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## Comments

### PRIVATE ACTIONS FOR THE BROKER'S "CHURNING" OF A SECURITIES ACCOUNT

The relationship between a securities broker<sup>1</sup> and his customer contains a potential conflict of interest. On the one hand, the broker gives advice on securities transactions, and on the other, he acts as a salesman and derives income from the transactions on which he gives advice.<sup>2</sup> This potential conflict of interest becomes actual when the broker "churns" his customer's account. "Churning" involves a broker's improper attempt to derive profits for himself with little regard for the interests of his customer.<sup>3</sup> It occurs when the dealer induces transactions in the customer's account which are excessive in size and frequency with respect to the character of the account.<sup>4</sup> Although "churning" is not established by any single rule or formula,<sup>5</sup> it seems clear that the elements of control and excessive trading must be established.<sup>6</sup>

#### I. ELEMENTS

##### A. *The Element of Control*

Overtrading of an account does not automatically establish

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1. Since courts use the terms "broker" and "dealer" interchangeably, this comment will also disregard the technical distinctions between the terms.

2. See Comment, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 870 (1967). See also Annot., 32 A.L.R.3d 635, 638 (1970).

3. *Stevens v. Abbott*, 288 F.Supp. 836 (E.D. Va. 1968).

4. *Powers v. Francis DuPont & Co.*, 344 F.Supp. 429 (E.D. Pa. 1972); accord, *Fey v. Waltston & Co.*, 493 F.2d 1036 (7th Cir. 1974); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir. 1973). The American Law Institute defines churning as follows:

[*Churning.*] It is unlawful for a broker or dealer to effect with or for a customer with respect to whose account he or his agent had discretionary authority, 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 the basis of such factors as the size and character of the account, the needs and objectives of the customer as ascertained on reasonable inquiry, the pattern of trading in the account, and the amount of profits or commissions of the broker or dealer or his agent in relation to the size of the account.

ALI FED. SECURITIES CODE § 1306, (Tentative Draft No. 2, March, 1973).

See also 3 L. LOSS, SECURITIES REGULATION 1480 (2d ed. 1961) [hereinafter cited as Loss]; E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS 109-11 (1965); Comment, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

5. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974).

6. *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132 (8th Cir. 1970); *Jenny v. Shearson, Hammill & Co., Inc.*, CCH FED. SEC. L. REP. ¶ 95,021, at 97,581 (S.D.N.Y. 1975).

churning.<sup>7</sup> It must also be shown that the broker controlled the account. The necessary element of control clearly exists when the account is a formally discretionary account.<sup>8</sup> The Securities and Exchange Commission once limited the offense of churning to such an account.<sup>9</sup> Presently, however, the finding of the element of control is not limited to situations involving a formally discretionary account.<sup>10</sup> A broker is in control if he is, in effect, making the decisions regarding the nature and number of transactions. In determining whether the element of control exists, the facts and circumstances of each case must be considered.<sup>11</sup> Such a determination is a factual one.<sup>12</sup>

Of primary importance is evidence which bears upon the customer's sophistication and experience in securities transactions<sup>13</sup> and which shows the degree of the customer's reliance upon the broker's recommendations.<sup>14</sup> Some courts have found that the requisite control existed if the broker-customer relationship was one of special trust and confidence.<sup>15</sup> Other courts have required the existence of a fiduciary relationship.<sup>16</sup> There seems to be little distinction between the existence of special trust and confidence and the existence of a fiduciary relationship, as the courts generally look to the same factors in determining the existence of each.

In *Stevens v. Abbott, Proctor & Paine*,<sup>17</sup> the court held the defendant-dealer liable for churning the plaintiff's account. The plaintiff was a housewife with no business training. After graduating from high school, she attended a girls' finishing school and married a portrait artist. In finding the plaintiff to be utterly naive and

7. *Powers v. Francis I. DuPont & Co.*, 344 F.Supp. 429 (E.D.Pa. 1972).

8. *Cf. Jenny v. Shearson, Hammill & Co., Inc.*, CCH FED. SEC. L. REP. ¶ 95,021, at 97,581 (S.D.N.Y. 1975). A formally discretionary account is one in which the broker has expressly been given control of the transactions of that account.

9. *Norris & Hirshberg, Inc.*, 21 S.E.C. 865 (1946).

10. *Newburger, Loeb & Co. v. Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973). *See also Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

11. *Newburger, Loeb & Co. v. Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973).

12. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974).

13. *Fey v. Walston & Co.*, 493 F.2d 1036, 1045 (7th Cir. 1974); *Newburger, Loeb & Co., v. Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973).

14. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 433 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

15. *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 846 (E.D. Va. 1968).

16. *Powers v. Francis I. DuPont & Co.*, 344 F.Supp. 429 (E.D. Pa. 1972); *see also Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974); *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836 (E.D. Va. 1968).

17. 288 F.Supp. 836 (E.D. Va. 1968).

unsophisticated in financial matters, the court relied on the plaintiff's answer when questioned about the difference between stocks and bonds—"stocks have names and bonds don't."<sup>18</sup>

In *Hecht v. Harris, Upham & Co.*,<sup>19</sup> the plaintiff was a widow who had attended a teachers college for two years. The broker and his wife had befriended the plaintiff after her husband's death, and their relationship was both business and social. In finding that the defendant had churned the plaintiff's account, the court stated that the defendant had induced the plaintiff to place complete confidence in him.<sup>20</sup>

These cases involve plaintiffs who had not completed college and had little or no business experience. However, the real test is not the plaintiff's general education and business experience. Rather, it involves the plaintiff's sophistication in securities transactions. It is conceivable for the customer to be well-educated and experienced in business and yet still have the element of control present. For example, in *Weiser v. Shwartz*,<sup>21</sup> the plaintiff was a member of the advisory committee of an insurance company and the advisory board of a local bank. Nevertheless, the court found that he was unsophisticated as an investor. The court stated that customers, in general, are peculiarly dependent on the professional knowledge and skill of brokers.

If a customer, who is experienced in trading and not subject to undue influence, confirms the allegedly excessive trading as being consistent with his own speculative desires, the requisite element of control does not exist.<sup>22</sup> In *Nash v. J. Arthur Warren & Co.*,<sup>23</sup> the plaintiffs failed to establish that the broker controlled their accounts. The court noted that the plaintiffs were far from unsophisticated in stock transactions and they did not simply rely on the

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18. *Id.* at 838. In *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir. 1973), the court accepted the jury's finding of control, although it was ultimately held that the evidence was insufficient to support a finding of excessive trading. The plaintiff was a high school graduate, who had engaged in the insulating, painting, and carpentry contracting business and later became president of a corporation earning an annual salary of \$15,000-\$25,000.

19. 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

20. *Id.* at 426.

21. 286 F.Supp. 389 (E.D. La. 1968). In this case, the court held that the plaintiff's cause of action for churning was not barred by the statute of limitation because the plaintiff had not discovered the fraud. Although this case is not directly on point as to whether the defendant controlled the plaintiff's account, the portion of the opinion which considers the plaintiff's sophistication seems relevant. *But cf.* *Hayden, Stone, Inc. v. Brown*, 218 So.2d 230 (Fla. App. 1969).

22. *Cf.* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocoock*, 247 F.Supp. 373 (S.D. Tex. 1965); *see Fey v. Walston & Co.*, 493 F.2d 1036, 1050 (7th Cir. 1974).

23. 137 F.Supp. 615 (D. Mass. 1955).

representations of the broker.<sup>24</sup>

Transactions which were truly initiated by the customer are evidence that the broker did not control the customer's account.<sup>25</sup> However, if the customer initiates transactions as a result of reliance on the broker's recommendations, then mere initiation by the customer does not refute the broker's control.<sup>26</sup> Asking the customer's permission is a futile gesture where the customer does not understand the nature of the transactions<sup>27</sup> and where the customer places special trust and confidence in the broker's recommendations.<sup>28</sup>

### B. *The Element of Excessive Trading*

Once the control element has been established, it must also be shown that the broker abused this control through excessive trading of the account.<sup>29</sup> The essential question is whether the volume and frequency of the transactions were "excessive" in light of the nature of the account and the needs and objectives of the customer.<sup>30</sup> No precise test has been formulated for determining whether an account was excessively traded.<sup>31</sup> However, certain factors have been considered in making the determination:

1. *The nature of the account.* The investment objectives of a customer are an important standard against which to measure excessiveness.<sup>32</sup> A larger number of transactions are generally needed to find excessiveness in respect to a trading account, where the purpose is to generate profits from trading, than with respect to an

24. In a companion case, this same court failed to find the defendant controlled the plaintiff's account because the plaintiff was fully apprised of the number and frequency of the transactions in her account. *Carr v. Warner*, 137 F.Supp. 618 (D. Mass. 1955). Subsequent cases indicate, however, that simply because the customer knows the number and frequency of the transactions does not necessarily mean that the broker did not control the account. See cases cited note 126 *infra*. The real question is not whether the customer was fully apprised of the transactions, but whether the customer was sophisticated enough to know that his account was being traded excessively.

25. *Newburger, Loeb & Co. v. Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973); *Thomson v. Karn*, 35 S.E.C. 451 (1953). See also *Powers v. Francis I. DuPont & Co.*, 344 F.Supp. 429 (E.D. Pa. 1972); 3 L. Loss, *supra* note 4, at 1479-80.

26. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 433 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); *accord*, *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 839 (E.D. Va. 1968).

27. *Newkirk v. Hayden, Stone & Co.*, CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965).

28. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968). This element of control is intertwined with the defense of waiver and estoppel.

29. *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132 (8th Cir. 1970).

30. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 435 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

31. *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132 (8th Cir. 1970).

32. *Fey v. Walston & Co.*, 493 F.2d 1036, 1045 (7th Cir. 1974).

investment account, where profits are to be derived from dividends and long-term capital appreciation.<sup>33</sup>

In a commodities account, a large number of transactions is expected, because of the high volatility of the commodity market.<sup>34</sup> Nevertheless, excessive trading can exist in a commodities account. Where the broker handling a securities account induces a customer to open a commodities account to provide an additional opportunity for generating commissions, the commodity account may be regarded as a mere device for churning the securities account.<sup>35</sup>

2. *The turn-over rate.* This test compares the total cost of purchases during a given time period to the amount of the original investment.<sup>36</sup> In *Stevens v. Abbott, Proctor & Paine*,<sup>37</sup> the turn-over averaged an equivalent of more than two times a year. The court held that this was clearly excessive.<sup>38</sup> In *Hecht v. Harris, Upham & Co.*,<sup>39</sup> the turn-over rate was between 8.05 and 11.5 for a period of six years and ten months. This was held to be evidence of churning.<sup>40</sup>

3. *In-and-out trading.* Another consideration in determining excessiveness is the presence of a pattern of in-and-out trading. In-and-out trading is a sale of part or all of a customer's portfolio with the proceeds immediately reinvested in other securities followed by the sale of the newly acquired securities in a short period of time.<sup>41</sup> Another type of transaction which is condemned is the so-called "reversal." Reversal occurs when certain securities are sold and then repurchased in a short period of time.<sup>42</sup>

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33. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 432 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). In *Walter S. Grubbs*, 28 S.E.C. 323, 329 (1948), it was held that excessive trading may be established by fewer transactions, if the account was of a non-speculative nature. A trading account can, however, be churned even though the number of transactions is small. The churning occurs when the broker trades solely to generate commissions without considering whether the trade is beneficial to the customer. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 432 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); see *Jenny v. Shearson, Hammill & Co.*, CCH FED. SEC. L. REP. ¶ 95,021, at 97,581 (S.D. N.Y. 1975).

34. *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132, 134 (8th Cir. 1970).

35. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 437 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

36. *Id.* at 435. See also *R.H. Johnson & Co.*, 36 S.E.C. 467 (1955); *Behel, Johnsen & Co.*, 26 S.E.C. 163 (1947).

37. 288 F.Supp. 836 (E.D. Va. 1968).

38. *Id.* at 842.

39. 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

40. *Id.* at 436.

41. *Id.* at 435. See also *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 846 (E.D. Va. 1968).

42. *R.H. Johnson & Co.*, 33 S.E.C. 180 (1951), *aff'd*, 198 F.2d 690 (2nd Cir. 1952), *cert. denied*, 344 U.S. 855 (1952). See also *Norris & Hirshberg, Inc. v. S.E.C.*, 177 F.2d 228 (D.C. Cir. 1949).

4. *The holding period of the respective securities.* The length of time for which each security was held is important in determining whether the account has been excessively traded.<sup>43</sup> However, the holding period must be considered in light of whether the account is for investment or trading purposes. In *Stevens v. Abbott, Proctor & Paine*,<sup>44</sup> in holding for the plaintiff, the court noted that 85 per cent of the securities were held less than six months, 70 per cent ninety days or less, and 39 per cent thirty days or less.<sup>45</sup>

5. *The broker's profit.* If the broker's profit is large compared to the amount of the original investment, such evidence supports an allegation of "churning."<sup>46</sup> Also, in *Stevens v. Abbott, Proctor & Paine*,<sup>47</sup> the finding of churning was supported by the fact that the commissions from the customer's account represented a major portion of the broker's earnings. In that case, this figure exceeded 40 per cent in at least two years.<sup>48</sup> In *Hecht v. Harris, Upham & Co.*,<sup>49</sup> 39 per cent of the broker's commissions were earned from the plaintiff's account.<sup>50</sup>

6. *Opinion of an expert witness.* As a result of certain recent cases in which a verdict has been directed for the dealer-defendant, it seems mandatory for the plaintiff to produce an expert witness. The expert witness must analyze the above factors and conclude that the account was excessively traded.<sup>51</sup> If the fact finder is presented with the raw data concerning the plaintiff's transactions and no expert opinion is offered, the court may easily find for the defendant as a matter of law.<sup>52</sup> The Court of Appeals for the Eighth Circuit, in affirming a directed verdict for the defendant dealer in an action for churning a commodities account, stated that the jury

43. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 436 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

44. 288 F.Supp. 836 (E.D. Va. 1968).

45. *Id.* at 840. The court stated that the purpose of the account was not active trading. A more active account was involved in *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 436 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970), where the court noted that 82% of the securities were held less than a year, 67% were held less than nine months, and 45% were held less than six months. The court relied upon this evidence in finding that the defendant had churned the plaintiff's account.

46. *E. H. Rollins & Sons*, 18 S.E.C. 347, 381 (1945).

47. 288 F.Supp. 836 (E.D. Va. 1968).

48. *Id.* at 840.

49. 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

50. *Id.* at 436. In *Norris & Hirschberg, Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949), the plaintiff's gross trading profit was \$53,000, while the defendant's gross commissions were \$530,000. Such evidence supported the finding of churning.

51. *See, e.g.*, *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365 (1st Cir. 1973); *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132 (8th Cir. 1970).

52. *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 372 (1st Cir. 1973).

had not been presented with any objective criteria for determining churning. Since trading in commodity futures is a specialized field, the mere fact of trading, standing alone, did not provide a sufficient basis for submission to the jury.<sup>53</sup>

## II. THEORETICAL BASES FOR PRIVATE REMEDIES

Until a few years ago, the Securities and Exchange Commission dealt with the offense of churning through enforcement of the anti-fraud provisions of the federal securities acts.<sup>54</sup> Today, private actions seem to be the major deterrent against the offense of churning.<sup>55</sup>

### A. Liability Under the Federal Securities Acts<sup>56</sup>

Although the anti-fraud provisions of the federal securities acts<sup>57</sup> make no specific reference to a private right of action, private actions for violations of these provisions have become well established.<sup>58</sup> In acknowledging these causes of action, the courts have taken it upon themselves to provide such remedies as are necessary to make effective the congressional purpose of the acts.<sup>59</sup>

One of the principal congressional purposes of the federal securities acts was to protect the investor in a highly sophisticated securities field.<sup>60</sup> It is essential that the highest ethical standards prevail in every facet of the securities industry.<sup>61</sup> A broker who is guilty of the offense of churning a customer's account violates section 17(a)

53. *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132, 135 (8th Cir. 1970).

54. See *Irish v. SEC*, 367 F.2d 637 (9th Cir. 1966); *Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963); *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347 (1945).

55. See, e.g., *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); *Stevens v. Abbott, Proctor, & Paine*, 288 F.Supp. 836 (E.D. Va. 1968); *Lorenz v. Watson*, 258 F.Supp. 724 (E.D. Pa. 1966); *Twomey v. Mit-chum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968).

56. Securities Act of 1933, 15 U.S.C. § 77a *et seq.* (1970); Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (1970).

57. Securities Act of 1933, § 17a, 15 U.S.C. § 77q(a) (1970). Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).

58. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 423 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). See also *Wyandotte Transportation Co. v. United States*, 389 U.S. 191 (1967); *J.I. Case v. Borak*, 377 U.S. 426, 433 (1964); *Katz v. Amos Treat & Co.*, 411 F.2d 1046 (2d Cir. 1969); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961); *Matheson v. Armubust*, 284 F.2d 670 (9th Cir. 1960); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 787 (2d Cir. 1951); *Lorenz v. Watson*, 258 F.Supp. 724, 730 (E.D. Pa. 1966); *Kardon v. National Gypsum Co.*, 73 F.Supp. 798, 800, 802-03 (E.D. Pa. 1946), *modified*, 83 F.Supp. 613 (E.D. Pa. 1947).

59. *J.I. Case v. Borak*, 377 U.S. 426, 433 (1964); *cf.* *Bell v. Hood*, 327 U.S. 678, 684 (1946).

60. *Cf.* *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1207 (9th Cir. 1970).

61. *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963).



of the Securities Act of 1933,<sup>62</sup> section 10(b) of the Securities Exchange Act of 1934,<sup>63</sup> and Securities and Exchange Commission Rule 10b-5.<sup>64</sup> These violations may be the theoretical basis for a private action, even though the plaintiff (customer) and defendant (broker) are not in the classic buyer-seller relationship.<sup>65</sup>

As with other fraud actions under the federal securities acts, the above sections are not the sole basis for a private action.<sup>66</sup> Churning a customer's account is also a violation of section 15(c)(1) of the Securities Exchange Act of 1934.<sup>67</sup> Moreover, churning is a direct violation of Securities and Exchange Commission Rule 15c-1-7,<sup>68</sup> which, by its very terms, makes churning unlawful.<sup>69</sup> The language of rule 15c-1-7, which specifically prohibits "transactions which are excessive in size or frequency," might indicate that all other statutory prohibitions, which are more indirect, should be abandoned in

62. 15 U.S.C. § 77q(a) (1970). The Securities Act of 1933 is concerned with the initial distribution of securities rather than subsequent trading. L. LOSS, SECURITIES REGULATION 130 (temp. student ed. 1961). Because churning is a problem involving subsequent trading, in a technical sense there has been no violation of the 1933 Act. However, in pleading the case, the plaintiff-customer will allege all possible statutory violations and the courts simply find that the broker has churned the account without specifying the statutory violations. See *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 843 (E.D. Va. 1968); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 422 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); *cf. Norris & Hirshberg, Inc. v. SEC*, 177 F.2d 228 (D.C. Cir. 1949); 3 L. Loss, *supra* note 4, at 1480.

63. 15 U.S.C. § 78j(b) (1970). See *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 845 (E.D. Va. 1968); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 422, 423, 432 (N.D. Cal. 1968), *modified*, 430 F.2d 1202, 1207 (9th Cir. 1970); *Lorenz v. Watson*, 258 F.Supp. 724 (E.D. Pa. 1966); *Newkirk v. Hayden, Stone & Co.*, CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 690, 69 Cal.Rptr. 222 (1968); 6 L. Loss, *supra* note 4, at 3679 (Supp. 1969).

64. See 17 C.F.R. § 240.10b-5 (1973), for cases which hold that churning is a violation of rule 10b-5; see also cases cited note 63 *supra*.

65. *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 444 (2d Cir. 1971); *Lorenz v. Watson*, 258 F.Supp. 724, 732 (E.D. Pa. 1966).

66. See ALI, INTRODUCTORY MEMORANDUM TO FEDERAL SECURITIES CODE, at xv (Tentative Draft No. 2, March, 1973).

67. 15 U.S.C. § 780(c)(1) (1970); *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836 (E.D. Va. 1968); see *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 431 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); *Lorenz v. Watson*, 258 F.Supp. 724, 734 (E.D. Pa. 1966); *Newkirk v. Hayden, Stone & Co.*, CCH FED. SEC. L. REP. ¶ 91,621, at 95,321 (S.D. Cal. 1965).

68. 17 C.F.R. § 240.15c1-7. For cases which stand for the proposition that churning violates rule 15c1-7, see cases cited note 67 *supra*. See also 3 L. Loss, *supra* note 4, at 1479.

69. Rule 15c-1-7(a) states:

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 or dealer designed to effect with or for any customer's account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

favor of rule 15c-1-7. However, section 15(c)(1) of the 1934 Act and rule 15c-1-7 have two major limitations. First, they are violated only if the churning involves over-the-counter transactions.<sup>70</sup> Second, any action brought under section 15(c)(1) is governed by the statute of limitations provided for in section 29(b) of the 1934 Act, whereas the other anti-fraud provisions of the federal securities acts are governed by the applicable state statute of limitations for fraud. The statute of limitations period begins to run when the churning fraud is or should be discovered,<sup>71</sup> and this is true whether the period for the statute of limitations is controlled by federal statute or state law.<sup>72</sup> But in accordance with section 29(b) of the Securities and Exchange Act of 1934,<sup>73</sup> all churning actions which are based on section 15(c)(1) and rule 15c-1-7 must be brought within one year after the discovery of the churning or within three years after the churning occurs.<sup>74</sup> If, on the other hand, the action is based on the

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70. See *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 431 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). *Lorenz v. Watson*, 258 F.Supp. 724, 734 (E.D. Pa. 1966).

71. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 (10th Cir. 1974); *Weiser v. Shwartz*, 286 F.Supp. 389, 392 (E.D. La. 1968); 3 L. Loss, *supra* note 4, at 1775-76. The statute of limitations will not begin to run because the customer has knowledge of all the transactions. He must at least have constructive knowledge that his account is being churned. Knowledge of the transactions only puts the sophisticated investor on inquiry. See *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172 (10th Cir. 1974); *Weiser v. Shwartz*, 286 F.Supp. 389, 392-93 (E.D. La. 1968).

72. *Weiser v. Shwartz*, 286 F.Supp. 389 (E.D. La. 1968); see *Bailey v. Glover*, 88 U.S. (22 Wall.) 342, 348 (1875).

73. 15 U.S.C. § 78cc(b) (1970) states:

[T]hat no contract shall be deemed void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 78o of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation.

74. *Newburger, Loeb & Co., Inc. v. Gross*, 365 F.Supp. 1364, 1371 (S.D.N.Y. 1973); *Lorenz v. Watson*, 258 F.Supp. 724, 734 (E.D. Pa. 1966). Both the *Newburger* and *Lorenz* cases applied the statute of limitations period of § 29(b) of the Securities and Exchange Act of 1934 to a cause of action for money damages even though § 29(b) speaks only of an action which voids a contract in violation of § 15(c)(1). In *Newburger*, the federal district court held that the distinction between tort and contract theory was not determinative, citing *Goldenberg v. Bache & Co.*, 270 F.2d 675 (5th Cir. 1959). See also *Geismar v. Bond & Goodwin*, 40 F.Supp. 876 (S.D.N.Y. 1941). But, in *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 441-42 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970), the court, in dictum, stated that the statute of limitations period in § 29(b) of the 1934 Act applied only to actions to declare contracts void. Moreover, in *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 845 (E.D.Va. 1968), the court held that § 29(b) did not apply to the plaintiff's churning action, even though one of the counts was an alleged violation of § 15(c)(1) of the 1934 Act. Hence, it is unclear whether the statute of limitations for a churning action based on § 15(c)(1) is

other anti-fraud provisions, the controlling statute of limitation is the same as that of the state in which the churning occurred. The state limitations period is generally more liberal than the limitation period in section 29(b) of the 1934 Act.<sup>75</sup> As a result of these two considerations section 15(c)(1), which directly prohibits churning, can be used only if the securities churned were non-exchange securities and the action is brought within one year after the churning is discovered or within three years after the churning occurs.

If the broker churns a commodity account, not only does the customer have an action under section 17(a) of the 1933 Act,<sup>76</sup> section 10(b), and rule 10b-5 of the 1934 Act,<sup>77</sup> but there is also an action based on section 6(b) of the Commodity Exchange Act.<sup>78</sup> Such an action will withstand the defendant-dealer's contention that there is no liability under the former anti-fraud sections because the commodity future is not a security.<sup>79</sup>

Federal courts, of course, have jurisdiction in a churning action which is based on the anti-fraud provisions of the federal securities acts.<sup>80</sup> However, the petitioner should take care to plead specifically the use of a means or instrumentality of interstate commerce in accordance with the exact wording of the respective statute.<sup>81</sup> Since a churning action is based on the anti-fraud provisions, the plaintiff

governed by § 29(b) of the 1934 Act, or whether, like the other anti-fraud provisions, it is governed by the applicable state statute of limitations for fraud. See text accompanying note 75 *infra*.

75. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 (10th Cir. 1974); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 441 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). In *Dzenits*, the two-year Oklahoma statute of limitations for fraud applied to a "churning" action based on § 10(b) and rule 10b-5. In *Hecht*, the three-year California statute of limitations for fraud applied to a churning action based on all the anti-fraud sections of the federal securities acts except § 15(c)(1). See also *Fratt v. Robinson*, 203 F.2d 627, 634-35 (9th Cir. 1953); *Weiser v. Shwartz*, 286 F.Supp. 389, 391 (E.D. La. 1968).

76. 15 U.S.C. § 77ggg(a) (1970).

77. 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1973).

78. *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F.Supp. 764, 765 (S.D.N.Y. 1972); *Anderson v. Francis I. DuPont & Co.*, 291 F.Supp. 705, 710 (D. Minn. 1968); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 437 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). See also *Booth v. Peavey Co. Commodity Services*, 430 F.2d 132, 133 (8th Cir. 1970).

79. *Johnson v. Arthur Espey, Shearson, Hammill & Co.*, 341 F.Supp. 764, 765 (S.D.N.Y. 1972).

80. Federal jurisdiction may be based on § 22 of the Securities Act of 1933 (15 U.S.C. § 77yyy (1970)) and on § 27 of the Securities and Exchange Act of 1934 (15 U.S.C. § 78gg (1970)); see 28 U.S.C. § 1331 (1970); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 422 (N.D. Cal. 1968), *modified*, 430 F.2d 1202, 1206 (9th Cir. 1970).

81. *Lorenz v. Watson*, 258 F.Supp. 724, 730 (E.D. Pa. 1966). An intrastate telephone call may be sufficient to establish federal jurisdiction. See *Kerbs v. Fall River Industries, Inc.*, CCH FED. SEC. L. REP. ¶ 94,788, at 96,612 (10th Cir. 1974); *Myzel v. Fields*, 386 F.2d 718, 727 (8th Cir. 1967).

is required to plead fraud with particularity.<sup>82</sup> "Particularity" in this context means that the pleading must give the defendant fair notice of the claim asserted.<sup>83</sup> Common law fraud need not be alleged nor proven<sup>84</sup> and the burden of proof for churning under the anti-fraud sections of the federal securities acts, unlike common law fraud, is a "preponderance of the evidence standard."<sup>85</sup>

### B. *Liability Under the N.A.S.D. and N.Y.S.E. Rules*

Whether churning gives rise to a private action under the National Association of Security Dealers (N.A.S.D.)—Suitability Rule<sup>86</sup> or rules 401 and 435 of the New York Stock Exchange<sup>87</sup> (N.Y.S.E.) is unclear. In *Avern Trust v. Clarke*,<sup>88</sup> the seventh circuit court of appeals in dictum stated that a private cause of action could be based upon the rules of the N.A.S.D. and N.Y.S.E.<sup>89</sup> However, in *Colonial Realty Corp. v. Bache & Co.*,<sup>90</sup> the second circuit court of appeals stated that the courts cannot automatically imply federal civil liability for a member's violation of exchange or dealer

82. FED. R. CIV. P. 9(b). For a discussion of how the particularity requirement is met, see *Jenny v. Shearson, Hammill & Co.*, CCH. FED. SEC. L. REP. ¶ 95,021, at 97,581 (S.D. N.Y. 1975).

83. *Burkhart v. Allison Realty Trust*, 363 F.Supp. 1286, 1289 (N.D. Ill. 1973).

84. *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 212 (9th Cir. 1962).

85. *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970); *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 845-46 (E.D. Va. 1968).

86. National Association of Securities Dealers, Rule of Fair Practice, Art. III §§ 1 and 2 states:

Section 1. A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

Section 2. 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.

See Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233 (1966).

87. New York Stock Exchange Rule 401 states: "Every member, allied member and member organization shall at all times adhere to the principles of good business practice in the conduct of his or its business affairs." New York Stock Exchange Rule 435 states:

No member, member organization, partner or stockholder therein shall . . . (2) execute or cause to be executed on the Exchange purchases or sales of any stock for any account with respect to which he or it or another partner or stockholder therein is vested with any discretionary power, which purchases or sales are excessive in size or frequency in view of the financial resources in such account.

88. 415 F.2d 1238 (7th Cir. 1969), cert. denied, 397 U.S. 963 (1970).

89. See also *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969); *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 846 (E.D. Va. 1968).

90. 358 F.2d 178 (2d Cir. 1966).

association rules. The test is whether the rule imposes a duty unknown to common law. If such a duty is unknown at common law, then liability could be implied.<sup>91</sup> The court, in *Colonial*, concluded that there was no private action on the basis of the N.A.S.D.—Suitability Rule or on the basis of a N.Y.S.E. constitutional provision similar to N.Y.S.E. Rule 401.<sup>92</sup> The rationale of *Colonial* has been followed in subsequent decisions<sup>93</sup> and it appears that *Colonial* has received more support than *Avern Trust*. Therefore, the N.A.S.D.—Suitability Rule and N.Y.S.E. Rules 401 and 435 might not support a private action for churning, but this result is not absolutely certain. However, even in the cases affirming *Colonial*, violations of such rules are at least evidence of churning.<sup>94</sup>

### C. Liability Under State Statutes and Common Law

Churning violates not only the anti-fraud provisions of the federal securities acts, but also violates the anti-fraud sections of the state blue sky law.<sup>95</sup> Churning may also serve as a basis for an action of common law fraud, or an action for a breach of a fiduciary obligation. The federal securities acts expressly preserve other rights and remedies which may exist at law or in equity.<sup>96</sup> Hence, an action under a state statute or common law is appropriate and could be joined with the federal anti-fraud actions under the concept of pendent jurisdiction.<sup>97</sup>

A churning action based on a state blue sky law is so similar to an action based on the federal anti-fraud provisions<sup>98</sup> that any discussion would be repetitious. However, basing a churning action on common law fraud or breach of a fiduciary obligation is a wholly separate concept, and hence, must be considered separately.

91. *Id.* at 182.

92. New York Stock Exchange Constitution, art. XIV, § 6 (1968).

93. *Jenny v. Shearson, Hammill & Co.*, CCH FED. SEC. L. REP. ¶ 95,021 (S.D. N.Y. 1975); *Wells v. Blythe*, 351 F.Supp. 999, 1002 (N.D. Cal. 1972); *Mercury Investment Co. v. A.G. Edwards & Sons*, 295 F.Supp. 1160, 1163 (S.D. Tex. 1969); *cf. Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 431 (N.D. Cal. 1968), *modified*, 430 F.2d 1202, 1209 (9th Cir. 1970).

94. *Cf. Mercury Investment Co. v. A.G. Edwards & Sons*, 295 F.Supp. 1160, 1163 (S.D. Tex. 1969).

95. *See, e.g.*, UNIFORM SECURITIES ACT §§ 101, 102; §§ 409.101, .102, RSMo 1969.

96. Securities Act of 1933, § 16, 15 U.S.C. § 77p (1970); Securities and Exchange Act of 1934, § 28a; 15 U.S.C. § 78bb(a) (1970); *see Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968).

97. *Kasner v. H. Hentz & Co.*, 475 F.2d 119, 120 (5th Cir. 1973); *Jenny v. Shearson, Hammill & Co.*, CCH FED. SEC. L. REP. ¶ 95,021, at 97,582 (S.D.N.Y. 1975); *Mercury Investment Co. v. A.G. Edwards & Sons*, 295 F.Supp. 1160, 1163 (S.D. Tex. 1969); *see also U.M.W. v. Gibbs*, 383 U.S. 715 (1966); *McCurnin v. Kohlmeyer & Co.*, 477 F.2d 113 (5th Cir. 1973).

98. UNIFORM SECURITIES ACT § 101, Comment .01.

After examining the numerous violations of the federal securities acts which result from churning a customer's account, it might appear that an action for common law fraud or breach of a fiduciary obligation is both unnecessary and redundant. However, an action under the federal securities acts does not allow the plaintiff to recover punitive damages.<sup>99</sup> Therefore, a prayer for punitive damages must be based on an action at common law.

Even though the elements of common law fraud and deceit will differ from state to state, the elements are, essentially, the following: "There must be (1) a false representation of (2) a material (3) fact; (4) the defendant must know of the falsity (scienter) but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; (5) the plaintiff must justifiably rely on it; and (6) the plaintiff must have suffered damage as a consequence."<sup>100</sup>

Unlike an action under the federal anti-fraud provisions, some federal courts require the elements be proven by clear, cogent and convincing evidence.<sup>101</sup> An action for churning a customer's account does not easily fit into the elements of common law fraud. The broker probably made no positive representation. More than likely, no representation was made at all. The only feasible way in which the customer can meet the element of misrepresentation is to allege either that the broker misrepresented himself when he held himself out to the public, by impliedly promising to act in a fair and good faith manner—the "shingle" theory,<sup>102</sup> or that the broker misrepresented himself in failing to tell the customer of the excess transactions. Both of these allegations have problems associated with them. In the former, the broker may have intended to act in good faith at the inception of the relationship and hence, the representation was in all respects true when made. In the latter, the only misrepresentation is an omission; there was actually no representation made. Churning may exist in the absence of common law fraud and, thus, it is often difficult for the plaintiff to prove all fraud elements.<sup>103</sup>

99. See text accompanying note 155 *infra*.

100. *Burkhart v. Allson Realty Trust*, 363 F.Supp. 1286, 1291 (E.D. Ill. 1973); see *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968); *Latta v. Robinson Erection Co.*, 363 Mo. 47, 59, 248 S.W.2d 569, 576 (En Banc 1952); 3 L. Loss, *supra* note 4, at 1431.

101. *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 848 (E.D. Va. 1968).

102. Under the "shingle theory," the broker, by mounting his "shingle," makes the broad representation that he will deal fairly with his customers and that such transactions will be handled promptly in accordance with trade custom. *Harvey H. Shields, Jr.*, 39 S.E.C. 608, 609 (1954); see concurring opinion of *Clarke, J.*, in *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961); *E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS* 171 (1965).

103. See *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 171 (10th Cir. 1974).

To alleviate the proof problems caused by the stringent requirements of common law fraud, the customer may resort to an allegation of constructive fraud or breach of fiduciary duty. Although the term "constructive fraud" is elusive, some courts have said that constructive fraud arises on a breach of a duty by one in a confidential or fiduciary relationship to another which induces justifiable reliance by the latter to his detriment.<sup>104</sup> Therefore, whether churning gives rise to an action for constructive fraud or breach of a fiduciary obligation depends on whether the broker-customer relationship is one of special confidence and trust.

A confidential relationship exists when one relies upon and trusts another in regard to the handling of property and business affairs.<sup>105</sup> A real estate broker, as the agent of his customer, is in a fiduciary relationship with his customer. This relationship imposes on the real estate broker the obligations of frankness, full and complete disclosure of all material facts, loyalty, and the obligation to exercise the utmost good faith and fidelity toward his customer.<sup>106</sup> Some courts have stated that the relationship between a stockbroker and his customer is also that of a fiduciary, imposing upon the broker the duty of acting in the highest good faith towards the customer.<sup>107</sup> Other courts have said that the mere existence of a broker-customer relationship is not absolute proof of a fiduciary relationship.<sup>108</sup> However, in the context of an action for churning, it makes no difference whether the mere existence of a broker-customer relationship gives rise to a fiduciary relationship. By definition, one of the elements of a churning action is that the broker controlled the customer's account. If this element is satisfied, a

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104. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 711, 69 Cal. Rptr. 222, 237 (1968); *Winchell v. Gaskill*, 354 Mo. 593, 190 S.W.2d 266 (1945); *Hockenberry v. Cooper County State Bank*, 338 Mo. 31, 88 S.W.2d 1031 (1935); 32 AM. JUR. 2d, *Fraud and Deceit*, § 441 (1967).

105. *Davis v. Pitti*, 472 S.W.2d 382 (Mo. 1971). See also *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968); *Wilhoit v. Fite*, 341 S.W.2d 806 (Mo. 1960); 3 POMEROY, *EQUITY JURISPRUDENCE* §§ 955-63 (5th ed. 1941); 1 SCOTT, *TRUSTS* § 2.5 (1939).

106. *Tavagliante v. J.W. Wood Realty Co.*, 425 S.W.2d 208 (Mo. 1968); *Martin v. Hieken*, 340 S.W.2d 161 (St. L. Mo. App. 1960).

107. *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 846 (E.D. Va. 1968); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 709, 69 Cal. Rptr. 222 (1968). See also *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 440 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970) (dictum); *R.H. Johnson*, 33 S.E.C. 180, *aff'd*, 198 F.2d 690 (2d Cir.), *cert. denied*, 344 U.S. 855 (1952); *Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 396 S.W.2d 570 (Mo. En Banc. 1965) (dictum).

108. *Fey v. Walston & Co.*, 493 F.2d 1036, 1049 (7th Cir. 1974); *Avern Trust v. Clarke*, 415 F.2d 1238, 1240 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970).

confidential and fiduciary relationship should be found.<sup>109</sup> Therefore, if the broker did churn his customer's account, an action of constructive fraud and/or breach of a fiduciary duty should exist, since the control element of churning is proof that the relationship between the broker and his customer was one of special confidence and trust.

### III. LIABILITY OF THE BROKERAGE FIRM

"A stock brokerage firm can act only through its various partners, employees and agents and the acts of its employees and agents, in the course of their employment are the acts of the firm."<sup>110</sup>

The liability of the brokerage firm under the Securities Act of 1933, state blue sky law, and common law actions will be determined by the general principle of *respondeat superior*.<sup>111</sup> However, the liability of the brokerage firm under the Securities and Exchange Act of 1934 is expressly provided for and controlled by section 20 of the Act.<sup>112</sup> Section 20 states that a controlling person shall be jointly and severally liable to the same extent the controlled person is liable, unless the controlling person acted in good faith.<sup>113</sup> In the absence of the good faith defense, a brokerage firm will be liable under the 1934 Act if a broker-employee churns a customer's account.<sup>114</sup> Section 20 imposes liability even though the law of agency does not impose such liability.<sup>115</sup> In meeting the requirements of the good faith defense, it is necessary for the brokerage firm to show that some precautionary measures were taken to prevent the injury suffered.<sup>116</sup> It is the duty of a brokerage firm to maintain and enforce adequate supervision,<sup>117</sup> and where the firm fails to

109. See *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172 (10th Cir. 1974).

110. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 443 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

111. *SEC v. First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1972); *Blackburn v. Witter*, 201 Cal. App. 2d 518, 19 Cal. Rptr. 842 (1962). See also RESTATEMENT (SECOND) OF AGENCY §§ 261, 262 (1958).

112. 15 U.S.C. § 78t (1970); *Fey v. Walston & Co.*, 493 F.2d 1036, 1052 (7th Cir. 1974).

113. 15 U.S.C. § 78t(a) (1970).

114. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 443 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1210 (9th Cir. 1970); *Lorenz v. Watson*, 258 F.Supp. 724, 732 (E.D. Pa. 1966). See *SEC v. First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), *cert. denied*, 409 U.S. 880 (1972); *Gordon v. Barr*, 366 F.Supp. 156 (S.D.N.Y. 1973); 3 L. Loss, *supra* note 4, at 1808.

115. *Fey v. Walston & Co.*, 493 F.2d 1036 (7th Cir. 1974).

116. *Lorenz v. Watson*, 258 F.Supp. 724, 732 (E.D. Pa. 1966); *accord*, *Gordon v. Barr*, 366 F.Supp. 156 (S.D.N.Y. 1973); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 443 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1210 (9th Cir. 1970).

117. *Winkler v. SEC*, 377 F.2d 517, 518 (2d Cir. 1967).



maintain and diligently enforce a proper system of supervision and internal control, such failure results in a violation of the anti-fraud provisions of the 1934 Act.<sup>118</sup>

In considering what supervision and internal control is necessary to satisfy the "good faith" requirement, the following advice may be helpful. On approving a new account the brokerage firm should get the following customer information—citizenship, age, occupation, estimate of net worth and income, bank or credit reference, investment objectives, previous investment experience, and type of account.<sup>119</sup> In supervising existing accounts and the trading therein, the brokerage firm should watch carefully for excessive trading in accounts of investors who are inexperienced in securities transactions.

#### IV. DEFENSES

##### A. *Profit as a Defense*

That the customer's account makes an overall profit is not a defense to a churning action.<sup>120</sup> If the account is excessively traded, the charge of the additional commissions against the account's profitability results in a profit which is smaller than it would have been, absent the excessive trading.

##### B. *The Defense of Waiver and Estoppel*

The purpose of the federal securities acts is to protect the innocent investor, not an investor who loses his innocence and then waits to see how his investment turns out before deciding to invoke the provisions of the acts.<sup>121</sup> To create an estoppel, some reliant change in position by the one claiming the estoppel is essential. Waiver presupposes knowledge of one's rights and an intent to relinquish them.<sup>122</sup>

In churning actions, the concepts of waiver and estoppel are often synonymous with the element of control; a separate treatment

118. Reynolds & Co., 39 S.E.C. 902 (1960).

119. NYSE Rule 405; NYSE booklet, Supervision and Management of Registered Representatives and Customer Accounts 7-9 (1967); NASD Rules of Fair Practice, Art. III, § 21(b); Securities and Exchange Act § 15b, 17 C.F.R. 240.15b10-3 (1973).

120. Stevens v. Abbott, Proctor & Paine, 288 F.Supp. 836, 847 (E.D. Va. 1968); Hecht v. Harris, Upham & Co., 283 F.Supp. 417, 435 (N.D. Cal. 1968), modified, 430 F.2d 1202 (9th Cir. 1970). See Comment, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 878 (1967).

121. Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213-14 (9th Cir. 1962). See Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1207 (9th Cir. 1970).

122. Fey v. Walston & Co., 493 F.2d 1036, 1050 (7th Cir. 1974). See also Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208 (9th Cir. 1970).

of the concepts may be somewhat confusing.<sup>123</sup> However, since most courts treat the element of control separately from the defense of waiver and estoppel, they will be treated separately here.<sup>124</sup>

The defenses of waiver and estoppel are clearly applicable to a churning action if the customer knows of the excessive transactions and is sophisticated and experienced enough in securities transactions to know that the number of transactions is excessive.<sup>125</sup> Such evidence would also indicate that the broker does not control the customer's account.

Merely because a customer receives confirmation slips does not, however, mean that he is precluded from bringing an action for churning because of the waiver and estoppel defenses.<sup>126</sup> The real question, with regard to waiver and estoppel, is not whether the customer knew of each transaction, but whether the customer was experienced and sophisticated enough to understand that the frequency and volume were excessive. In *Hecht v. Harris, Upham & Co.*,<sup>127</sup> the court pointed out this distinction. The court held that even though the customer was estopped from complaining about the suitability of the transactions, the customer was not estopped from complaining that her account was churned by excessive transactions.<sup>128</sup> Churning is conduct which is not common in the experience of the ordinary individual and it is, consequently, not easily recognizable to unsophisticated investors.<sup>129</sup>

## V. DAMAGES

### A. Actual Damages

Three measures of recovery have been sought in actions for churning: the quasi-contractual theory, the "out-of-pocket" theory, and the "loss of bargain" theory.<sup>130</sup>

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123. *Fey v. Walston & Co.*, 493 F.2d 1036, 1045 (7th Cir. 1974).

124. See text accompanying note 7 *supra*, for a discussion of the element of control.

125. *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 374 (1st Cir. 1973). See *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); *Nash v. J. Arthur Warner & Co.*, 137 F.Supp. 615 (D. Mass. 1955); *Carr v. Warner*, 137 F.Supp. 611 (D. Mass. 1955).

126. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172 (10th Cir. 1974); *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 434 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970); *Newkirk v. Hayden, Stone & Co.*, CCH FED. SEC. L. REP. ¶ 91,621, at 95,320 (S.D. Cal. 1965).

127. 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

128. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

129. *Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 494 F.2d 168, 172 (10th Cir. 1974).

130. *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 849 (E.D. Va. 1968).

1. *The quasi-contractual theory.* The majority of churning cases invoke the quasi-contractual theory for determining damages. According to this theory, the customer is allowed to recover all the commissions paid to the broker. In *Hecht v. Harris, Upham & Co.*,<sup>131</sup> the trial court allowed the plaintiff to recover the commissions paid and interest thereon, in addition to the loss of dividends and principal which allegedly resulted from the broker's churning of the customer's account. However, the court of appeals reversed the damages portion of the trial court's decision, and limited damages to commissions paid to the broker and interest thereon. The appeals court held that the customer was estopped from complaining of the quality of the advice given by the broker, and thus could not recover the lost dividends and principal.<sup>132</sup>

In *Stevens v. Abbott, Proctor & Paine*,<sup>133</sup> the court held that the proper measure of damages was the broker's commissions, plus the transfer tax charge, plus the amount of capital gains taxes incurred from the defendant's churning.<sup>134</sup> At first glance, the awarding of capital gains tax paid by the customer seems inappropriate, since the tax on capital gains only diminishes the customer's gain and causes him no actual loss. However, one possible rationale for allowing recovery of capital gains tax paid is grounded on the assumption that had the account not been excessively traded, the gain might have been long-term capital gain instead of short-term capital gain,<sup>135</sup> or might not have been recognized at all.<sup>136</sup>

2. *The "out-of-pocket" theory.* The out-of-pocket theory allows the customer to recover the difference between the amount of his original investment and dividends therefrom, less any amounts received by the customer and the ending value of the account.<sup>137</sup> This measure of damage presents a problem where there has been churning of an account which makes an overall net profit, as the

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131. 283 F.Supp. 417 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

132. *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1211 (9th Cir. 1970).

133. 288 F.Supp. 836 (E.D. Va. 1968).

134. *Id.* at 851.

135. Where the broker purchases and sells securities on behalf of the customer within a six month period and a capital gain is realized, the gain is short-term capital gain. INT. REV. CODE OF 1954, § 1222(1). If the securities had been held longer than six months, the gain would be long-term capital gain and the customer would be entitled to a long-term capital gain deduction. INT. REV. CODE OF 1954, § 1202.

136. By holding appreciated securities until death, all appreciation goes untaxed. INT. REV. CODE OF 1954, § 1014(a).

137. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 730, 69 Cal. Rptr. 222, 249 (1968). *See also* *Pierce v. Richard Ellis & Co.*, 62 Misc.2d 771, 310 N.Y.S.2d 266 (1970).

calculated damages would be zero.<sup>138</sup> Since there has been no actual loss, this may be the desired result. However, such a rule ignores the possibility that had the account not been churned, the ending value of the account would have reflected a large profit. Moreover, the rule assumes that all transactions were improper.<sup>139</sup> In addition, the rule allows recovery for bad advice as well as excessive trading damages.

3. *The "loss of bargain" theory.* The final theory which the courts have recognized allows the plaintiff to recover the difference between the amount his account would have been if it had been properly managed and the actual ending balance.<sup>140</sup> This measure of damages requires that the plaintiff produce an expert to testify concerning the amount the account would have been, absent churning. Some courts have said that the loss of bargain theory lends itself to speculation and conjecture.<sup>141</sup> However, other courts have suggested that because the broker's improper management caused the loss, he is not in a position to complain about the speculation.<sup>142</sup>

In determining a proper measure of damages for a churning action, there appear to be two competing considerations. First, the customer must be compensated for his actual losses. Secondly, the customer should not be awarded damages based upon speculation and conjecture. As to the first consideration, logically, damages should be awarded with respect to only those transactions which were excessive. However, it is difficult, if not impossible, to determine which transactions were excessive.

In formulating a proper measure of damages, the quasi-contractual rule is a good starting point. Under this measure of damages, the plaintiff could recover all commissions paid to the broker, less those commissions which the broker could prove did not result from excessive trading. The advantage of this rule is that it is simple, and in this respect, eliminates some of the speculation. However, the rule also precludes the customer from recouping losses which would not have been incurred, absent churning. In some instances, transactions entered into by the broker may result in losses in the value of the traded securities themselves. It seems that the plaintiff should be able to recover these losses also. The out-of-pocket measure of damages takes these losses into account. However, the out-of-pocket theory does not discriminate between losses

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138. This assumes that the dividends from such an original account are less than or equal to the net profit.

139. *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 849 (E.D. Va. 1968).

140. *Id.* at 849.

141. *Id.*

142. See Comment, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 885 (1967).

caused by excessive trading and losses from unsound advice. As with commissions generated by excessive transactions, the proper approach might be to presume that all losses resulted from excessive trading, and reduce this amount to the extent that the broker could prove that the losses were not caused by excessive transactions. In summary, the customer should be able to recover commissions on the excessive transactions, and any losses incurred as a result of the excessive trading of securities.

A special measure of damages has been applied when the churning action is based on a breach of fiduciary obligation.<sup>143</sup> The customer may recover (1) any loss in value of the account, (2) any profit made by the dealer, and (3) any profit which would have accrued, but for the breach.<sup>144</sup>

In some cases, attorney's fees have been allowed, as where a broker's conduct has been vexatious or groundless or where he has been guilty of overreaching conduct or bad faith.<sup>145</sup> However, in *Stevens v. Abbott, Proctor & Paine*,<sup>146</sup> the court stated that the interest of justice did not require the awarding of counsel fees.<sup>147</sup>

### B. Punitive Damages

It has long been recognized that the investing public needs special protection in this specialized field.<sup>148</sup> The practice of churning a customer's account is deserving of the severest condemnation. "Its very nature brands it one of the most injurious types of fraud possible. Its perpetrators prey on unwary and inexperienced investor [sic], since it is they who most frequently divest themselves of complete control of their resources and place absolute trust and confidence in their fiduciaries."<sup>149</sup> The purpose of punitive damages is to indemnify the plaintiff,<sup>150</sup> punish the defendant,<sup>151</sup> and deter others from similar conduct.<sup>152</sup>

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143. See text accompanying note 109 *supra*.

144. Cf. RESTATEMENT OF TRUSTS § 205 (1935).

145. *Bradley v. School Board*, 53 F.R.D. 28 (E.D. Va. 1971).

146. 288 F.Supp. 836 (E.D. Va. 1968).

147. *Id.* at 849.

148. *Lorenz v. Watson*, 258 F.Supp. 724, 731 (E.D. Pa. 1966).

149. *Id.* at 733.

150. *Sperry Rand Corp. v. Electronic Concepts, Inc.*, 325 F.Supp. 1209, 1218 (E.D. Va. 1970); *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 848 (E.D. Va. 1968).

151. *Beggs v. Universal C.I.T. Credit Corp.*, 409 S.W.2d 719 (Mo. 1966); *Polk v. Missouri-Kansas-Texas R.*, 351 Mo. 865, 174 S.W.2d 176 (1943); *Wisner v. S.S. Kresge Co.*, 465 S.W.2d 666 (K.C. Mo. App. 1971); *Peak v. W.T. Grant Co.*, 386 S.W.2d 685 (K.C. Mo. App. 1965); *Wehrman v. Liberty Petroleum Co.*, 382 S.W.2d 56 (St.L. Mo. App. 1964); *State ex rel. Boswell v. Curtis*, 334 S.W.2d 757 (Spr. Mo. App. 1960).

152. See cases in notes 150 and 151 *supra*.

Where an action is brought pursuant to the Securities and Exchange Act of 1934, section 28(a) of the Act is directed at the issue of recoveries in excess of actual losses.<sup>153</sup> A few courts have construed section 28(a) as only prohibiting double recovery, and not prohibiting recovery of punitive damages.<sup>154</sup> However, the majority of the courts have construed section 28(a) as barring the recovery of punitive damages under the Securities and Exchange Act of 1934.<sup>155</sup> The Securities Act of 1933 does not have a provision which could be construed to expressly prevent recovery of punitive damages. Nevertheless, it has been held that punitive damages cannot be recovered under the 1933 Act.<sup>156</sup>

Because punitive damages are not recoverable under the federal securities acts, the question arises whether punitive damages are recoverable under common law actions. The overwhelming majority of courts have held that punitive damages, if appropriate, are permissible in an action based on common law.<sup>157</sup> State law will, of course, control, but it seems clear that punitive damages are recoverable for common law fraud.<sup>158</sup> As discussed previously, however, an action for common law fraud is not particularly suited in a churning situation.<sup>159</sup> Hence, the customer, in attempting to recover punitive damages, may choose to base his action on a breach of a

153. Section 28(a) of the Securities and Exchange Act of 1934 states:

[N]o person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

154. *Hecht v. Harris, Upham & Co.*, 283 F.Supp. 417, 444 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970) (dictum). See *Stevens v. Abbott, Proctor & Paine*, 288 F.Supp. 836, 848 (E.D. Va. 1968) (dictum); *Nagel v. Prescott & Co.*, 36 F.R.D. 445 (N.D. Ohio 1964).

155. *Richardson v. MacArthur*, 451 F.2d 35, 45 (10th Cir. 1971); *deHaas v. Empire Petroleum Co.*, 435 F.2d 1223, 1232 (10th Cir. 1970); *Avern Trust v. Clarke*, 415 F.2d 1238, 1241 (7th Cir. 1969); *Green v. Wolf Corp.*, 406 F.2d 291, 302 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) (dictum); *Burkhart v. Allson Realty Trust*, 363 F.Supp. 1286, 1290 (N.D. Ill. 1973); *In re Caesars Palace Securities Litigation*, 360 F.Supp. 366, 394 (S.D.N.Y. 1973).

156. *Globus v. Law Research Service, Inc.*, 418 F.2d 1267, 1283-87 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *accord*, *Burkhart v. Allson Realty Trust*, 363 F.Supp. 1286, 1290 (N.D. Ill. 1973). See also *Avern Trust v. Clarke*, 415 F.2d 1238, 1241 (7th Cir. 1969) (dictum).

157. *Flaks v. Koegel*, CCH FED. SEC. L. REP. ¶ 94,803, at 96,669 (2d Cir. 1974); *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044-45 (5th Cir. 1973), *cert. denied*, 412 U.S. 920 (1973); *Young v. Taylor*, 466 F.2d 1329, 1337-38 (10th Cir. 1972); *Burkhart v. Allson Realty Trust*, 363 F.Supp. 1286, 1290-91 (N.D. Ill. 1973); *In re Caesars Palace Securities Litigation*, 360 F.Supp. 366, 393-94 (S.D.N.Y. 1973); *Gann v. Bernz Omatic Corp.*, 262 F.Supp. 301, 304 (S.D.N.Y. 1966); 6 L. Loss, *supra* note 4, at 3781-83 (Supp. 1969); *contra*, *Schaefer v. First National Bank*, 326 F.Supp. 1186, 1193 (N.D. Ill. 1970).

158. *Flaks v. Koegel*, CCH FED. SEC. L. REP. ¶ 94,803, at 96,664 (2d Cir. 1974); *Burkhart v. Allson Realty Trust*, 363 F.Supp. 1286, 1291 (N.D. Ill. 1973); *In re Caesars Palace Securities Litigation*, 360 F.Supp. 366, 394 (S.D.N.Y. 1973).

159. See text accompanying note 101 *supra*.

fiduciary obligation.<sup>160</sup>

In *Brown v. Coates*,<sup>161</sup> the plaintiffs brought an action against a real estate broker for his breach of trust in a real estate transaction. In holding that the plaintiffs could recover punitive damages, the court said that the defendant-broker owed the plaintiffs the obligation of fair dealing and full disclosure.<sup>162</sup> The principles of this case are analogous to a churning action. It seems that punitive damages should also be allowed against a stockbroker. Even though the broker may be subject to disciplinary proceedings,<sup>163</sup> without punitive damages recovery may very well be limited to the broker's commissions resulting from the excessive trading.<sup>164</sup> Immunity from punitive damages might be an incentive to churn a customer's account, because damages would be limited to the commissions generated from excessive trading.

Under Missouri law, if punitive damages are awarded against the broker, they are also recoverable against the brokerage firm.<sup>165</sup> Moreover, in Missouri, churning is an intentional tort and, as such, serves as a basis for punitive damages.<sup>167</sup>

## VI. CONCLUSION

As long as the securities industry bases the amount of compensation paid to dealers upon the number of transactions per account,<sup>168</sup> the motivation for churning a customer's account will continue. To avoid a churning action, the broker should fully disclose all transactions. The broker should also disclose that the

160. See text accompanying note 104 *supra*.

161. 253 F.2d 36 (D.C. Cir. 1958).

162. [O]nce it has been shown that one trained and experienced holds himself out to the public as worthy to be trusted for hire to perform services for others, and those so invited do place their trust and confidence, and that trust is intentionally and consciously disregarded, and exploited for unwarranted gain, community protection, as well as that of the victim, warrants the imposition of punitive damages. . . . Punitive damages are particularly apt in such circumstances because they both punish the wrongdoer, and offer the wronged a greater incentive to bring derelicts to justice a process which can subject the victim to considerable expense and trouble.

253 F.2d at 40.

163. Comment, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 879-82 (1967).

164. This assumes the damages are based on a quasi-contractual theory. See text accompanying note 131 *supra*.

165. See *Coffee v. Permian Corp.*, 474 F.2d 1040, 1044-45 (5th Cir.), cert. denied, 412 U.S. 920 (1973).

166. *Tietjens v. General Motors Corp.*, 418 S.W.2d 75, 88 (Mo. 1967). See also *Webb Agency, Inc. v. Commercial Standard Insurance Co.*, 333 F.Supp. 966 (E.D. Mo. 1971).

167. Mo. APPROVED INSTR. § 10.01 (2d ed. 1969).

168. H.R. Doc. No. 95, pt. 5, § 25-1(b)6, 88th Cong., 1st Sess. (1963).

trade may be considered excessive for the customer's investment sophistication and his investment objectives. If it is possible that a transaction is excessive, the transaction should be initiated only after full disclosure of the possible excessiveness and after obtaining the written consent of the customer. The brokerage firm should maintain a diligent policy of supervision and internal control.

JAMES MICHAEL VAUGHAN