turnover rate" calculations. Here, the total cost of purchases for the account during a given period of time is compared to the amount invested at the beginning of the period.[30] The turnover rate necessary to constitute churning has varied, depending upon the facts of the case.[31]

In-and-out trading is another example of excessive trading.[32] This pattern of trading occurs when all or part of a customer's portfolio is sold with the proceeds immediately invested in other securities. These new securities are then sold within a short period of time.[33] A similar

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market" and knew investments were inconsistent with a conservative strategy); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676-78 (9th Cir. 1982) (investor "was a trader looking for quick, short-term gains, and taking short-term gains and losses requires frequent trading"; no churning was established).

26. *See* Note, *supra* note 1, at 874-75; *Miley*, 637 F.2d at 325, 334 n.13.

27. *See* Note, *supra* note 1, at 874-75; *Thompson*, 709 F.2d at 1417; *Miley*, 637 F.2d at 325, 334 n.13.

28. *See* Note, *supra* note 1, at 875. *See also infra* notes 68-69 (the Know Your Customer Rule of the NYSE and the Suitability Rule of the NASD).

29. *See* Note, *supra* note 1, at 875.

30. *See Mihara*, 619 F.2d at 819; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; *Stevens*, 288 F. Supp. at 842; Note, *supra* note 1, at 875.

31. *See Mihara*, 619 F.2d at 819 (average monthly turnover for a period of two years and six months was 14 times and clearly supported a finding of excessive trading); *Stevens*, 288 F. Supp. at 842 (an average of greater than two turnover rate per year was clearly evidence of excessive trading); *Hecht*, 430 F.2d at 1210 (court affirmed that a turnover rate between 8.04 and 11.5 times during a six-year, ten-month period was evidence of churning).

"While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading." *Mihara*, 619 F.2d at 821 (citations omitted). In *Mauriber*, the court stated that the failure of the plaintiff to calculate a turnover rate was not fatal to the case; the turnover rate is not determinative of the plaintiff's case. *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529.

32. *See Mihara*, 619 F.2d at 819; *Stevens*, 288 F. Supp. at 842; Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 436 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); Comment, *supra* note 9, at 285; Note, *supra* note 1, at 876-77.

33. *See* Note, *supra* note 1, at 876-77. *See also Mihara*, 619 F.2d at 819 (during two-year, six-month period, 81.6% of securities were held for 180 days or less); *Stevens*, 288 F. Supp. at 840 (during five-year period, 85% of the securities were held less than six months, 70% were held 90 days or less, and 39% were held 30 days or less); *Hecht*, 283 F. Supp. at 436 (during six-year, ten-month period, 45% of securities were held less than six months, 67% were held less than nine months, and 82% were held less than a year).

abuse is reversal trading whereby particular securities are sold and then repurchased within a short period of time.[34] In shuffling or cross-trading, a broker manipulates his or her customers' accounts so that the customers effectively buy and sell only from one another.[35] Proof of any of these schemes is adduced through detailed listings of the transactions made during the alleged churning period.[36] Justifying any of these particular trading patterns will be very difficult for the broker.[37]

Brokerage profits excessive in view of the size of the customer's investment are another factor considered by the courts.[38] These high profits generally coincide with a high turnover rate. In many cases, the fees generated from the churned customer's account represent a large portion of that broker's entire income.[39]

2. The Broker's Exercise of Control

Proof of exercise of control by the broker over the customer's account is determined by the facts and circumstances of each case.[40] Clearly, in a discretionary account arrangement, the broker has control.[41] Likewise, a broker is "in control" when he or she influences the customer to such an extent that the broker is, in effect, making the decision to invest and the customer is relying upon his or her decisions.[42] The court will examine the sophistication and experience of the customer with respect to securities transactions[43] and the amount of

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In a typical churning situation, the turnover rate is high in the early stages, followed by longer holding periods later on. *Mihara*, 619 F.2d at 819.

34. *See, e.g.*, Comment, *supra* note 9, at 285.

35. *See, e.g.*, Note, *supra* note 1, at 877.

36. *See id. See also Mihara*, 619 F.2d at 819; *Hecht*, 283 F. Supp. at 436.

37. *See* Note, *supra* note 1, at 877.

38. *See id.* at 877-78; Comment, *supra* note 9, at 286.

39. *See Stevens*, 288 F. Supp. 840 (fees earned from the plaintiff's account amounted to over 40% of the broker's profits for two of the five years in question); *Hecht*, 283 F. Supp. at 436 (commissions generated from plaintiff's account amounted to 51% of total commissions earned by broker for the period).

40. Note, *supra* note 1, at 871-74. *See, e.g.*, *Mihara*, 619 F.2d at 821; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,526; *Stevens*, 288 F. Supp. at 838, 840.

41. Note, *supra* note 1, at 871. In a discretionary account, the broker has the power to exercise his or her own discretion in making securities transactions. *Id.*

42. *See* Note, *supra* note 1, at 871-74. *See, e.g.*, *Mihara*, 619 F.2d at 821 ("[t]he account need not be a discretionary account whereby the broker executes each trade without the consent of the client. As the *Hecht* case indicates, the requisite degree of control is met when the client routinely follows the recommendations of the broker.").

43. *See* Note, *supra* note 1, at 872-74. *See also* Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 172 (10th Cir. 1974) ("the degree of sophistication of the investor is, of course, important and it is a question of fact. . . . At bar, plaintiff arguably had no understanding of 'churning' or of its possible existence until after she had consulted an attorney."); *Stevens*, 288 F. Supp. at 838-40 (plaintiff described as a housewife with no business training, never em-

reliance the customer places upon the broker's recommendations.[44]

Such factors as the customer's general background and ability to understand securities transactions as well as advice given by the broker will all be considered.[45] Dependence upon the broker is more likely in a situation where the customer does not understand the securities market or the advice of the broker.[46] Courts characterize this dependence as a fiduciary relationship[47] or one of trust and confidence,[48] requiring an

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ployed for pay, and utterly naive and unsophisticated with reference to financial transactions).

44. *See* Note, *supra* note 1, at 872-74. *See also Dzenits*, 494 F.2d at 172 (whether there was reliance by the plaintiff on the broker's statements and reassurances is a question of fact in a churning case); *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,526-27 (broker secured control by pressuring plaintiff to sign documents giving discretionary powers to trade plaintiff's account; broker continually assured plaintiff that her maneuvers were consistent with plaintiff's investments objectives); *Stevens*, 288 F. Supp. at 838-40 (plaintiff who funded her family's needs from the income from the investments turned over, in toto, the handling of her financial affairs to the broker-defendant).

45. *See Miley*, 637 F.2d at 324-25; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444 at 96,926-27; *Stevens*, 288 F. Supp. at 838-40; *Hecht*, 283 F. Supp. at 434-35.

46. *See Dzenits*, 494 F.2d at 172. *See also Stevens*, 288 F. Supp. at 838, 838-40 (plaintiff's knowledge of the securities market was summarized by her answer that the difference between a stock and a bond is that "stocks have names and bonds don't").

47. *See Miley*, 637 F.2d at 325; *Mihara*, 619 F.2d at 821-22. Such a characterization of the broker as a fiduciary is not without difficulty when generally applied to the broker-dealer profession. The common law defined the fiduciary relation in terms of nice distinctions; such a relation arose out of an "agent's" association with a "principal" whereby the agent would act on the principal's "behalf and *subject to his control*." RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958) (emphasis added). Stockbrokers have therefore had occasion to proclaim themselves mere principals in their dealings with customers. Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). In a principal to principal transaction conducted at arm's length and with the customer in control, no fiduciary duty should attach:

> Moreover, it seems often to be true, particularly in the case of the large stock and bond dealing houses which frequently act for themselves as well as for others, that the principal resorts to the so-called broker rather as one from whom stock, bonds and other similar property can be obtained than as a mere agent, and under circumstances reasonably indicating that it is a matter of indifference to him whether he buys through his agency, so long as the price contemplated is not exceeded. In such cases, it is difficult to see much evidence of a fiduciary relationship.

2 F. MECHEM, A TREATISE ON THE LAW OF AGENCY § 2411, at 1976 (2d ed. 1914 & photo. reprint 1979). *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 975 (1983); W. SEAVEY, HANDBOOK OF THE LAW OF AGENCY § 11 (1964).

This aside, the courts have not been hesitant to label a broker's duty to his or her customer a "fiduciary" one. Several developments in the field of securities law have contributed to this now-expansive accountability of the broker-dealer. First, the SEC has, from its earliest decisions, urged that "[i]nherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession." *In re* Duker & Duker, 6 S.E.C. 386, 388 (1939). *See also In re* William J. Stelmack Corp., 11 S.E.C. 601, 621-22 (1942); *In re* Allender Co., 9 S.E.C. 1043, 1053-55 (1941); *In re* Hope, 7 S.E.C. 1082, 1083-84 (1940); *In re* Jansen and Co., 6 S.E.C. 391, 394 (1939). This line of administrative decisions gave rise to a 1943 circuit court decision which has come to dominate the field. In affirming the SEC, the court in Charles Hughes & Co. v. SEC held that a brokerage house, by virtue of having held itself out as "competent" in investments, was thereby under a "duty" not to overreach its customers, regardless of common-law agency principles. 139 F.2d 434, 436-37 (2d

affirmative duty by the broker to recommend transactions to meet the customer's needs and to object to those which do not.[49] The problem that occurs in churning is that the broker not only fails in this duty, but also takes advantage of the customer's dependence and naivete.[50]

3. Broker's Intent to Defraud or Willful and Reckless Disregard for the Customer's Interests.

Under the Supreme Court's holding in *Ernst & Ernst v. Hochfelder*,[51] scienter is now a requisite element to establish a violation of federal securities rule 10b-5.[52] Since the majority of churning suits allege a 10b-5 violation, the customer has almost universally been required to allege and prove scienter by the broker.[53] A majority of recent federal court decisions hold that scienter may be established by showing either the broker's intent to defraud or the broker's willful and reckless disregard for the customer's interests.[54] Recklessness has been described as highly unreasonable conduct which is an extreme departure from the standard of ordinary care.[55]

Proof of scienter tends to be conclusory. Churning, in itself, is considered a scheme or artifice to defraud within the meaning of rule 10b-5.[56] Thus, once excessive trading and the broker's control are estab-

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Cir. 1943). Better known as the "shingle theory," the reasoning of the court in *Charles Hughes* remains potent precedent. Finally, the securities exchanges themselves have imposed duties upon their broker-members in the form of "suitability rules" which demand of brokers standards of commercial fair dealing beyond those required under the common law for arm's length transactions. *See infra* notes 68-69 and accompanying text. *See also* L. LOSS, *supra*, at 975.

It might now be said that "[t]he shingle and fiduciary theories have largely eliminated the common-law distinction between a broker-dealer when acting as an agent, in the capacity of a broker, and when acting as a principal, in the capacity of a dealer." N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.03, at 2-15 (1977). In the context of broker-dealer fraud, vestiges of agency doctrine linger, however. It is clear, for instance, that a broker will be far less accountable "when his only relationship with the customer is that of an order clerk." L. LOSS, *supra*, at 976. It is in this gray area, with brokers that are more than order clerks but less than managers of discretionary accounts, that debate is likely to continue.

48. *Stevens*, 288 F. Supp. at 846.

49. *See id.*; Note, *supra* note 1, at 871.

50. *See, e.g.*, *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,526-28; *Stevens*, 288 F. Supp. at 838-40; *Hecht*, 283 F. Supp. at 434-35. *See also* Note, *supra* note 1, at 873-74 (the broker may have greater fiduciary responsibilities in dealing with less educated, less experienced, unsophisticated investors).

51. 425 U.S. 185 (1976).

52. *Id.* at 193. The Supreme Court left unanswered the question of whether recklessness may satisfy the scienter requirement. *Id.* at 193-94 n.12.

53. *Thompson*, 709 F.2d at 1416-17; *Miley*, 637 F.2d at 324; *Mihara*, 619 F.2d at 821; *Mansbach*, 598 F.2d at 1023-24; *Rolf*, 570 F.2d at 44-47; *Carras*, 516 F.2d at 256.

54. *See Miley*, 637 F.2d at 324; *Mansbach*, 598 F.2d at 1023-24.

55. *Rolf*, 570 F.2d at 47.

56. *See Miley*, 637 F.2d at 324 n.4.

lished, scienter would be assumed unless the broker could justify his or her actions.[57]

C. *Causes of Action*

Churning is a recognized violation of the antifraud provisions of the federal securities acts and has been held to give rise to a private right of action under these acts.[58] Customers have relied primarily upon the broker's violations of section 10(b) of the Securities Exchange Act of 1934[59] and Securities and Exchange Commission rule 10b-5.[60] In basing their actions on these federal antifraud provisions, customers are of course required to plead fraud with particularity in order to avoid dismissal.[61]

Several other provisions of the federal securities acts have been

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57. *See Rolf*, 570 F.2d at 47.

58. *See Miley*, 637 F.2d at 324-25; *Mihara*, 619 F.2d at 820-21; *Mansbach*, 598 F.2d at 1023-25; *Rolf*, 570 F.2d at 44-48; *Hecht*, 430 F.2d at 1206-09; *Stevens*, 288 F. Supp. at 845-47.

59. 15 U.S.C. § 78j(b) (1976) provides:

> [i]t 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.

60. 17 C.F.R. § 240.10b-5 (1983) provides:

> [i]t 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.

These two provisions, § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5, have a broad application and a favorable statute of limitations. Because the Securities Act provides no specified limitations period, the applicable state statute of limitations is used. *See Stevens*, 288 F. Supp. at 844-45.

61. See FED. R. CIV. P. 9(b) which provides "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." *See also* Jenny v. Shearson, Hammill & Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,021, at 97,581 (S.D.N.Y. Mar. 11, 1975).

The customer must plead specifically the use of an interstate commerce means or instrumentality and give the defendant fair notice of the asserted claims. *See* Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1289 (N.D. Ill. 1973); Noland v. Gurley, 566 F. Supp. 210, 216 (D. Colo. 1983).

used as a basis by the customer for a private right of action.[62] In particular, churning a customer's account is a violation of section 15(c)(1) of the Securities Exchange Act of 1934[63] and Securities and Exchange Commission rule 15c1-7.[64] Rule 15c1-7 specifically prohibits excessive trading.[65] However, section 15(c)(1) and rule 15c1-7 are somewhat limited in application.[66]

The federal courts are divided[67] as to whether a private cause of action may be maintained under the Know Your Customer Rule of the New York Stock Exchange (NYSE)[68] or the Suitability Rule of the

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62. *See Noland*, 566 F. Supp. at 214 (in addition to other claims, plaintiff in a commodities case was permitted to maintain a claim under § 17(a) of the 1933 Act).

63. 15 U.S.C. § 78*o*(c)(1) (1976).

64. 17 C.F.R. § 240.15c1-7 (1983). *See* Armstrong v. McAlpin, 699 F.2d 79, 90-91 (2d Cir. 1983); Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68, 74 (S.D.N.Y. 1981); Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968).

65. Securities and Exchange Commission Rule 15c1-7 provides in pertinent part:

> (a) The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15(c) of the Act, is hereby defined to include any act of any broker, dealer or municipal securities dealer designed to effect with or for any customer's account in respect to which such broker, dealer or municipal securities dealer or his agent or employee is vested with any discretionary power any transactions or purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

17 C.F.R. § 240.15c1-7 (1983).

66. These provisions are limited in application to over-the-counter transactions. *See Hecht*, 283 F. Supp. at 431; Comment, *supra* note 9, at 288-90. Section 29(b) of the 1934 Act may apply to § 15(c) actions and require that such actions be brought within one year after the sale or purchase which involves the violation and within three years after the violation. 15 U.S.C. § 78cc(b). *See* Comment, *supra* note 9, at 288-90.

67. *Compare Miley*, 637 F.2d at 333, *and* Jablon v. Dean Witter & Co., 614 F.2d 677, 679-81 (9th Cir. 1980), *and* Gordon v. duPont Glore Forgan, Inc., 487 F.2d 1260, 1262-63 (5th Cir. 1973), *cert. denied*, 417 U.S. 946 (1974), *and* Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 180-83 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966), *and Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,530, *and* Russo v. Bache Halsey Stuart Shields, Inc., 554 F. Supp. 613, 618-19 (N.D. Ill. 1982), *and* Klitzman v. Bache Halsey Stuart Shields, Inc., 499 F. Supp. 255, 259 (S.D.N.Y. 1980) (no cause of actions exists), *with* Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135, 142 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969), *and Noland*, 566 F. Supp. at 215, *and* Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 403-04 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977). For further discussion on whether a private cause of action exists, see Note, *The Suitability Rule: Should a Private Right of Action Exist?*, 55 ST. JOHN'S L. REV. 493 (1981); Roach, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities Code*, 29 HASTINGS L.J. 1067 (1978); Nichols, *supra* note 12; Comment, *supra* note 9; 1975 DUKE L.J. 489.

68. The rule states:

> Every member organization is required through a general partner or an officer who is a holder of voting stock to
>
> (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organizations.
>
> (2) Supervise diligently all accounts handled by registered representatives of the organization.

National Association of Security Dealers (NASD), section 2 of article III of the NASD Rules of Fair Practice.[69] The majority of decisions deny a private right of action on the basis that these are self-regulatory rules designed for member use only and that no provision of the Securities Exchange Act creates a civil remedy for a violation of these rules.[70] In spite of this view, a few federal circuits permit a private cause of action, in appropriate circumstances, where a customer alleges overreaching, misrepresentation, manipulation, or deception.[71] In any case, the NYSE and NASD rules may serve as standards against which to assess the excessiveness of a broker's management of the customer's account.[72]

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2 N.Y.S.E. GUIDE (CCH) ¶ 2,405 (1980).

69. The rule states:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

NASD SEC. DEALERS MANUAL (CCH) ¶ 2152 (1980). Compare the analogous provisions of the proposed Federal Securities Code:

> It is unlawful for a broker, dealer, municipal broker, or municipal dealer, in contravention of the Commission's rules,
>
> . . . .
>
> (3) to recommend a transaction in a security unless he reasonably believes that it is not unsuitable for the customer on the basis of (A) information furnished by the customer on reasonable inquiry with respect to his investment objectives, financial situation, and needs, and (B) any other information known by the broker, dealer, municipal broker, or municipal dealer.

FEDERAL SEC. CODE § 915(a)(3) (Proposed Official Draft 1978).

70. *See Miley*, 637 F.2d at 333; *Jablon*, 614 F.2d at 681; *Gordon*, 487 F.2d at 1263 *Colonial Realty*, 358 F.2d at 182; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,530; *Russo*, 554 F. Supp. at 619; *Klitzman*, 499 F. Supp. at 259.

71. *See* Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164, 168 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977); *Buttrey*, 410 F.2d at 142; *Noland*, 566 F. Supp. at 215.

72. *See Miley*, 637 F.2d at 333; *Mihara*, 619 F.2d at 824. The literature concerning suitability is fairly expansive. *See* Allen, *Liability Under the Securities Exchange Act for Violations of Stock Exchange Rules*, 25 BUS. LAW. 1493 (1970); Bines, *Setting Investment Objectives: The Suitability Doctrine* (pts. I & II), 4 SEC. REG. L.J. 276 (1976), 4 SEC. REG. L.J. 418 (1977); Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604 (1971); Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233 (1966); Hoblin, *A Stock Broker's Implied Liability to its Customers for Violation of a Rule of a Registered Stock Exchange*, 39 FORDHAM L. REV. 253 (1970); Lashbrooke, *Implying a Cause of Action for Damages: Rule Violations by Registered Exchanges and Associations*, 48 U. CIN. L. REV. 949 (1979); Lowenfels, *Implied Liability Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12 (1966); Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633 (1966); MacLean, *Broker's Liability for Violation of Exchange and NASD Rules*, 47 DEN. L.J. 63 (1970); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445; Nichols, *The Broker's Duty to His Customer Under Evolving Federal Fiduciary and Suitability Standards*, 26 BUFFALO L. REV. 435 (1977); Rediker, *Civil Liability of Broker-Dealers Under SEC and NASD Suitability Rules*, 22 ALA. L. REV. 15 (1969); Roach, *The Suitability Obligations of Brokers: Present, 1983 and the Proposed Federal Securities Code*, 29 HASTINGS L.J. 1067

Since 1982, a few injured customers have sought relief for churning under the Racketeer Influenced and Corrupt Organizations Act (RICO).[73] While RICO provides primarily for criminal actions, section 1964(c)[74] establishes a private right of action for treble damages, costs, and attorney's fees to anyone injured by reason of a violation of the Act including fraud in the sale of securities.[75] The purpose of RICO is to eradicate organized crime and to provide penalties and remedies to deal with the unlawful activities of organized crime members.[76] The remedial purposes of RICO are to be construed liberally[77] and have been applied to persons other than members of organized crime.[78] However,

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(1978); Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act*, 17 W. RESERVE L. REV. 925 (1966); Wolfson & Russo, *The Stock Exchange Member: Liability for Violation of Stock Exchange Rules*, 58 CALIF. L. REV. 1120 (1970); 83 HARV. L. REV. 603 (1970); 83 HARV. L. REV. 825 (1970); 8 LOY. L.A.L. REV. 151 (1975); 55 ST. JOHN'S L. REV. 493 (1981); 24 SW. L.J. 384 (1970); 44 TUL. L. REV. 633 (1970); 1969 U. ILL. L.F. 551; 121 U. PA. L. REV. 388 (1972); 22 VILL. L. REV. 130 (1976).

73. 18 U.S.C. §§ 1961-68 (1976 & Supp. V 1981). *See* Mauriber v. Shearson/Am. Express, Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 99,444 (S.D.N.Y. 1983); Noland v. Gurley, 566 F. Supp. 210 (D. Colo. 1983); Harper v. New Japan Sec. Int'l, Inc., 545 F. Supp. 1002 (C.D. Cal. 1982); Landmark Sav. & Loan v. Rhoades, 527 F. Supp. 206 (E.D. Mich. 1981). *See also* 95 HARV. L. REV. 1101 (1982); Comment, *Reading the "Enterprise" Element Back Into RICO: Sections 1962 and 1964(c)*, 76 NW. U.L. REV. 100 (1981); Blakely & Gettings, *Racketeer Influenced and Corrupt Organizations (RICO): Basic Concepts — Criminal and Civil Remedies*, 53 TEMP. L.Q. 1009 (1980).

The *Harper* decision provides one of the more complete analyses of RICO as it should apply to churning cases. The court began its analysis by highlighting the more pertinent RICO provisions:

> The substantive provisions of RICO prohibit the following activities:
>
> (1) The use of income or proceeds from a pattern of racketeering activity by a principal in that activity to acquire an interest in or to establish an enterprise engaged in interstate commerce. Section 1962(a).
>
> (2) Acquisition of an interest in or control of an enterprise engaged in interstate commerce through a pattern of racketeering activity. Section 1962(b).
>
> (3) Operation of an interest engaged in interstate commerce through a pattern of racketeering activity. Section 1962(c).
>
> (4) Conspiracy to commit any of the above activities. Section 1962(d).

Harper, 545 F. Supp. at 1004 (construing 28 U.S.C. § 1962(a)-(d)).

74. 18 U.S.C. § 1964(c) (1976) states that "[a]ny person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee."

75. *See Noland*, 566 F. Supp. at 216-17; *Harper*, 545 F. Supp. at 1004; Note, *supra* note 73, at 1101-02. Section 1961(1) provides that fraud in the sale of securities constitutes racketeering activity. 18 U.S.C. § 1961(1) (1976 & Supp. V 1981).

76. *See* 18 U.S.C. § 1961 Congressional Statement of Findings and Purpose (1976). *See also Noland*, 566 F. Supp. at 217; *Harper*, 545 F. Supp. at 1004; Note, *supra* note 73, at 1101.

77. *See* 18 U.S.C. § 1961 Liberal Construction of Provisions (1976). *See also Noland*, 566 F. Supp. at 217; *Harper*, 545 F. Supp. at 1005-06.

78. *See* United States v. Bledsoe, 674 F.2d 657 (8th Cir. 1982), *cert. denied sub nom.* Phillips v. United States, 103 S. Ct. 456 (1983); United States v. Aleman, 609 F.2d 298 (7th Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); United States v. Campanale, 518 F.2d 352 (9th Cir.

the majority of courts dealing with the problem of churning have denied the use of RICO as a means of relief.[79] These courts reason that the act of churning is not within the spirit of the purposes to which RICO is directed.[80] These courts also reason that sufficient remedies are available under federal and state securities laws and state common law.[81] Finally, it is thought that no evidence exists to suggest that RICO was meant to preempt or supplement the remedies provided by these securities laws.[82]

A number of actions based upon state law have been alleged by customers injured by their brokers' churning activities. Among these are breach of the broker's fiduciary duty to his or her customer,[83] common-law fraud,[84] misrepresentation,[85] negligence,[86] and violations of the antifraud provisions of the state securities laws.[87] Assuming that

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1975), *cert. denied sub nom.* Grancich v. United States, 423 U.S. 1050 (1976); United States v. Gibson, 486 F. Supp. 1230 (S.D. Ohio 1980), *aff'd*, 675 F.2d 825 (6th Cir. 1982).

79. *See, e.g., Noland*, 566 F. Supp. at 218; *Harper*, 545 F. Supp. at 1006-07.

The *Harper* court noted that while RICO provisions as a whole have been liberally construed, a number of courts have construed the

> treble damage provision [§ 1964(c)] more narrowly than a broad reading of the provision would suggest. These courts, relying on legislative history, parallels to antitrust law, and policy considerations, have held that treble damages should not be available to plaintiffs whose sole injury stems from the predicate acts of racketeering.

Harper, 545 F. Supp. at 1006. The *Harper* court adopted this view and held that "a plaintiff must allege some [racketeering] injury 'by reason of a violation of § 1962' in order to have standing to bring an action for treble damages under RICO." *Id.* at 1006. *See* Van Schaick v. Church of Scientology, 535 F. Supp. 1125, 1135-39 (D. Mass. 1982); Adair v. Hunt Int'l Resources Corp., 526 F. Supp. 736, 746-48 (N.D. Ill. 1981); Landmark Sav. & Loan v. Rhoades, 527 F. Supp. 206, 208-09 (E.D. Mich. 1981); Waterman Steamship Corp. v. Avondale Shipyards, Inc., 527 F. Supp. 256, 259 (E.D. La. 1981); Note, *supra* note 73, at 1105-14 (1982). *But see Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 99,531-32. The court in *Mauriber* held that requiring a racketeering injury is not consistent with the legislative history of RICO nor founded upon the statutory language. *Id.*

80. *See Noland*, 566 F. Supp. at 218; *Van Schaick*, 535 F. Supp. at 1138; *Adair*, 526 F. Supp. at 747; *Waterman*, 527 F. Supp. at 260.

81. *See Noland*, 566 F. Supp. at 218; *Harper*, 545 F. Supp. at 1007; *Van Schaick*, 535 F. Supp. at 1138; *Adair*, 526 F. Supp. at 747; *Waterman*, 527 F. Supp. at 259-60.

82. *See, e.g., Noland*, 566 F. Supp. at 218; *Harper*, 545 F. Supp. at 1007.

83. *See, e.g., Miley*, 637 F.2d at 325 n.6, 329.

84. *See* Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 559 F. Supp. 388, 389 (E.D. Mo. 1983); Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578, 578 (E.D. Cal. 1982); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 847-48 (E.D. Va. 1968). The *Stevens* court held the plaintiff to a stricter standard of proof than the three elements of a federal securities law violation by requiring proof by clear, cogent, and convincing evidence. 288 F. Supp. at 848.

85. *See Noland*, 566 F. Supp. at 214; *Surman*, 559 F. Supp. at 389; *Cunningham*, 550 F. Supp. at 578.

86. *See, e.g.*, Sawyer v. Raymond, James & Ass'n, 642 F.2d 791, 792 (5th Cir. 1981); *Cunningham*, 550 F. Supp. at 578.

87. *See Miley*, 637 F.2d at 325 n.6; *Noland*, 566 F. Supp. at 215; *Surman*, 559 F. Supp. at 389.

these state claims arise from the same common nucleus of operative facts from which the federal claims derive, the federal court generally exercises pendent jurisdiction over the state claims.[88] Furthermore, proof of the three requisite elements of a federal securities law churning violation generally will enable the injured customer to hold the broker liable for breach of fiduciary duty[89] and common-law fraud.[90] The customer should be careful, however, to plead and prove the alleged state claims as defined by the applicable state law. The advantage of pleading and proving a state action is that, unlike under the federal securities acts,[91] an action at common law may be used as a basis for recovery of punitive damages.[92]

Customers have also sought relief from the "deeper pocket" of the brokerage firm for the acts of its broker.[93] Several theories of recovery have been attempted. A number of courts permit the imposition of aiding and abetting liability against a brokerage firm based on section 10(b) and rule 10b-5.[94] To establish aiding and abetting liability, the

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88. *See infra* notes 195-256 and accompanying text.

89. *See Miley*, 637 F.2d at 324. In *Miley*, the court stated "[a]dditionally, upon proving the three requisite elements of a federal securities law churning violation, the investor will, in most or perhaps all cases, be entitled to hold the broker liable under a pendent state claim for breach of fiduciary duty." *Id.*

One of the required elements is control of the account by the broker. This control creates a fiduciary relationship between the broker and customer. The broker has a duty to properly advise and manage transactions for the customer. If the broker abuses this duty by churning the customer's account, the broker may be liable for breach of the fiduciary duty. *See id.* at 324-25; Comment, *supra* note 9, at 282.

90. *See Mansbach*, 598 F.2d at 1024; *Stevens*, 288 F. Supp. at 847-48. These courts recognize, however, that the standard of proof for common-law fraud may require clear and convincing evidence as opposed to the preponderance of evidence required under a § 10(b) and rule 10b-5 action. *Mansbach*, 598 F.2d at 1024; *Stevens*, 288 F. Supp. at 847-48.

A claim of misrepresentation may be difficult to establish under state law. The plaintiff may allege misrepresentation on the basis that the broker held himself or herself out to the public with the implied promise to carry out his or her services in a fair and good-faith manner. This implied promise of good faith is generally known as the "shingle theory." Under this theory, the broker commits misrepresentation in a churning situation by failing to act in good faith and to advise the customer of the excessive transactions. *See* Note, *supra* note 1, at 870; Comment, *supra* note 9, at 293. *See generally supra* note 47.

For a presentation of the distinctions between common-law and federal securities law fraud, see L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 799-817 (1983); N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.02 (1977).

91. *See infra* notes 179-81 and accompanying text.

92. *See infra* notes 182-94 and accompanying text.

93. *See Rolf*, 570 F.2d at 44-48; *Armstrong*, 699 F.2d at 90-92; Karlen v. Ray E. Friedman & Co. Commodities, 688 F.2d 1193, 1198 & n.5 (8th Cir. 1982); *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529-30; *Noland*, 566 F. Supp. at 219-20; Kaufman v. Magid, 539 F. Supp. 1088, 1095-96 (D. Mass. 1982); Liskey v. Oppenheimer & Co., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10 (W.D. Okla. Jan. 12, 1982).

94. *See Rolf*, 570 F.2d at 44-48; *Armstrong*, 699 F.2d at 90-92; *Karlen*, 688 F.2d at 1198 & n.5; *Noland*, 566 F. Supp. at 219-20; *Kaufman*, 539 F. Supp. at 1095-96. *See generally* S.

customer first must prove that the primary party—the broker—committed a securities law violation.[95] Next, the customer must show a sufficient level of scienter on the part of the brokerage firm.[96] Proof of an intent to defraud or reckless disregard for the customer's interests satisfies the scienter requirement.[97] The final requirement to establish aiding and abetting liability is proof of substantial assistance on the part of the brokerage firm in the fraudulent mismanagement of the customer's account.[98] "Substantial assistance" may include repeated misrepresentations by acting as a conduit to accumulate or distribute securities, executing transactions, investing proceeds, or financing transactions.[99] Failure to learn of or disclose the fraud committed by the broker may also support a finding of "substantial assistance" against the brokerage firm.[100]

Under section 20(a) of the Securities Exchange Act of 1934[101] and section 15 of the Securities Act of 1933,[102] customers may allege that the brokerage firm is jointly and severally liable as "controlling persons" of the broker who committed the churning violation.[103] Sections 20 and 15 impose joint and several liability on persons who control

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JAFFE, BROKER-DEALERS AND SECURITIES MARKETS § 9.03 (1977 & Supp. 1983); L. Loss, *supra* note 90, at 1182-89.

95. *See Rolf*, 570 F.2d at 47; Woodward v. Metro Bank, 522 F.2d 84, 95 (5th Cir. 1975); SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 429 U.S. 908 (1975). *Cf.* Landy v. FDIC, 486 F.2d 139, 162 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974) (required independent wrong).

96. *See, e.g.*, *Rolf*, 570 F.2d at 44.

97. *See id.* at 44-47; *Armstrong*, 699 F.2d at 91; *Noland*, 566 F. Supp. at 219-20; *Kaufman*, 539 F. Supp. at 1096.

98. *See Rolf*, 570 F.2d at 48; *Armstrong*, 699 F.2d at 91.

99. *Rolf*, 570 F.2d at 48.

100. *Id.*

101. 15 U.S.C. § 78*t*(a) (1976) states:

> [e]very person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Section 20 is used far more frequently than § 15 of the 1933 Act as a basis for "controlling persons" liability.

102. 15 U.S.C. § 77*o* (1976) states:

> [e]very person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

103. *Rolf*, 570 F.2d at 48 & n.17; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529-30; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10. *See generally* 5 JAFFE, *supra* note 94, at § 9.02; L. Loss, *supra* note 90, at 1179-82.

others who have violated substantive provisions of the securities acts.[104] While "controlling" is not defined by the statutes, liability obviously may be established by proof that a person (broker) acted under the direction of the controlling person (brokerage firm) in an employer-employee relationship.[105] Section 15 permits a controlling person to escape liability by proving that it had no knowledge of nor reasonable grounds to believe the existence of the facts which allegedly establish the liability of the controlled person.[106] Likewise, section 20 permits a complete defense for the brokerage firm if it can show that it acted in good faith and did not induce the acts constituting the violation of federal law.[107] Section 15 requires the customer to prove the "controlling person" had a state of mind of something more than mere negligence.[108] In a section 20 "controlling person" violation, the burden of proving good faith shifts to the brokerage firm once the customer establishes that the broker completed the transactions through the employing brokerage firm and the brokerage firm received a commission on the transaction.[109] To establish "good faith," the brokerage firm must show, at least, that it has not been negligent in supervision and that it maintained and enforced a reasonable and proper system of supervision and internal control over the broker.[110]

Common-law respondeat superior may also be an available theory to impute vicarious liability upon the brokerage firm.[111] This theory of recovery is more plaintiff-oriented than the "controlling persons" theory because scienter is not required and the good-faith exception is not permitted.[112] To recover under respondeat superior, the customer must prove that the broker's misconduct occurred in the course of the broker's employment and that the brokerage firm received profits from the fraudulent transactions.[113] There is a split of authority among the fed-

104. *See, e.g., Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529-30.

105. *See, e.g., Noland*, 566 F. Supp. at 220.

106. *See* 15 U.S.C. § 770 (1976 & Supp. V 1981); Holloway v. Howerdd, 536 F.2d 690, 694 (6th Cir. 1976); *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529-30.

107. *See* 15 U.S.C. § 78*t*(a) (1976); Carpenter v. Harris, Upham & Co., 594 F.2d 388, 394 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979); *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,530; *Noland*, 566 F. Supp. at 220; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509.

108. *See Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529-30.

109. *See, e.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705, 716 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

110. *See id.*

111. *See id. See also Holloway*, 536 F.2d at 695; *Mauriber*, [Current] FED. SEC. L. REP. (CCH) ¶ 99,444, at 96,529; *Noland*, 566 F. Supp. at 221; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10.

112. *See Kohn*, 620 F.2d at 716; *Noland*, 566 F. Supp. at 221; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10.

113. *See, e.g., Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at

eral circuits whether section 20 supplants the doctrine of respondeat superior and provides the sole theory of vicarious liability.[114] The majority view holds that section 20 does not supplant the doctrine of respondeat superior.[115] This view holds that there is no warrant for believing section 20 was intended to narrow the remedies available to customers.[116] In fact, under both the 1933 and 1934 Acts, the law states that the rights and remedies provided shall be in addition to any and all rights and remedies that may exist at law or in equity.[117] Further, neither Act was intended to insulate a brokerage firm from liability under common-law agency principles.[118] Moreover, the brokerage firm has an affirmative duty to prevent the use of the prestige of the firm to defraud the investing public.[119]

III. MEASURE OF DAMAGES

A. Calculation or Speculation?

In the typical churning case, the customer complains that the broker excessively traded his or her account and/or purchased unsuitable securities, given the customer's investment interests.[120] While the sole gain to the broker in this situation is the excessive commissions generated, the broker's misconduct causes two distinct harms to the customer.[121]

First, the customer suffers by having to pay the excessive commissions.[122] The breach of both the federal securities laws and the bro-

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92,509-10.

114. *Compare Kohn*, 629 F.2d at 716, *and Holloway*, 536 F.2d at 694-95, *and Noland*, 566 F. Supp. at 221, *and Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509 (§ 20 does not supplant respondeat superior) *with* Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975) (§ 20 does supplant the doctrine of respondeat superior). *See* Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 CAL. W.L. REV. 152 (1979).

115. *See Kohn*, 629 F.2d at 716; *Holloway*, 536 F.2d at 694-95; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10; *Noland*, 566 F. Supp. at 221.

116. *See Kohn*, 629 F.2d at 716; *Holloway*, 536 F.2d at 695; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,509-10.

117. See 15 U.S.C. § 78bb(a) (1976), which states in pertinent part: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . . ." *See also Kohn*, 629 F.2d at 716; *Noland*, 566 F. Supp. at 221.

118. *See Karlen*, 688 F.2d at 1198 n.5; *Holloway*, 536 F.2d at 695. The *Holloway* court stated that the provisions in the 1933 Act and 1934 Act "were not intended to preempt the operation of the doctrine of respondeat superior in a case involving unlawful activities of a brokerage firm's employees." *Id.*

119. *Holloway*, 536 F.2d at 696; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,510.

120. Brodsky, *supra* note 8, at 159.

121. Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. 1981).

122. *Id. See* Mihara v. Dean Witter & Co., 619 F.2d 814, 826 (9th Cir. 1980). The customer's account may have been excessively traded in types of stocks that met the customer's

ker's fiduciary duty entitle the customer to receive the commissions and interest paid as a result of the excessive trading,[123] perhaps along with the capital gains taxes incurred as a result of the churning.[124] This compensation is due the customer regardless of whether the customer's account has increased or decreased in value.[125]

Second, the customer is harmed by the decline in his or her account due to the unsuitable trading conducted by the broker.[126] The decline in the value of the customer's account represents the customer's trading loss—a compensable violation unrelated to the amount of commissions paid to the broker.[127] To calculate the customer's trading loss, the actual performance of the customer's account may be compared to a hypothetical, well-managed account similar in nature to the customer's account.[128]

In theory, the customer should be fully compensated for the twin harms of excessive commissions paid and trading losses incurred.[129] However, calculating damages which would fully compensate the customer without being unduly speculative at the expense of the broker is a difficult task which has resulted in mixed and confused damage awards.[130] Courts have been especially plagued with the task of awarding trading losses due to unsuitable transactions.[131] Determining a precise award of trading loss is made difficult by the unified nature of the churning violation and the volatile nature of the stock market.[132] While the damage calculation may be difficult, it might be argued that this risk of uncertainty should be borne by the broker-wrongdoer and not the injured customer.[133] Further, the judiciary's responsibility to set

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objectives. Thus no claim of unsuitability is available. *See also* Brodsky, *supra* note 8, at 159.

123. *See Miley*, 637 F.2d at 326; *Mihara*, 619 F.2d at 826.

124. *See* Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 851-52 (E.D. Va. 1968) (only permitted recovery of commissions, capital gains taxes incurred, and state transfer tax paid). The customer may also miss dividends due to excessive trading. Nichols, *supra* note 12, at 445. *See generally* Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975).

125. *See Miley*, 637 F.2d at 326.

126. *Id. See also* Brodsky, *supra* note 8, at 159; Nichols, *supra* note 12, at 445.

127. *See* Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Miley*, 637 F.2d at 326.

128. *See* Note, *supra* note 1, at 886; Brodsky, *supra* note 8, at 165-66. *See also Rolf*, 570 F.2d at 49-50; *Miley*, 637 F.2d at 328; Nichols, *supra* note 12, at 445.

129. *See Miley*, 637 F.2d at 327; Brodsky, *supra* note 8, at 158-59.

130. *Miley*, 637 F.2d at 327; Brodsky, *supra* note 8, at 158-59. *Accord* McNeal v. Paine, Webber, Jackson, & Curtis, Inc., 598 F.2d 888, 894 n.14 (5th Cir. 1979) (as amended).

131. *Miley*, 637 F.2d at 327; Brodsky, *supra* note 8, at 159.

132. *See Miley*, 637 F.2d at 327; *Carras*, 516 F.2d at 259. In *Carras*, the court, while recognizing the need to fully compensate the customer for lost equity, felt compelled because of the *excessive* degree of churning and unstable market to limit damages to the ascertainable losses of commissions, service charges, and taxes attributable to the excessive trading. *Id.*

133. Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1213 (9th Cir. 1970) (Powell, J., dissenting). *Accord* Karlen v. Ray E. Friedman & Co. Commodities, 688 F.2d 1193, 1202 (8th

fair and reasonable damages should not be abdicated because of the difficulty or imprecision of calculating the damages.[134]

Some courts, however, refuse to award trading loss damages because such an award is viewed as speculative and conjectural.[135] The fallacy in awarding trading losses, these courts argue, is that even properly managed, conservative accounts may lose value in a given period.[136] By imposing trading loss damages, the broker is thereby held to a higher standard than should be expected.[137] Trading loss damages would amount to the awarding of punitive damages under the guise of compensatory damages.[138]

In short, the courts are not in agreement with the proper award of damages when a broker churns unsuitable securities in a customer's account.[139] The better view, however, permits an award of damages for the excessive commissions churned and the trading losses attributable to unsuitable transactions.[140] This loss-of-bargain method provides the injured customer compensation for both of the harms proximately caused by the broker and is based upon an objective formula which prohibits undue speculation at the expense of the broker.[141]

B. Miley-Rolf Formula: Loss of Bargain

This formula, adopted to date by the Second and Fifth Circuits, compensates a customer for excessive commissions and trading losses.[142] To approximate trading losses, the formula compares the actual performance of the customer's account with the estimated per-

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Cir. 1982).

134. *Miley*, 637 F.2d at 327. *See generally* Brodsky, *supra* note 8, at 158-59.

135. *See, e.g., Carras*, 516 F.2d at 259; *Stevens*, 288 F. Supp. at 849.

136. *See Stevens*, 288 F. Supp. at 849.

137. *Id.*

138. *Id.*

139. Brodsky, *supra* note 8, at 157.

140. *Id.* at 158-59. *See* Note, *supra* note 1, at 885-86.

141. *Miley*, 637 F.2d at 328-29. *See* Brodsky, *supra* note 8, at 160-61; Note, *supra* note 1, at 885.

142. *Rolf*, 570 F.2d at 49-50; *Miley*, 637 F.2d at 328-29. In *Rolf*, the Second Circuit remanded the case to the district court to determine damages for trading losses as well as excessive commissions paid and interest thereon according to the formula it devised. *Rolf*, 570 F.2d at 48. The court also requested the district court to reconsider the issue of prejudgment interest since it was obvious that Rolf had lost a principal sum. *Id.* at 50.

In *Miley*, the Fifth Circuit affirmed the jury award of $54,000 in compensatory damages. *Miley*, 637 F.2d at 326. The district judge permitted recovery for both commissions and interest paid as a result of excessive trading, and the trading loss from unsuitable trading by the broker resulting in a decline in the value of the customer's portfolio in excess of the average decline in the stock market. *Id.* The *Miley-Rolf* formula can be used to assess damages for a section 10(b) violation as well as for a state claim such as breach of the broker's fiduciary duty to the customer. *See id.* at 329.

formance of a suitable account free of broker misconduct.[143] In the absence of a specialized account, the estimation of the suitable account is pegged to the average percentage performance in the value of the Dow Jones Industrials Index, Standard and Poor's Index, or another recognized index of value during the churning period.[144] The formula for determining the loss-of-bargain damages consists of two distinct components:

(A) Churning Damage Award, in an amount equal to commissisons and interest paid as a result of excessive trading;[145] and
(B) Trading Loss Damage, derived by
  (1) calculating the original market value of the customer's investment and dividends at the point unsuitable trading began;[146]
  (2) subtracting the value of the customer's account on the date the broker's misconduct ceased, to arrive at the Gross Economic Loss (GEL);[147]
  (3) subtracting from the GEL the average percentage decline in the value of the Dow Jones Industrials, Standard and Poor's Index, another well-recognized index of value, or a combination of indices for the period of misconduct;[148] and
  (4) subtracting any withdrawals made by the customer during the misconduct period and any settlements or awards for the same unsuitable transactions received from other sources.[149]

The *Miley-Rolf* formula was announced in a "bear market" period; the value of the GEL was thus adjusted for a declining stock market.[150] To adapt this formula for a "bull" or upswing market period, the average percentage increase in the value of the index during the misconduct period should be added to the GEL.[151] A further improve-

143. *See Rolf*, 570 F.2d at 49; *Miley*, 637 F.2d at 328.

144. *See Rolf*, 570 F.2d at 49; *Miley*, 637 F.2d at 328. The district court has the discretion to select a more case-oriented gauge by using a specialized portfolio, a selective portion of an index, or a different method shown by one of the parties to be more accurate than a recognized index. *See Rolf*, 570 F.2d at 49 n.22; *Miley*, 637 F.2d at 328.

145. *See Rolf*, 570 F.2d at 50; *Miley*, 637 F.2d at 326-28. A court may also decide to permit an award of capital gains taxes incurred due to churning as well as other state transfer taxes paid on the excessive trading. *See, e.g., Stevens*, 288 F. Supp. at 850-51.

146. *See Rolf*, 570 F.2d at 49. In a case such as *Rolf* where a dealer-supervisor is charged with aiding and abetting, the point at which the aiding and abetting began may be after the point unsuitable trading began by the broker or advisor. *Id.* at 49 n.20.

147. *Rolf*, 570 F.2d at 49 n.21.

148. *Rolf*, 570 F.2d at 49 & n.22; *Miley*, 637 F.2d at 328.

149. *See Rolf*, 570 F.2d at 49-50. This portion of the formula in *Rolf* was combined with (B)(1), but has been separated to permit a more logical application of the formula.

150. *See, e.g., Rolf*, 570 F.2d at 49 n.22. A bear market is "[a] market in which prices are falling or expected to fall." BLACK'S LAW DICTIONARY 140 (5th ed. 1979). *See generally* THE DOW JONES AVERAGES 1885-1980 (P. Pierce ed. 1982).

151. A bull market is a [illegible] for a market in which prices are rising or are

ment on the *Miley-Rolf* formula would permit the customer to attempt to establish, through the use of expert testimony, the performance of a hypothetical, properly managed account suited to the customer's investment interests.[152] This hypothetical account's performance would be compared to the GEL rather than using the average percentage change in the value of the suggested indices in (B)(3) above.[153] The *Miley* decision indicated that the Fifth Circuit would be receptive to this method of calculation if the customer can demonstrate that this method is more accurate.[154]

This formula has been criticized for permitting speculative and conjectural damages as well as for ignoring the fact that many well-managed accounts suffer losses even in a bull market.[155] The use of a broad-based index fails to consider whether the index as a whole is similar to the securities in the broker's account.[156] In response to the broad-based index criticism, the *Miley-Rolf* formula permits the district judge to use his or her discretion to select a more appropriate gauge of stock valuation.[157]

Overall, the *Miley-Rolf* formula is a logical approach to compensate the customer for churning and trading losses. While it is not a precise theory, it does provide sufficient guidelines to reduce the risk of windfalls.[158] Further, the formula attempts to set a ceiling on damages by preventing speculation on other harms, not included in the formula, which a jury might feel are caused by the broker's misconduct.[159]

The customer must prepare his or her evidence carefully in order to successfully present the *Miley-Rolf* formula for recovery.[160] The use

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expected to rise." BLACK'S LAW DICTIONARY 177 (5th ed. 1979).

Adding the percentage increase in the value of the index during an upswing market period permits the customer to recover the amount that an account without misconduct would have naturally earned.

152. *See* Brodsky, *supra* note 8, at 165-66; Note, *supra* note 1, at 885-86. Using a hypothetical account with proper management permits potentially larger trading loss damages than the more static account concept adopted by the *Miley-Rolf* formula. *Compare* Brodsky, *supra* note 8, at 165-66 *with Rolf*, 570 F.2d at 49.

153. *See* Brodsky, *supra* note 8, at 165-66.

154. *Miley*, 637 F.2d at 328. *See also Rolf*, 570 F.2d at 49 n.22 (the Second Circuit may also be receptive to a more appropriate method of calculation).

155. *See, e.g., Carras*, 516 F.2d at 259; *Stevens*, 288 F. Supp. at 849.

156. *See Stevens*, 288 F. Supp. at 849.

157. *Rolf*, 570 F.2d at 49 n.22; *Miley*, 637 F.2d at 328.

158. *Miley*, 637 F.2d at 329. Since many of the churning cases arise within the jurisdiction of the Second Circuit, the *Miley-Rolf* formula will likely be used often in the resolution of these cases. *See* Brodsky, *supra* note 8, at 161.

159. *Miley*, 637 F.2d at 329. The formula prohibits the jury from speculating on possible harms such as emotional suffering. *But cf.* Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 532 F. Supp. 480, 485 (S.D. Ohio 1982) (punitive damages based on state court claims in a churning action may include recovery for the infliction of mental distress).

160. *See, e.g.*, Costello v. Oppenheimer & Co., 711 F.2d 1361, 1374-75 (7th Cir. 1983). In

of a summary chart of exhibits to prove the commissions paid and trading loss suffered is as indispensable to the customer's case as expert testimony.[161] The more cohesive and organized the damage evidence, the more likely the customer will be adequately compensated for his or her injuries.

C. *Other Forms of Recovery*

1. Out-of-Pocket

The out-of-pocket approach calculates the difference between the value of the customer's account and dividends at the beginning of the misconduct period, and the value of the account returned to the customer at the end of the period less any withdrawals made by the customer.[162] The difference arrived at is the total amount of damages awarded to the customer.[163]

This approach has been criticized for ignoring the possibility that losses may be due not to the churning, but rather to an overall decline in the market.[164] Thus, in a declining market, this formula awards windfall damages to the customer.[165] Further, even a well-managed ac-

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Costello, the court criticized the plaintiff for attempting to characterize his loss as a "realized" loss problem. *Id.* at 1374. A "realized" loss is determined upon sale while market loss is determined by comparing the original value of stock to the current market value. *Id.*

161. *See, e.g., id.* at 1375. The court noted that, unlike the typical churning case involving a unified offense, the plaintiff in this case claimed specific trades constituted the churning violation. The court chastised the plaintiff for dumping massive amounts of raw data upon the court that were "fairly sophisticated and specialized in nature, using financial terms and notations surely beyond the ken of the average juror as well as [the court]." *Id.* at 1375. The court complained that "no . . . expert testimony, nor even any helpful summary of the exhibits was introduced." *Id.*

The court stated that it was highly unrealistic that the jury could properly assimilate the information and use it as a basis for awarding damages for realized losses. It held that the plaintiff failed to properly establish proof of damages to support a recovery of realized losses and, thereby, reduced the judgment awarded to an amount equal to the commissions paid during the churning period. *Id.* However, the court provided that the plaintiff could elect to vacate the judgment and proceed with a new trial on the issue of churning and the damages incurred by the plaintiff. *Id.*

162. *See, e.g., Karlen*, 688 F.2d at 1201-02; Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 730-33 69 Cal. Rptr. 222, 249-51 (1968). *See also* Note, *supra* note 1, at 884-85; Brodsky, *supra* note 8, at 161-62; Comment, *supra* note 9, at 298-99.

163. *See Karlen*, 688 F.2d at 1201; *Twomey*, 262 Cal. App. 2d at 730, 69 Cal. Rptr. at 249. In *Karlen*, the Eighth Circuit affirmed the out-of-pocket award of damages in the amount of $92,474.50. The court found that the defendant failed to object to the substance of the jury instructions on damages before they were submitted to the jury and was thereby prohibited from raising such an objection on appeal. *Karlen*, 688 F.2d at 1201. In *Twomey*, the Court of Appeals of California upheld an out-of-pocket award of $32,356.71 in spite of the fact that part of the loss may have been due to overall market decline. *Twomey*, 262 Cal. App. 2d at 730-33, 69 Cal. Rptr. at 249-51.

164. *See, e.g., Stevens*, 288 F. Supp. at 849-50; Brodsky, *supra* note 8, at 162; Note, *supra* note 1, at 884-85.

165. *See, e.g., Stevens*, 288 F. Supp. at 849-50; Note, *supra* note 1, at 884.

count in a steady or increasing market may depreciate without misconduct.[166] As well, if the account still maintains a net profit at the end of the misconduct period, the out-of-pocket formula would theoretically permit no damages.[167] However, this ignores the probability that, without churning violations, the net profit figure would have been much greater.[168] The Securities and Exchange Commission consistently refuses to permit the broker to use net profit as a defense.[169]

2. Quasi-Contractual and Variations

The basic quasi-contractual theory of recovery requires the broker to return the excessive commissions churned plus interest thereon.[170] This was one of the earlier methods of calculating damages in churning cases.[171] The decisions awarding quasi-contractual damages adopted the limited view that the amount of excessive commissions was the only harm proximately caused by the broker.[172] The fallacy of this view is that it overlooks the harm caused by inappropriate or unsuitable transactions managed by the broker resulting in trading losses.[173] Trading losses are as significant a harm to the customer as excessive commissions and the customer deserves adequate compensation for these losses as well.[174]

A variation on the basic quasi-contractual remedy permits the customer to recover the capital gains tax that the customer was required to pay due to the churning misconduct, in addition to the excessive commissions and interest.[175] The justification for awarding the capital gains taxes paid is that "but for" the churning, the sales from the excessive transactions would not have been made and the taxes not incurred.[176] State transfer taxes paid on the excessive transactions may also be recovered under the same rationale.[177]

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166. *See Stevens*, 288 F. Supp. at 849.

167. *See* Comment, *supra* note 9, at 298-99.

168. *See Stevens*, 288 F. Supp. at 849-50; Comment, *supra* note 9, at 299.

169. *See* Note, *supra* note 1, at 878. *See also Stevens*, 288 F. Supp. at 849-50.

170. *See, e.g., Costello*, 711 F.2d at 1375; *Hecht*, 430 F.2d at 1211-12 (the court refused any other damages due to churning because the plaintiff was found to have waived the claim of unsuitabilty and was thereby estopped from trading loss damages).

171. *See, e.g.*, Newkirk v. Hayden, Stone & Co., [1964-1965 Transfer Binder] FED SEC. L. REP. (CCH) ¶ 91,621 (S.D. Cal. Sept. 30, 1965). *See generally* Note, *supra* note 1, at 883-84 (*Newkirk* was the only churning case which, at that time, had awarded damages).

172. *See, e.g., Stevens*, 288 F. Supp. at 850.

173. *See* Brodsky, *supra* note 8, at 161. *See also Miley*, 637 F.2d at 326.

174. *See Rolf*, 570 F.2d at 48-50; *Miley*, 637 F.2d at 326.

175. *See Carras*, 516 F.2d at 259; *Stevens*, 288 F. Supp. at 850-51.

176. *See Stevens*, 288 F. Supp. at 850-51; Brodsky, *supra* note 8, at 162.

177. *See Stevens*, 288 F. Supp. at 851. New York State imposed a transfer tax on the securities when they were sold or transferred from one person to another on the New York Stock

While this variation provides additional compensation to the customer, it also ignores the harm of trading loss. Both the basic theory and the variation fail to adequately compensate the customer for the harm proximately caused by the broker's misconduct.[178]

D. *Punitive Damages*

Punitive damages may not be awarded under the federal securities provisions section 10(b) or rule 10b-5.[179] Section 28(a) of the Securities Exchange Act of 1934 prohibits recovery in excess of actual damages demonstrated.[180] This section is construed to prohibit the award of non-pecuniary damages including punitive damages.[181] However, it is well established that punitive or exemplary damages may be awarded if permitted by state law *and* a state law violation is joined to the federal securities violation.[182] State law violations such as breach of fiduciary duty and fraud or reckless disregard of the customer's interests in his or her account have been held to give rise to punitive damages in the churning context.[183]

Exemplary damages may be awarded against both the broker and the brokerage firm if the customer establishes the requisite elements under state law.[184] Generally, the evidence necessary to establish the scienter requirement under a 10b-5 churning case is also sufficient to support an award of punitive damages under state law.[185] Some state common-law actions may require the customer to show actual malice, fraud, or oppression to recover punitive damages.[186]

The *Miley* court devised a formula for judging the excessiveness of

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178. *See, e.g., Miley*, 637 F.2d at 326-29.

179. *See, e.g.*, Juster v. Rothschild, Unterberg & Towbin, 554 F. Supp. 331, 334 (S.D.N.Y. 1983); *Emmons*, 532 F. Supp. at 485; Millas v. L.F. Rothschild, Unterberg & Towbin, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,441, at 92,617 (N.D. Cal. Feb. 5, 1982); Nye v. Blyth, Eastman Dillon & Co., 588 F.2d 1189, 1200 (8th Cir. 1978); *Carras*, 516 F.2d at 259-60.

180. 15 U.S.C. § 77bb (1976). The statute prohibits recovery of "a total amount in excess of actual damages." *Id.*

181. *See, e.g., Carras*, 516 F.2d at 259-60; *Emmons*, 532 F. Supp. at 485.

182. *See* Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1036 (5th Cir. 1981); *Miley*, 637 F.2d at 329; *Nye*, 588 F.2d at 1200; *Juster*, 554 F. Supp. at 334; *Emmons*, 532 F. Supp. at 485; *Millas*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,441, at 92,617.

183. *See Miley*, 637 F.2d at 330-31. *But see Mihara*, 619 F.2d at 825-26 (the court determined state law required more than a showing of breach of fiduciary duty; malice or actual fraud must be established to recover punitive damages). *Mihara*, 619 F.2d at 825-26.

184. *See* Comment, *Punitive Damages and the Federal Securities Act: Recovery via Pendent Jurisdiction*, 47 MISS. L.J. 743, 759-63 (1976); Comment, *The Reappearance of Punitive Damages in Private Actions for Securities Fraud*, 5 TEX. TECH L. REV. 111, 126-39 (1973). *See also Mihara*, 619 F.2d at 826.

185. *See, e.g., Miley*, 637 F.2d at 330.

186. *See, e.g., Mihara*, 619 F.2d at 825.

an award of punitive damages in a churning case.[187] Three times the compensatory damage award was selected by that court as an appropriate benchmark for significant business torts.[188] The compensatory damage component of this formula is properly limited to the broker's gain from churning: the unjust commissions generated by the excessive transactions.[189]

Other courts indicate that larger awards of punitive damages as compared to compensatory damages would be appropriate.[190] This more expansive view seems especially justifiable when assessing punitive damages against a brokerage firm. A larger award is necessary to serve as an appropriate punishment against a firm that generates a large dollar volume.[191]

At least one district court permits not only punitive damages, but also damages for mental distress to be recovered if allowable under state law and if state violations are pendent to a federal securities claim.[192] This case involved Ohio law which permits punitive damages for malicious fraud and intentional infliction of mental distress.[193] The court held that the plaintiff sufficiently alleged the proper elements under Ohio law to entitle him to offer proof at trial to recover exemplary damages for fraud and infliction of emotional distress.[194]

IV. DEFENSE TACTICS

A. Arbitration: Severance and Arbitration of Pendent State Claims

In the standard investment account contract, the customer often agrees to clauses providing for arbitration in the event of any controversies arising out of the account.[195] While the stated purpose of in-

187. *Miley*, 637 F.2d at 331-32.

188. *Id.*

189. *Id.* at 332. The broker's gain from his churning misconduct consists of the excessive commissions. In order to appropriately punish the broker, punitive damages ought to correspond to the amount of gain taken by the broker. *Id.*

190. *See, e.g., Mihara*, 619 F.2d at 826.

191. *Id.*

192. *Emmons*, 532 F. Supp. at 485.

193. *Id. See* Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St. 2d 282, 390 N.E.2d 320 (1979); Logsdon v. Graham Ford Co., 54 Ohio St. 2d 336, 376 N.E.2d 1333 (1978) (damages for malicious fraud).

194. *Emmons*, 532 F. Supp. at 485.

195. Miley v. Oppenheimer & Co., 637 F.2d 318, 335 (5th Cir. 1981); Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578, 579 (E.D. Cal. 1982); Liskey v. Oppenheimer & Co., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508 (W.D. Okla. Jan. 12, 1982).

Arbitration in the federal securities law context is discussed generally in S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS ch. 17 (1977 & Supp. 1983); L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1189-96 (1983); Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims*, 29 DE PAUL L. REV. 693 (1980);

cluding arbitration clauses is to provide for a cheaper and more efficient adjudication of disputes,[196] brokers in reality urge inclusion and enforcement of these provisions to reduce the chance of potentially larger jury awards in favor of more conservative arbitration awards. Notwithstanding this motivation for including arbitration as a standard contract clause, these provisions have been viewed as valid and binding.[197]

Pursuant to section 2 of the United States Arbitration Act, written arbitration provisions are "valid, irrevocable, and enforceable" unless there are grounds for revoking the arbitration agreement.[198] The Arbitration Act was designed to compel the federal courts to recognize and enforce arbitration agreements.[199] Section 3 of this act mandates that federal courts refer all arbitrable issues to arbitration as provided in the agreement, and to stay the federal trial until arbitration is completed.[200] Applying the Arbitration Act literally would in effect refer all churning violations—both state and federal—to arbitration.[201]

A consensus of courts, however, recognizes that federal claims arising under section 10(b) of the Securities Exchange Act of 1934 are not subject to arbitration because of Congress' intent to assure injured parties the right to pursue relief for securities law violations in federal court.[202] This concept of invalidating arbitration in favor of federal ju-

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Neville, *The Enforcement of Arbitration Clauses in Investor-Broker Agreements*, ARB. J., Mar. 1979, at 5; 65 CALIF. L. REV. 120 (1977); 62 YALE L.J. 985 (1953).

196. *See, e.g.*, S. REP. NO. 536, 68th Cong., 1st Sess. 3 (1924); *see also* Dickinson v. Heinold Sec., Inc., 661 F.2d 638, 643 (7th Cir. 1981); *Cunningham*, 550 F. Supp. at 584; Krause, *supra* note 195, at 693-94.

197. *Cunningham*, 550 F. Supp. at 579. *See Dickinson*, 661 F.2d at 645.

Note also the provisions of the proposed Federal Securities Code:

> A purported waiver of compliance with this Code (as defined in section 225) or a rule of recovery thereunder is void . . . .
>
> . . . .
>
> . . . [However, the language above] does not affect (1) a good faith settlement of, or agreement to arbitrate, an existing dispute . . . or (3) an advance agreement
>
> . . . .
>
> (B) by any person to arbitrate a dispute arising under a rule of a self-regulatory organization (other than the Municipal Board), unless (i) a violation of the rule is a violation of this Code . . . .

FEDERAL SEC. CODE § 1725(a), (c) (Proposed Official Draft 1978).

198. 9 U.S.C. § 2 (1976).

199. *See Miley*, 637 F.2d at 335; Sawyer v. Raymond, James & Assoc., Inc., 642 F.2d 791, 792 (5th Cir. 1981); *Cunningham*, 550 F. Supp. at 579, 584.

200. 9 U.S.C. § 3 (1976).

201. *See Cunningham*, 550 F. Supp. at 579-80.

202. *See* Wilko v. Swan, 346 U.S. 427, 438 (1953); *Dickinson*, 661 F.2d at 643-44; *Sawyer*, 642 F.2d at 792; *Miley*, 637 F.2d at 334; Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1030 (6th Cir. 1979); Sibley v. Tandy Corp., 543 F.2d 540, 543 (5th Cir. 1976), *cert denied*, 434 U.S. 824 (1977); Roueche v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 554 F. Supp. 338, 339 (D. Hawaii 1983); *Cunningham*, 550 F. Supp. at 580; Baratta v. S.D. Cohn & Co., [1982-1983

risdiction was first applied by the United States Supreme Court in *Wilko v. Swan.*[203] The *Wilko* decision involved a violation of the Securities Act of 1933.[204] The Court decided that, looking to Congress' intent in the Securities Act to protect investors by forbidding waiver of their rights, the Act would best be implemented through the invalidation of arbitration agreements.[205] Lower courts, recognizing that statutory language identical to that relied upon by the *Wilko* Court is found in the 1934 Act, have urged *Wilko* as support for refusing to enforce arbitration in claims arising under section 10(b) of the 1934 Act.[206]

Unresolved is the issue of jurisdiction over pendent state claims: typically claims for common-law fraud, misrepresentation, or breach of fiduciary duty.[207] Defendant-brokers have urged that these claims should be severed from the federal action and arbitrated.[208] Typically, brokers have requested either a stay of the federal action until arbitration of the state issues is completed, or simultaneous proceedings in both federal court and in arbitration.[209] The federal circuits are divided as to whether arbitration should be compelled in these state claims under the mandate of the United States Arbitration Act.[210]

Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,035, at 94,920 (S.D.N.Y. Dec. 29, 1982); *Liskey*, [1981-1982 Transfer Binder] FED SEC. L. REP. (CCH) ¶ 98,419, at 92,508; Rankl v. Stroud, Suplee & Co., [1981 Transfer Binder] FED. SEC. L. REP. (CCH) 97,827, at 90,119-20 (E.D. Pa. June 12, 1980).

203. *Wilko*, 346 U.S. at 438.

204. *Id.* at 428. The plaintiff-customer filed an action against a securities brokerage firm to recover damages for violation of § 12(2) of the Securities Act of 1933. *Wilko*, 346 U.S. at 428-29.

205. *Wilko*, 346 U.S. at 438.

206. *See, e.g., Mansbach*, 598 F.2d at 1030; *Cunningham*, 550 F. Supp. at 580.

207. *See Sawyer*, 642 F.2d at 792; *Mansbach*, 598 F.2d at 1030; *Sibley*, 543 F.2d at 542-43; Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 559 F. Supp. 388, 390 (E.D. Mo. 1983); *Cunningham*, 550 F. Supp. at 580; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508.

208. *See Miley*, 637 F.2d at 334; *Sawyer*, 642 F.2d at 792; *Dickinson*, 661 F.2d at 641; *Sibley*, 543 F.2d at 542; *Cunningham*, 550 F. Supp. at 578-79; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508.

209. *See, e.g., Sibley*, 543 F.2d at 542; *Roueche*, 554 F. Supp. at 339. *But see Dickinson*, 661 F.2d at 641 (defendant moved for arbitration of arbitrable claims, but requested that the arbitration be stayed until federal resolution of the non-arbitrable claims); *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508 (the defendant argued that the court should sever the state claims, order arbitration of these claims, but—to simplify matters—stay the arbitration until after the federal trial).

210. *Compare* Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981), *and* Sawyer v. Raymond, James & Ass'n, 642 F.2d 791 (5th Cir. 1981), *and* Sibley v. Tandy Corp., 534 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977), *and* Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578 (E.D. Cal. 1982), *and* Liskey v. Oppenheimer & Co., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419 (W.D. Okla. Jan. 12, 1982), *and* Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 559 F. Supp. 388 (E.D. Mo. 1981) *and* Rankl v. Stroud, Suplee & Co., [1981] FED. SEC. L. REP. (CCH) ¶ 97,827 (E.D. Pa. June 12, 1980) (denying arbitration when impracticable to separate non-arbitrable federal claims from arbitrable state claims) *with* Dickinson v. Heinold Sec., Inc., 661 F.2d 638 (7th Cir. 1981), *and* Roueche v.

A number of circuit courts recognize an exception to imposing arbitration known as the doctrine of intertwining.[211] The Fifth Circuit developed this theory in *Sibley v. Tandy*:

> [W]hen it is impractical if not impossible to separate out non-arbitrable federal securities law claims from arbitrable [state] claims, a court should deny arbitration in order to preserve its exclusive jurisdiction over federal securities act claims. . . . An arbitrator making a decision on the common law claims would [be] impelled to review the same facts needed to establish the plaintiff's securities law claim.[212]

The intertwining theory permits the district court to exercise discretion to refuse to order severance and arbitration if the case falls within the parameters of the theory.[213] In general, the court must first determine that all claims in the action involve the same series of occurrences and would be resolved by consideration of the same factual and legal conclusions for both the federal and pendent state claims, based upon evidence common to both.[214] Courts adopting the intertwining theory reason that arbitration would be inefficient and duplicative as well as inconsistent with the goals of the Arbitration Act and a scheme of exclusive federal jurisdiction.[215]

Permitting severance and arbitration of pendent state claims while imposing a stay on the federal action impinges upon the exclusive jurisdiction of the federal courts to determine federal securities law violations.[216] In effect, the prior arbitration of state claims allows the arbitrator to decide central factual issues which may bind the federal court through collateral estoppel.[217] The federal court is, however, charged with sole responsibility to decide the ultimate issues in a federal securi-

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Merrill Lynch, Pierce, Fenner, & Smith Inc., 554 F. Supp. 338 (D. Hawaii 1983), *and* Ging v. Parker-Hunter Inc., 544 F. Supp. 49 (W.D. Pa. 1982), *and* Baselski v. Paine, Webber, Jackson & Curtis, Inc., 514 F. Supp. 535 (N.D. Ill. 1981) (compelling arbitration of arbitrable state claims).

211. *See, e.g., Miley*, 637 F.2d at 335-37; *Sawyer*, 642 F.2d at 792-93; *Mansbach*, 598 F.2d at 1030; *Sibley*, 543 F.2d at 543; *Surman*, 559 F. Supp. at 390; *Rankl*, [1981] FED. SEC. L. REP. (CCH) ¶ 97,827, at 90,120; *Cunningham*, 550 F. Supp. at 581-85; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508.

212. *Sibley*, 543 F.2d at 543 (citations omitted).

213. *See* Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Haydu, 675 F.2d 1169, 1172 (11th Cir. 1982); *Sawyer*, 642 F.2d at 792-93; *Miley*, 637 F.2d at 335-36; *Surman*, 559 F. Supp. at 390; *Cunningham*, 550 F. Supp. at 581-82; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,419, at 92,508.

214. *Sawyer*, 642 F.2d at 793; *Miley*, 637 F.2d at 335-36; *Sibley*, 543 F.2d at 543-44; *Surman*, 559 F. Supp. at 390; *Cunningham*, 550 F. Supp. at 581-82.

215. *See Sawyer*, 642 F.2d at 793; *Miley*, 637 F.2d at 335-36; *Mansbach*, 598 F.2d at 1030; *Sibley*, 543 F.2d at 543; *Cunningham*, 550 F. Supp. at 581-82; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508-09.

216. *See, e.g., Miley*, 637 F.2d at 335-36; *Cunningham*, 550 F. Supp. at 582-83.

217. *See Miley*, 637 F.2d at 335-36; *Cunningham*, 550 F. Supp. at 582.

ties claim; prior resolution by the arbitrator forces the federal court to draw its conclusions based upon the arbitrator's findings.[218]

The threat of collateral estoppel may be eliminated by allowing the federal action to proceed first while staying the arbitration of state claims.[219] Yet this situation does not solve the problem of exclusive jurisdiction. Bifurcating the federal and state claims creates an incentive for the plaintiff to forego the federal suit and pursue the faster and cheaper state arbitration.[220] This defeats the very purpose of the federal securities laws and exclusive federal jurisdiction to protect the injured investor.[221]

On the other hand, if the investor files all of his or her claims in federal court, he or she would still face a long arbitration proceeding before receiving full judgment.[222] The delay caused by proceeding with arbitration may induce the investor to drop the state claims and only collect damages for the federal claims.[223] This defeats the purpose of pendent jurisdiction and may result in less than the full compensation due the investor.[224]

Bifurcation of the proceedings when the arbitrable and non-arbitrable claims are intertwined is clearly duplicative and inefficient.[225] Both courts would be required to hear essentially the same evidence and proof.[226] Even when the federal case proceeds first, the arbitrator in the later proceeding hearing the state claims must make essentially the same factual and legal determinations decided in federal court.[227] Moreover, since the misconduct necessary to prove a section 10(b) violation almost always satisfies the requirements for the state claims of breach of fiduciary duty and fraud, it is illogical and inefficient to send the case to arbitration after the federal court has already found the requisite misconduct.[228] In rebuttal to this argument, some courts argue that duplication in the arbitration of state claims is kept to a minimum

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218. *See Miley*, 637 F.2d at 335-36; *Cunningham*, 550 F. Supp. at 582.

219. *See, e.g., Dickinson*, 661 F.2d at 644; *Miley*, 637 F.2d at 336.

220. *See Cunningham*, 550 F. Supp. at 584 n.7.

221. *Id.*

222. *See Miley*, 637 F.2d at 336-37.

223. *See id.* at 337. *But see Dickinson*, 661 F.2d at 644 ("plaintiffs who prevail in federal court may have no need to pursue their arbitrable claims because they will have already recovered their damages.").

224. *See Miley*, 637 F.2d at 337.

225. *See Mansbach*, 598 F.2d at 1030; *Cunningham*, 550 F. Supp. at 582-85; *Rankl*, [1981] FED. SEC. L. REP. (CCH) ¶ 97,827, at 90,120.

226. *See Mansbach*, 598 F.2d at 1030; *Cunningham*, 550 F. Supp. at 582; *Rankl*, [1981] FED. SEC. L. REP. (CCH) ¶ 97,827, at 90,120.

227. *See Cunningham*, 550 F. Supp. at 582.

228. *See Miley*, 637 F.2d at 337.

by collateral estoppel.[229]

The courts which support the doctrine of intertwining also argue that the policy of the Arbitration Act is better served by refusing to sever and arbitrate pendent state claims.[230] The policy of the Arbitration Act was to avoid the unnecessary expense and delay of litigation by permitting the parties to agree to resolve conflicts through the more efficient process of arbitration.[231] Compelling bifurcation and arbitration defeats this policy by extending the length of litigation and, in effect, doubling the cost of litigation.[232]

The opposing view held by at least one circuit court and a few district courts would enforce the severance and arbitration of pendent state claims.[233] When the arbitrable and non-arbitrable claims are mixed, the district court would have the discretion to stay the arbitration pending resolution of the non-arbitrable federal claims.[234] The only issue for the federal court to determine is whether the arbitration agreement is valid and binding upon the parties.[235] In most cases, the arbitration clause is unambiguous and therefore binding.[236] The basis for this view is that the strong federal policy favoring arbitration mandates enforcement of these agreements.[237] Securities violations involve complex issues and factual determinations. Arbitration permits experts to bring special skills to bear upon the resolution of these technical cases.[238]

Those courts upholding arbitration offer several counterarguments to the doctrine of intertwining. Staying arbitration until after the federal trial, it is argued, preserves the federal courts' exclusive jurisdiction over non-arbitrable federal claims while avoiding problems of collateral estoppel.[239] In any event, threats to exclusive federal jurisdiction

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229. *See Dickinson*, 661 F.2d at 644-45 (through the use of detailed federal court findings and FED. R. CIV. P. 52(a), duplication of effort is eliminated by collateral estoppel).

230. *See, e.g., Cunningham*, 550 F. Supp. at 584-85.

231. *See* S. REP. NO. 536, 68th Cong., 1st Sess. 3 (1924); *Cunningham*, 550 F. Supp. at 579, 584-85.

232. *See Cunningham*, 550 F. Supp. at 584-85 & n.7.

233. *See* Dickinson v. Heinold Sec., Inc., 661 F.2d 638 (7th Cir. 1981); Roueche v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 554 F. Supp. 338 (D. Hawaii 1983); Ging v. Parker-Hunter, Inc., 544 F. Supp. 49 (W.D. Pa. 1982); Baselski v. Paine, Webber, Jackson & Curtis, Inc., 514 F. Supp. 535 (N.D. Ill. 1981). *See also* Krause, *supra* note 196, at 716-18.

234. *See Dickinson*, 661 F.2d at 664; *Roueche*, 554 F. Supp. at 340; *Ging*, 544 F. Supp. at 55; *Baselski*, 514 F. Supp. at 543.

235. *See Dickinson*, 661 F.2d at 645.

236. *Id.*

237. *See id.* at 643, 645-46; *Roueche*, 554 F. Supp. at 340.

238. *See Dickinson*, 661 F.2d at 646 (technical disputes such as securities violations are better resolved by arbitrators with technical expertise).

239. *See Dickinson*, 661 F.2d at 644; *Roueche*, 554 F. Supp. at 340.

do not justify forsaking arbitration.[240] Furthermore, duplication of proof should not preclude arbitration.[241] With detailed findings by the district court and the provisions of Federal Rule of Civil Procedure 52(A),[242] collateral estoppel should eliminate the bulk of duplication at arbitration.[243] Those courts upholding arbitration have found no problem with plaintiffs dropping their arbitrable claims after receiving a favorable federal verdict.[244]

One prime problem with the intertwining exception to arbitration is that this exception "swallows" the rule.[245] Courts adopting the doctrine of intertwining have attempted to restrict its use to cases where the federal and state claims involve the same factual and legal conclusions.[246] However, skillful attorneys should invariably be able to craft complaints alleging securities law violations "intertwined" with state claims.[247] This is one valid criticism of the doctrine which the courts have neither addressed nor corrected.

Courts compelling arbitration have justified their conclusions with heavy reliance upon the Arbitration Act.[248] These courts have read section 3 of the Act as providing for bifurcation of the controversy and arbitration of the state claims.[249] The Act was indeed intended to make arbitration a viable, enforceable alternative to litigation.[250] By its terms, however, section 3 does not mention bifurcation or compel split

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240. *See Dickinson*, 661 F.2d at 644.

241. *See id.*

242. FED. R. CIV. P. 52(a) states as follows:

> In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).

243. *See Dickinson*, 661 F.2d at 644.

244. *See, e.g., id.* at 644 n.13. In the alternative, plaintiffs who have succeeded on their federal claims may settle their arbitrable claims based upon the federal courts' finding of fact. *Id.* at 644.

245. *See id.* at 645-46; *Roueche*, 554 F. Supp. at 340.

246. *See Haydu*, 675 F.2d at 1172; *Sawyer*, 642 F.2d at 792-93; *Miley*, 637 F.2d at 335-36; *Surman*, 559 F. Supp. at 390; *Cunningham*, 550 F. Supp. at 581-82; *Liskey*, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,419, at 92,508.

247. *See Dickinson*, 661 F.2d at 646; *Roueche*, 554 F. Supp. at 340.

248. *See, e.g., Dickinson*, 661 F.2d at 643, 645-46.

249. *See id.* at 645.

250. *See* 9 U.S.C. §§ 1-14 (1976).

proceedings.[251] Congress' intent, as discussed above, was to reverse the courts' traditional refusal to enforce arbitration agreements.[252] The Act was aimed at facilitating the resolution of controversies without the unnecessary expense and delay of protracted litigation.[253] Congress did not contemplate that the Act would cause the blind enforcement of arbitration agreements or the circumvention of other federal laws.[254] Arbitration in actions involving mixed or intertwined federal and state claims disserves the policies of the Arbitration Act and adds delay and expense to the conflict between the parties.[255] Moreover, the arbitrator's traditional capacity to rationally resolve the most tangled of technical factual patterns is often lost; the federal court determinations will usually estop the arbitrator's consideration of the essential issues.[256]

In sum, in the interest of preserving the federal courts' prerogative over securities law violations as well as ensuring judicial economy and the plaintiff's interest in compensation, the doctrine of intertwining should be applied to bar severance when the plaintiff's state and federal claims are functionally equivalent.

B. Customer's Profits

A net profit in the customer's account is not a sufficient defense to a churning cause of action.[257] An account earning a small net profit while churned might be shown to have earned a substantial profit without such misconduct.[258] It will of course be more difficult to convince a jury of a churning violation if the customer received a profit in any amount.[259] Tactically, the customer ought usually to be able to present proof of *net loss* in the value of his or her account and then proceed to establish the *total loss* sustained due to excessive commissions paid and trading losses suffered.

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251. *See id.* § 3; *Cunningham*, 550 F. Supp. at 583.

252. *See, e.g., Cunningham*, 550 F. Supp. at 584.

253. *See* S. REP. No. 536, 68th Cong., 1st Sess. 3 (1924); *Cunningham*, 550 F. Supp. at 584.

254. *See Cunningham*, 550 F. Supp. at 583. The court stated that "there is some language in the legislative history suggesting that Congress had in mind cases in which *only* arbitrable claims exist." *Id.* (emphasis added).

255. *See Cunningham*, 550 F. Supp. at 584-85. *See also supra* text accompanying notes 230-32. *But see* S. JAFFE, *supra* note 195, at 338-42.

256. *See Cunningham*, 550 F. Supp. at 584-85.

257. *See* Note, *supra* note 1, at 878-79; Comment, *supra* note 9, at 296.

258. *See, e.g., Miley*, 637 F.2d at 326; *Rolf*, 570 F.2d at 49-50. *See also* Note, *supra* note 1, at 878.

259. *See* Note, *supra* note 1, at 878.

C. *Laches, Estoppel, Waiver, and Ratification*

The broker may raise the defenses of laches,[260] estoppel,[261] waiver,[262] and ratification[263] to deny liability to the customer in an action brought under section 10(b).[264] The Ninth Circuit stated pointedly that "[t]he purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."[265] When the investor awaits investment results before filing suit, the broker may argue waiver and estoppel.[266] Laches may be similarly invoked as a defense because no applicable federal statute of limitations exists.[267]

Confirmation slips and periodic statements sent the customer, sufficiently informing him or her of the transactions in the account,[268] may also act to bar the customer's complaint. If the customer fails to seasonably relate his or her investment objectives to the broker in such a case, the broker may invoke waiver, estoppel, or laches.[269] Likewise,

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260. Laches requires proof of a lack of diligence by the party against whom the defense is made and prejudice to the party asserting the defense. *See* Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970) (citing Costello v. United States, 365 U.S. 265 (1961)); *Mihara*, 619 F.2d at 822. *See generally* S. JAFFE, BROKER-DEALERS AND SECURITIES MARKETS § 15.05 (1977 & Supp. 1983).

261. Estoppel may be imposed if the defendant shows that the

> plaintiff by his conduct intentionally or through culpable neglect, led defendant to believe that trading was proceeding as agreed, and that defendant, in reasonable reliance on that belief, continued to trade so that it would prejudice defendant if plaintiff [were] permitted to deny that the trading was authorized . . . .

Karlen, 688 F.2d at 1198 n.4 (district court's instructions to the jury). *See generally* S. JAFFE, *supra* note 260, at § 15.05.

262. Waiver is defined as the voluntary or intentional relinquishment of a known legal right. *See Hecht*, 430 F.2d at 1208. To establish the defense that the plaintiff waived his or her rights in a churning case, the defendant must show that "plaintiff, with knowledge of unauthorized transactions and of the right to object thereto, voluntarily and intentionally failed to make proper objection within a reasonable time." *Karlen*, 688 F.2d at 1197 n.4 (district court's instructions to the jury). *See generally* S. JAFFE, *supra* note 260, at § 15.05.

263. Ratification is established by showing the "plaintiff, with full knowledge of the facts, manifested in some way that he was electing to treat the allegedly unauthorized transactions as authorized, or that his conduct would be justifiable only if there was such an election." *Karlen*, 688 F.2d at 1197 n.4 (district court's instructions to the jury).

264. *See Karlen*, 688 F.2d at 1197-201; *Hecht*, 430 F.2d at 1207-09.

265. Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213-14 (9th Cir. 1962). *See also Hecht*, 430 F.2d at 1207-08.

266. *See, e.g.*, Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 428 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

267. *See id.*

268. *See id.* at 428-30. These slips and statements must disclose the essentials of the transactions in order to be effective against the broker. The essentials of the transaction include slips showing each security or commodity transaction, a monthly statement of the account, and a request for immediate notification of any error. *Id.* at 426-28.

269. *Id.* at 428-30. A customer may be barred from recovery in a 10b-5 action if he or she

an informed customer who permits his or her broker to rely upon apparent acquiescence with the account for a substantial time may be barred from any action on account of ratification, estoppel, waiver, and laches.[270]

Furthermore, a broker's proof of customer knowledge of the transactions in the account may enable the broker to prevent a claim of unsuitability and hence trading losses.[271] While the informed customer may be denied a claim of *unsuitability*, he or she will not thereby be held responsible for acquiescing in *excessive trading* of the account.[272] Unless the customer is a skilled market analyst, confirmation slips and periodic statements do not sufficiently apprise the customer of the overall trading status of the account.[273] Proof of the customer's lack of knowledge of, or failure to consent to, transactions in the account may of course be presented, and may constitute a defense for the customer.[274] The customer's defense in this regard will of course be a factual issue, based upon the customer's level of sophistication during the alleged period of misconduct.[275]

V. CONCLUSION

Churning is a unified offense consisting in two harms for the broker's customer: excessive trading of the account as well as trading in unsuitable securities. For proof of the offense, the customer has traditionally been required to establish excessive trading of the account as well as exercise of control over the account by the broker. The customer is now also generally held to proof of scienter in the broker—either an intent to defraud or a reckless disregard for the customer's interests.

While a variety of federal avenues of relief have been possible,

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failed to exercise due diligence. The broker must show that the customer was guilty of recklessness and not mere negligence. *See* Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1035 (5th Cir. 1981); *Mihara*, 619 F.2d at 822.

270. *See Hecht*, 238 F. Supp. at 429-30.

271. *See, e.g., Mihara*, 619 F.2d at 822; *Hecht*, 430 F.2d at 1211-12.

272. *See, e.g., Karlen*, 688 F.2d at 1200; *Petrites*, 646 F.2d at 1035; *Mihara*, 619 F.2d at 822; *Hecht*, 430 F.2d at 1211-12.

273. *Karlen*, 688 F.2d at 1200. Confirmation slips and monthly statements do not enable an unskilled or inexperienced customer to determine an overall position of net profit or loss. In the case of an inexperienced customer, courts generally permit an action for churning even though regular transaction information was received by the customer. *Id.*

274. *See id.* at 1200-01; *Petrites*, 646 F.2d at 1035.

275. *See, e.g., Karlen*, 688 F.2d at 1200-01. *But see* Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1417-19 (11th Cir. 1983) (customer desired to "play the market," and knew that the securities purchased would yield results inconsistent with conservative objectives, but he did not question the returns because they were in line with his objectives); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676-78 (9th Cir. 1982) (customer took many positive steps to insure his account would be actively traded, which negated any inference of excessive trading).

most customers have pursued actions against brokers under section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission rule 10b-5. Private rights of action under the RICO statute have also been attempted, generally without success. On the state level, customers have founded theories of recovery upon state law fraud, breach of fiduciary duty, misrepresentation, negligence, or violations of the state's securities laws. The deeper pockets of the brokerage firm itself have been reached by defrauded customers under the section 10(b) theory of aiding and abetting. Firms have also been held vicariously liable to injured customers under either the controlling persons doctrine of the federal securities laws or common-law principles of respondeat superior.

Calculating damages which fully compensate the customer for the offense without being unduly speculative at the broker's expense has been a difficult task for the courts. To date, the most logical and comprehensive method of calculation has been the *Miley-Rolf* formula. Under this calculus, damages are awarded for the excessive commissions paid and trading losses incurred. Under the better view, courts should additionally have the discretion to permit the parties to assert different methods of calculation for damages, provided that they are more accurate. On the punitive side, it is settled that punitive damages may not be awarded under section 10(b) or rule 10b-5. Such damages have, however, been permitted when allowed under the relevant state law, in cases where state law violations have been joined to federal securities law violations.

The broker has not been left defenseless. Arbitration clauses have become standard in securities contracts. These clauses, while ineffective against federal claims, have been invoked by defendant-brokers to remove state claims from the federal forum for arbitration. To retain the churning claims intact at the federal level and avoid the problems associated with bifurcating the case, several circuits have used the doctrine of intertwining to justify the retention of arbitrable, pendent state claims which involve essentially the same problems of proof as the federal claims. A number of federal courts continue to insist on the arbitration of state claims. Other defenses invoked by defendants are those familiar at common law. Upon proof that the customer knew of the transactions but acquiesced in or ratified them, brokers have also raised the defenses of laches, estoppel, waiver, and ratification.

The customer victimized by churning is seemingly left with a great variety of remedies. Under both state and federal law, churning constitutes fraud in the clearest sense. Moreover, in the last few decades, the securities field has become one of the most regulated and policed sectors of American enterprise, with a body of rapidly evolving case law of

great potential benefit to the plaintiff. Federal statutory approaches have also seemingly kept pace with problems like churning. Under rule 10b-5, it is now settled that churning constitutes "a device, scheme, or artifice to defraud." Under the federal statutes, private rights of actions by customers have also been implied.

Despite the civil damages currently available to the customer, the remedies for churning remain sorely inadequate. Proof problems predominate for the plaintiff. To prove the "unified" offense of churning, the customer must first endure an entire series of improper transactions. If the broker's fraud is discovered after only a short period of time, the customer's proof of excessive trading will be extremely difficult. The elements of scienter and control are also difficult to demonstrate before a judge or jury. Perhaps most troubling for the plaintiff is the expense of litigation. The proof essential to a churning cause of action is almost always voluminous and extensive expert testimony is almost always necessary.

Even upon proof of the tangled elements of the churning cause of action, a number of jurisdictions continue to award less than adequate damages. Effective compensation tends to be denied on the grounds that the recovery of any amount in excess of the commissions paid is speculative. Punitive damages are disallowed outright under the federal securities laws; when permitted, punitive damages are often limited by the courts to arbitrary cutoff figures.

The broker's ready defenses in a churning suit often limit any chance of recovery for the customer. Brokers often escape full liability through the inclusion of arbitration clauses in their standard-form securites contracts; the attempt is to avoid liberal federal jury awards in favor of more conservative arbitration awards. Brokerage firms often escape full liability by establishing the good-faith exception to the controlling persons doctrine after establishing that the controlling persons provisions supplant the common-law doctrine of respondeat superior.

One recalls the words of an Eighth Circuit justice of some forty years ago:

> The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action. The Congress has seen fit to regulate this business. Though such regulation must be done in strict subordination to constitutional and lawful safeguards of individual rights, it is to be enforced notwithstanding the frauds to be suppressed may take on more subtle and involved forms than those in which dishonesty manifests itself in cruder and less special-

ized activities.[276]

The import of the words is perhaps truer now than then. The courts' obligation is clear. No matter how difficult of detection, no matter what difficulties of remedy, the courts must come to offer meaningful redress to the customer in securities fraud cases.

276. Archer v. SEC, 133 F.2d 795, 803 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943).