Notre Dame Law School
NDLScholarship

Journal Articles Publications

1987

The Elusive Concept of Control in Churning Claims under Federal Securities and Commodities Law

Patricia A. O'Hara
Notre Dame Law School, pohara1@nd.edu

Follow this and additional works at: https://scholarship.law.nd.edu/law_faculty_scholarship

Part of the Securities Law Commons

Recommended Citation
Patricia A. O'Hara, *The Elusive Concept of Control in Churning Claims under Federal Securities and Commodities Law*, 75 Geo. L. J. 1875 (1986-1987).
Available at: https://scholarship.law.nd.edu/law_faculty_scholarship/875

This Article is brought to you for free and open access by the Publications at NDLScholarship. It has been accepted for inclusion in Journal Articles by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

The Elusive Concept of Control in Churning Claims Under Federal Securities and Commodities Law

PATRICIA A. O'HARA*

Account executives in the trading departments of most brokerage houses stand in a classic conflict of interest position with respect to their customers.[1] On one hand, they frequently hold themselves out as investment counselors, purporting to offer disinterested advice to their clients regarding the merits of buying or selling a particular investment. On the other hand, the firm generates its profits and compensates its sales staff either by charging commissions on transactions that the firm executes as agent on the customer's behalf or by selling securities to a customer as principal from the firm's own inventory at a price above the firm's original cost.[2]

---

* Associate Professor of Law, The Law School, University of Notre Dame. B.A. 1971, University of Santa Clara; J.D. 1974, University of Notre Dame. The author wishes to express appreciation to her colleague, Douglas W. Kmiec, and to Timothy J. Carey of Finley, Kumble, Wagner, Heine, Underberg, Manley & Casey, New York, New York, for their helpful review of an earlier draft of this article. The author also wishes to acknowledge the valuable student research assistance of Anthony A. Bonacci, Mary M. Sullivan, and Jeffrey D. Linton.

1. *See* 1 S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES § 2.2[a] (1978) (discussing conflict of interest); Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 573-76 (1984) (conflict of interest exists when broker acts as investment advisor and as salesman generating commissions); Hyman, *Churning in Securities: Full Compensation for the Investor*, 9 U. DAYTON L. REV. 1, 1 (1983) (same); Packard, *A Test for Churning in Stock Options*, 4 CORP. L. REV. 222, 223 (1981) (same); Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 870 (1967) (same); Comment, *Private Actions for the Broker's "Churning" of a Securities Account*, 40 MO. L. REV. 281, 281 (1975) (same).

2. When a sales representative of a broker-dealer firm accepts from a customer an order to purchase or sell a security and executes that order on the customer's behalf with another broker-dealer, the firm is functioning in its capacity as a broker. 5B A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 210.02, at 9-5 (2d rev. ed. 1986). The relationship between customer and firm is that of principal and agent. *Id.* at 9-5 to 9-6 A customer compensates a firm for its services in executing the order by payment of a commission, which represents a percentage of the trade price. Firms generally compensate salesmen by paying them a percentage of the commissions they produce. For an excellent description of the brokerage industry's commission-rate system, see Poser, *supra* note 1, at 573-76.

A sales representative of a broker-dealer firm may also accept an order from a customer for purchase or sale of a security and satisfy the order by selling the customer that security from the firm's own inventory or purchasing the security from the customer for the firm's own account. 5B A. JACOBS, *supra*, § 210.02, at 9-5 to -6. In this situation, the firm is functioning as a dealer, and the relationship between the parties is that of vendor-purchaser rather than principal-agent. *Id.* When functioning as a dealer, the firm does not charge a commission. It profits if it subsequently resells a security in its inventory to a customer at a higher price than it originally paid to obtain the security for its own account. When the resale results in a profit, the difference between the resale price and the firm's original cost is referred to as the "spread" or "markup."

In summary, a broker functions as an agent, acting on behalf of the customer. A dealer functions

Whether functioning as broker or dealer, the brokerage house profits from

---

as a principal, buying or selling for the firm's own account. The statutory definitions of broker and dealer in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-kk (1982 & Supp. III 1985) reflect this fundamental distinction. Section 3(a)(4) of the 1934 Act, 15 U.S.C. § 78c(a)(4) (1982), states: "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." In contrast, § 3(a)(5) of the 1934 Act, 15 U.S.C. § 78c(a)(5) (1982), provides:

> The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

In the commodities industry the futures commission merchant is the counterpart of the brokerage house in the securities industry. 1 P. JOHNSON, COMMODITIES REGULATION § 1.33, at 101 (1982). Section 2(a)(1), 7 U.S.C. § 2 (1982), of the Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1982 & Supp. III 1985) defines a "futures commission merchant" to include:

> [I]ndividuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that, in or in connection with such solicitation or acceptance of orders, accepts [sic] any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

Futures commission merchants charge their customers commissions for their services. Such commissions, however, are calculated differently than in the securities industry because of differences inherent in the commodities trading process. Lowe, *Churning in Commodity Futures Accounts*, 5 CORP. L. REV. 322, 325-26 (1982).

Commodity futures are standardized contracts for purchase and sale of a quantity of a commodity at a certain price for delivery at some future date. *Id.* at 322-23. The seller (a "short") agrees to deliver and the buyer (a "long") agrees to buy a specified quantity and grade of a particular commodity for an agreed price at a defined period in the future. 1 P. JOHNSON, *supra*, § 1.03, at 8. The bulk of futures contracts, however, are never actually performed. *Id.* § 1.04, at 9. Instead, they are extinguished through a second transaction in which the original trader enters the market a second time to acquire the same type of contract bearing an obligation opposite to his first transaction. The two transactions offset each other, and the party is thereby excused from actual performance. *Id.* If there has been a movement in the market price between the two transactions, the offsetting party either will be required to pay money or will be entitled to receive money to complete the offset, depending on the direction of movement in the market price. *Id.* at 9-10.

Commissions are paid to the futures commission merchant at the time the trader liquidates his position through offset. Lowe, *supra*, at 325. The commission may be a percentage of the value of the contract or a fixed sum. *Id.* The commodities trader, therefore, owes one commission for two transactions in contrast to a securities customer who owes a commission on every trade. *Id.* The commission may represent a larger percentage of the commodities trader's original investment, however, because commodity futures contracts may be purchased with a smaller deposit than is required to purchase securities. *Id.* at 326.

The distinctions between a broker, a dealer, and a futures commission merchant can assume substantial importance in a variety of legal contexts. For example, whether a securities firm is acting as a broker or a dealer may affect the existence of a fiduciary duty to the customer. Brokers, dealers, and futures commission merchants, however, may all be tempted to induce active trading in a customer's account for the purpose of generating profits for themselves. Thus, similar to industry practice, this article uses the word "broker" to refer to brokers, dealers, futures commission merchants and their sales representatives, unless the context indicates a more precise application. The article uses the word "commissions" to refer to profits, whether generated in the form of commissions or in the form of markups over original cost.

execution of the transaction, independently of whether the customer profits on the investment.[3] Thus, the industry's compensation system creates an incentive for a broker to induce active trading in a customer's account.[4] This self-interest stands at odds with the fiduciary duties normally ascribed to a broker when functioning as an advisor to a client.[5]

A broker's temptation to put his own interest ahead of the customer's interest increases if the customer sets up a discretionary account, formally vesting the broker with authority to make trading decisions on the customer's

3. In a graphic metaphor, Stuart Goldberg has described the conflict of interest inherent in the compensation system of brokerage firms as follows:

> Whether it is a purchase of a new stock or a sale of a bond already owned, and regardless of gain or loss on the transaction, the broker-dealer gets its commission, and the registered representative gets his or her split. In a very real sense, a brokerage firm when dealing with a commission transaction, is like a poker casino or a pari-mutuel horse track—the owners take their cut and just can't lose. What they have in common is that the more action, the higher the total amount of the cut and the greater the ultimate profits. However, what these three financial institutions are definitely *not* supposed to have in common is the same attitude toward the consumer.... In the last instance of a securities investor, the broker-dealer is deemed a fiduciary who is charged with the duty of loyalty to its customers.

1 S. GOLDBERG, *supra* note 1, § 2.1, at 2-3 (cross-reference omitted).

While Mr. Goldberg's discussion focuses on the commission-rate system in pure brokerage transactions, the same potential for conflict exists in principal transactions in which a securities firm takes a markup over its original cost.

4. The Fifth Circuit noted in Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. Unit A Feb. 1981):

> For as long as investment brokers have been remunerated on a commission basis, the potential has existed for brokers to excessively trade accounts in an effort to generate fees. Not surprisingly, for almost as long a period of time, civil suits alleging excessive trading or "churning" in violation of the broker's common law fiduciary duty and the federal securities law have dotted the federal docket.

Id. at 323 (footnote omitted); *see* 1 S. GOLDBERG, *supra* note 1, § 2.2[a], at 2-8 (broker's income depends on commission generated); Poser, *supra* note 1, at 573-76 (same).

5. When an investment firm functions as a broker, it acts as an agent on behalf of its customer and, therefore, owes certain fiduciary duties to the customer under common law principles. 5B A. JACOBS, *supra* note 2, § 210.03, at 9-12. The scope of fiduciary duties the broker owes may vary significantly, however, depending upon whether the customer opens a discretionary account, in which the broker has authority to conduct trading without consulting the client, or a nondiscretionary account, in which a broker needs client authorization for trades. As might be expected, a broker owes more extensive duties in the former situation.

In contrast to the fiduciary duties ascribed to the status of a broker, when an investment firm functions as a dealer, it acts as a principal for its own account. Thus, under common law principles, the investment firm does not stand in a fiduciary relationship to its customer. N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS ¶ 2.03, at 2-15 (1977). The SEC has developed two theories in administrative proceedings, however, which greatly undercut the common law notion that a dealer as vendor may treat his customer at arm's length. *Id.* See *infra* notes 78-96 and accompanying text for a discussion of the "shingle theory" and "fiduciary theory."

behalf.[6] The same incentive may be present, however, even when the account is technically established as a nondiscretionary account if the broker, for all practical purposes, is making the trading decisions.[7]

Churning occurs when a broker violates the fiduciary duties he owes to a customer in favor of his own remunerative self-interest.[8] If a customer can establish that a broker controlled the level of activity in the customer's securities or commodities account, through either a formal grant of discretionary authority or the functional equivalent thereof, and traded that account excessively in light of the customer's financial resources and investment objectives to generate greater profits for himself, then the customer may recover damages for churning under federal securities and commodities laws.[9]

---

6. In a discretionary account, a broker may trade without an express authorization from the customer for each transaction. Hill v. Bache, Halsey, Stuart, Shields, Inc., 790 F.2d 817, 820 n.3 (10th Cir. 1986). In a nondiscretionary account, the customer is supposed to authorize each trade. *Id.*

The rules of various stock exchanges and of the National Association of Securities Dealers (NASD) require that a grant of discretionary power be in writing. *E.g.*, N.Y.S.E. Rule 408, 2 N.Y.S.E. Guide (CCH) ¶ 2408, at 3701-4 to -5 (1979); N.A.S.D. RULES OF FAIR PRACTICE art. III, § 15(b), N.A.S.D. Manual (CCH) ¶ 2165, at 2078 (1986). The absence of a writing, however, does not preclude the customer from asserting that the broker exercised a degree of control over a nondiscretionary account equivalent to a grant of discretionary power. Such cases are the central focus of this article.

7. As Stuart Goldberg notes in his discussion of the control element of a churning case:

> [I]n order to prove that churning took place in an investor's account it must first be established that the broker-dealer was "vested" with "discretionary power." This power can arise in several ways: most obvious would be in an account in which an express formal written discretionary agreement was executed by the investor running in favor of the broker-dealer or a designated registered representative; less obvious, but of equal legal effect, is the situation in which the broker-dealer exercises implied *de facto* ("in fact") control. Situations involving this latter type, of implied discretionary power, constitute virtually all of the litigation regarding churning, and create the most difficult issue of proving its existence.

1 S. GOLDBERG, *supra* note 1, § 2.8, at 2-22 to -23; *see* Williamsport Firemen Pension Bds. v. E.F. Hutton & Co., 567 F. Supp. 140, 144 (M.D. Pa. 1983) (essential element of churning claim is that broker has authority to exercise complete discretion over activity in account; however, requisite degree of control by broker may be present even if account is nondiscretionary); Newburger, Loeb & Co. v. Gross, 365 F. Supp. 1364, 1371 (S.D.N.Y. 1973) (finding of control not dependent on account being formally labeled discretionary but rather on who in fact was making decisions), *aff'd*, 563 F.2d 1057 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978).

8. *See, e.g.*, Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1501 (11th Cir. 1985); Costello v. Oppenheimer & Co., 711 F.2d 1361, 1367 (7th Cir. 1983); Stevens v. Abbott, Procter & Paine, 288 F. Supp. 836, 845 (E.D. Va. 1968).

9. *See, e.g.*, Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1501 (11th Cir. 1985); Bowley v. Stotler & Co., 751 F.2d 641, 644 (3d Cir. 1985); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 775 (9th Cir. 1984); Costello v. Oppenheimer & Co., 711 F.2d 1361, 1367 (7th Cir. 1983); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416-17 (11th Cir. 1983); Karlen v. Ray E. Friedman & Co. Commodities, 688 F.2d 1193, 1203 (8th Cir. 1982); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676 (9th Cir. 1982); Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. Unit A Feb. 1981); Mihara v. Dean Witter & Co., 619 F.2d 814,

Although much attention has been given to the various tests used to measure excessive trading in a churning case and to the difficult issue of damages, there has been little focus on the question of control over the account.[10] Establishing that a broker controlled the level of trading in a customer's account is the very foundation of a churning suit.[11] If a customer opens a discretionary account, the form of the account itself establishes the requisite control by the broker.[12] Courts and governing regulatory agencies, however, have wrestled unsuccessfully with the problem of delineating what constitutes de facto control by a broker in a nondiscretionary securities or commodities account. In light of the growing number of churning suits, this pivotal issue merits further attention.[13]

To establish the proper context for examination of this elusive aspect of a churning suit, this article first reviews the statutory bases for a churning claim under federal securities and commodities laws and the basic elements of a private action for churning. It then traces the judicial and administrative evolution of the concept of control in churning claims involving nondiscretionary securities and commodities accounts. Next, it analyzes the problems presented by the existing disparity in standards used to determine control. Finally, this article proposes a suggested framework for examining the facts in a churning suit with a view to resolving the control issue. This article recommends a return to the emphasis on relational reliance, which dominated the early enforcement decisions of the Securities and Exchange Commission (SEC) in churning cases. Focusing on reliance in the context of the customer's relationship with his broker is analogous to the proof of reliance required of a plaintiff in a normal transactional fraud suit brought under the same antifraud provisions involved in churning claims.

820-21 (9th Cir. 1980); Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1069 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978); Carras v. Burns, 526 F.2d 251, 258 (4th Cir. 1975).

10. For a collection of authorities on the excessive trading element of a churning case, see *infra* note 44. For a collection of authorities on the computation of damages in a churning case, see *infra* note 64. For previous discussions by commentators of the control element of a churning case, see *infra* note 74.

11. Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 432 (E.D. Pa. 1972); Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968).

12. *See, e.g.*, Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676 (9th Cir. 1982); Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105, at 24,454 n.7 (CFTC Sept. 3, 1980); Jenny v. Shearson, Hammill & Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,568, at 94,381-82 (S.D.N.Y. Oct. 6, 1978).

13. Professor Loss has noted that litigation over churning seems to be increasing. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 151 (Supp. 1986).

I. THE STATUTORY BASES FOR A CHURNING CLAIM UNDER FEDERAL SECURITIES AND COMMODITIES LAW

When a customer entrusts control of his account to a broker, the broker assumes a fiduciary duty to exercise that control in favor of the customer.[14] Liability for churning rests upon the breach of fiduciary duty that occurs if the broker subsequently abuses his control by engaging in a pattern of trading that advances his self-interest in a manner detrimental to the interests of the customer.[15]

In common law terms, churning is more akin to constructive fraud than to actual fraud.[16] For example, in a typical securities fraud case, a plaintiff complains about some type of active deception on the part of the defendant that influenced the plaintiff's decision to engage in a particular investment transaction. The plaintiff alleges that in the course of making a decision to buy or sell an investment, he relied on certain information supplied by the defendant that was inaccurate or incomplete. If the defendant acted with the

---

14. *See* Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951, 952-54 (E.D. Mich. 1978) (broker owes only limited transactional duties to customer when pure nondiscretionary account is involved, in which the customer rather than the broker determines which purchases and sales to make; in contrast, broker handling discretionary account becomes customer's fiduciary in a broad sense and owes special duty to act in highest good faith; broker owes customer same fiduciary duties as in discretionary account if broker usurps control over a technically nondiscretionary account); Stevens v. Abbott, Procter & Paine, 288 F. Supp. 836, 847 (E.D. Va. 1968) (broker handling discretionary account has duty to act in highest good faith toward customer); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 720, 69 Cal. Rptr. 222, 243 (1968) (broker who undertakes to control customer's account owes duty to ascertain customer's financial situation and manage account accordingly); Pierce v. Richard Ellis & Co., 62 Misc. 2d 771, 772, 310 N.Y.S.2d 266, 268 (Civ. Ct. 1970) (when broker handles discretionary account, he becomes fiduciary for customer's benefit and undertakes highest obligation of good faith and fair dealing).

15. Moscarelli v. Stamm, 288 F. Supp. 453, 462 (E.D.N.Y. 1968). Judge Bartels' opinion captures the breach of trust at the heart of a churning claim:

> Over-trading, *per se*, in an account whose transactions are initiated by a customer does not constitute churning in the absence of any fiduciary relationship. But over-trading will constitute churning whenever a broker or dealer, who is in a position to determine the volume and frequency of transactions by reason of the confidence imposed in him, abuses the confidence of the customer for personal gain by frequent and numerous transactions disproportionate to the investment in the account. Such conduct on the part of the broker provides an action for breach of trust under common law principles.

Id. at 457 (citations omitted).

16. *See* Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171 (10th Cir. 1974) (although gravamen of churning allegation is existence of fraud, this refers to fraud in law; churning is in nature of constructive fraud in that it is considered a scheme under rule 10b-5 involving deception of customer and reliance by customer on integrity of broker); Marshak v. Blyth, Eastman, Dillon & Co., 413 F. Supp. 377, 379 (N.D. Okla. 1975) (same); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 711-12, 69 Cal. Rptr. 222, 237-38 (1968) (customer's pleadings that included allegations of excessive trading raised issue of breach of fiduciary relationship constituting constructive fraud; constructive fraud arises on breach of duty by one in confidential or fiduciary relationship to another that induces justifiable reliance by latter to his prejudice).

requisite degree of culpability, the plaintiff recovers damages for actual fraud—the injury to his informational reliance interest in making a decision to buy or sell.[17]

In a churning suit, however, the fraud does not arise from an informa-

---

17. For example, the bulk of suits complaining about fraud in connection with the purchase or sale of a security are brought under § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1982), and rule 10b-5, 17 C.F.R. § 240.10b-5 (1986) promulgated thereunder.

Section 10(b) and rule 10b-5 do not expressly provide for a private right of action. A private right of action was first implied under § 10(b) in Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). By 1969, 10 of the 11 federal circuit courts recognized the existence of an implied remedy under § 10(b) and rule 10b-5. *See* 6 L. LOSS, SECURITIES REGULATION 3871-73 (2d ed. Supp. 1969) (collecting cases). The United States Supreme Court confirmed the existence of an implied cause of action under § 10(b) and rule 10b-5 in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 & n.9 (1971). The Supreme Court recently reaffirmed its recognition of this private right of action in Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of this implied remedy is simply beyond peradventure.").

Unlike the various express causes of action provided under federal securities law, the elements of an implied claim under § 10(b) and rule 10b-5 do not all arise from the face of the statute or the text of the rule. They are in large part a product of judicial development and thus have changed over time.

Volumes have been written on the elements, defenses, and measure of damages applicable to an implied action under rule 10b-5. *See generally* 3 L. LOSS, SECURITIES REGULATION 1448-74, 1763-97 (2d ed. 1961); 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD §§ 8.1-.9 (1982); 4 *id.* §§ 9.1-.3, 11.2, 11.5 (1982); 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 §§ 36-40.09 (1985).

The requirements most frequently mentioned for proof of an implied claim under rule 10b-5 in a transactional fraud setting include the following:

(1) Plaintiff must be a purchaser or seller of a security. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733-34 (1975) (discussing Congress' provision of express remedies for nonpurchasers elsewhere in legislative scheme and difficulty of determining actual damages). While some early decisions limited the scope of defendant parties' liability by a privity requirement, privity is no longer required. *See* 3 A. BROMBERG & L. LOWENFELS, *supra*, § 8.5 (discussing dissolution of privity requirement for rule 10b-5 actions). Primary liability extends to violative conduct by "any person." A plaintiff can also sue persons whose involvement in the violative conduct is only secondary, under principles of aiding and abetting or conspiracy. *See generally* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification and Contribution*, 120 U. PA. L. REV. 597 (1972) (distinguishing primary and secondary liability and discussing elements of aiding and abetting and conspiracy claim). *But see* Fischel, *Secondary Liability under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981) (rejecting viability of secondary liability theories in light of recent Supreme Court decisions strictly interpreting federal securities laws); Comment, *Rule 10b-5 Liability after Hochfelder: Abandoning the Concept of Aiding and Abetting*, 45 U. CHI. L. REV. 218 (1977) (rejecting aiding and abetting concept in favor of narrower "substantial factor" test).

(2) Plaintiff must establish a violation of one of the three prohibitory subsections of the rule. *See infra* note 27 (setting forth text of rule 10b-5). In a transactional setting this typically takes the form of an allegation that the defendant misstated or omitted a material fact. If a plaintiff alleges an omission, silence on the part of the defendant is actionable only if the defendant was under a duty to disclose. *See* Dirks v. SEC, 463 U.S. 646, 653-59 (1983); Chiarella v. United States, 445 U.S. 222, 225-30 (1980) (liability premised on duty to disclose arising from fiduciary relationship). Materiality of the misstated or omitted information is tested according to whether or not there is a substantial likelihood that a reasonable investor or shareholder would consider the information important in deciding to purchase or sell. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)

tional deception surrounding a particular investment decision; instead a constructive fraud arises from frustration of the customer's expectation that if he delegates authority to a broker to make investment decisions for him, the broker will act in the customer's best interest and not his own. Churning thus involves injury to the customer's relational reliance interest—that is, exploitation by a broker of the confidence placed in him by a customer in the context of their ongoing relationship.[18]

Grounded in the law of fiduciary responsibility and constructive fraud,

("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

(3) Plaintiff must establish use of interstate commerce, the mails, or a facility of a national securities exchange in some part of the transaction.

(4) Plaintiff must establish that the violation of the substantive prohibition of rule 10b-5 was "in connection with the purchase or sale of a security." *See infra* note 27 (setting forth text of rule 10b-5). The language "in connection with" reached its broadest scope during the era of expansive interpretation of rule 10b-5 in Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 11-13 (1971).

(5) Plaintiff must establish reliance. *See* 3 A. BROMBERG & L. LOWENFELS, *supra*, § 8.6(1) (discussing element of reliance in rule 10b-5 actions). This requirement is relaxed in cases involving omissions by a presumption in favor of reliance upon proof of materiality and a duty to disclose. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (obligation to disclose and withholding of material fact establish requisite element of causation in fact; positive proof of reliance is not prerequisite to recovery). Some courts have also relaxed the reliance requirement by allowing plaintiff to establish reliance on the integrity of the market, as opposed to reliance on disputed information. *See* Shores v. Sklar, 610 F.2d 235 (5th Cir. 1980), *vacated and remanded*, 647 F.2d 462, 468-70 (5th Cir. May 1981) (en banc) (even though plaintiff did not rely on offering circular, he could successfully state claim under rule 10b-5 based on allegations that security purchased was brought into market fraudulently and he relied on integrity of offerings in market) *cert. denied*, 459 U.S. 1102 (1981); Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981) (reliance on information from those working in or reporting on securities market, where information is circulated after material misrepresentation or omission, is sufficient to support 10b-5 cause of action), *cert. denied*, 458 U.S. 1107 (1982); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975) (proof of reliance on particular misrepresentations unnecessary to establish rule 10b-5 claim; proof of purchase and of materiality of misrepresentations is sufficient), *cert. denied*, 429 U.S. 816 (1976). *See generally* Rapp, *Rule 10b-5 and "Fraud-on-the-Market"—Heavy Seas Meet Tranquil Shores*, 39 WASH. & LEE L. REV. 861 (1982); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143 (1982).

(6) Plaintiff must establish scienter on the part of the defendant. A showing of negligence is insufficient. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (no private cause of action will lie without allegation of scienter). The Supreme Court left open the question of whether or not reckless conduct may subject a defendant to liability in this context. *Id.* at 193 n.12. In the wake of *Hochfelder*, numerous courts have held that reckless behavior is sufficient for liability. 3B H.S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.22[4][f], at 9-155 (1986).

18. For a general discussion comparing active fraud in a transactional setting and constructive fraud in a fiduciary relationship, see Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1249-58 (1983). In this article, Professor Langevoort explores whether churning and similar misconduct by brokers can withstand analysis under rule 10b-5 in the wake of the Supreme Court decision in Santa Fe Industries v. Green, 430 U.S. 462 (1977). In *Santa Fe*, the Court approved a trial court's dismissal of a complaint filed by minority shareholders of a corporation who sought to challenge under § 10(b) and rule 10b-5 the fairness of a Delaware short-form merger engineered by the majority shareholder to eliminate the minority interest. *Id.* at 468-71.

The Court held that a complaint involving a mere breach of fiduciary duty is not actionable under § 10(b) and rule 10b-5, absent allegations of fraud, misrepresentation, or deception. *Id.* at 471-74.

After *Santa Fe*, shareholder complaints alleging mismanagement or self-dealing by corporate fiduciaries face a difficult path if framed under rule 10b-5. Under a strict reading of the holding in *Santa Fe*, they should not be cognizable under § 10(b). Innovative appellate courts, however, have carved inroads into the *Santa Fe* doctrine by upholding such complaints if they allege nondisclosure of material information that if revealed would have permitted a shareholder an opportunity to remedy the abuse. Langevoort, *supra*, at 1274 & nn.105-07.

In marked contrast to the controversy surrounding corporate mismanagement cases, churning actions under rule 10b-5 have remained virtually unaffected by *Santa Fe*, even though churning claims also turn on a breach of fiduciary duty. Lower courts simply proceed on the assumption that churning involves deception and is proscribed by rule 10b-5. *Id.* at 1247. Professor Langevoort concludes that the difference in treatment between breach of fiduciary duty cases involving corporate mismanagement under rule 10b-5 and those involving churning is justified, but not for the reasons articulated in the opinions. *Id.* at 1271-83.

Professor Langevoort theorizes that the Supreme Court's attempt in *Santa Fe* to set up a dichotomy between a breach of fiduciary duty and fraud is essentially untenable. *Id.* at 1248. Tracing the development of the concepts of fiduciary duty and fraud through common law, the federal mail fraud and wire fraud statutes, and the federal securities laws, he argues that every secret breach of fiduciary duty is inherently deceptive. At a minimum, it deprives the principal of facts necessary to protect his own interest in deciding whether to retain or terminate the fiduciary. *Id.* at 1257-58. To the extent that every secret breach of fiduciary duty involves deception, *Santa Fe*'s distinction between fiduciary duty and fraud becomes illusory. *Id.* at 1277. Thus, Professor Langevoort argues it is necessary to move to a second level of inquiry and determine whether the interest of the person defrauded is within the zone of interests sought to be protected under rule 10b-5. *Id.*

Pointing to the requirement in rule 10b-5 that the deception at issue be "in connection with the purchase or sale of a security," he reasons that only breaches of fiduciary duty that affect the investment decision process and impair the transaction-encouraging purpose of the rule fall within its coverage. *Id.* He concludes that mismanagement breaches are generally too far removed from the shareholders' investment decision to fall within the protection of rule 10b-5, but breaches by securities professionals that affect the integrity of the investment process are within the zone of interests protected by the rule. *Id.* at 1294-95. Professor Langevoort offers this analysis as a sounder theoretical justification for the difference in treatment between these two categories of cases.

In developing his thesis that the distinction between a breach of fiduciary duty and fraud is largely illusory, Professor Langevoort begins by comparing and contrasting active fraud in a transactional setting with constructive fraud in a fiduciary setting. *Id.* at 1249-52. He notes that the law of fraud supports the concept of a "transactional reliance interest" in that it defines the circumstances under which one person may rely on another to supply him with information needed to make a decision. The law of fraud protects against cheating in the contract formation process, thus reducing the transactional costs that would attend independent discovery efforts by the decisionmaker. *Id.* at 1251-52.

In contrast, the law of fiduciary responsibility promotes what Professor Langevoort describes as a "relational reliance interest." It defines the circumstances under which a person may delegate discretion to a fiduciary with confidence that the fiduciary will act loyally with regard to his interests. The law of fiduciary duty protects against cheating by the fiduciary after the relationship is established, thus reducing the transactional costs which would attend constant oversight by the principal or a specialized contract anticipating opportunistic behavior by the fiduciary. *Id.* at 1249-50.

Professor Langevoort argues that the two doctrines are quite similar conceptually, although they differ in focus. *Id.* at 1252, 1257. Transactional fraud involves an active decisionmaker who relied on inaccurate or incomplete information. Constructive fraud usually involves a passive principal who delegated decisionmaking authority to a faithless agent. In both circumstances, however, the injured party is misinformed to his detriment because even the passive principal must implicitly churning may be remedied by an action brought at common law.[19] Shortly after its formation, the SEC also acted to prohibit churning. Section 15(c)(1) of the Securities Exchange Act of 1934 prohibits broker-dealers from using any fraudulent or manipulative device to effectuate transactions in the over-the-counter market.[20] Pursuant to rulemaking authority granted in this section, the SEC promulgated rule 15c1-7,[21] which defines the term "manipulative, deceptive or other fraudulent device or contrivance," as used in section 15(c)(1), to include "transactions or [sic] purchase or sale which are excessive in size or frequency in view of the financial resources and character" of an account in which a broker-dealer has been vested with discretionary authority.[22]

Rule 15c1-7 applies only to churning of a discretionary account in transactions effected through the over-the-counter market.[23] The SEC has always maintained, however, that the rule represents only one instance in which churning is illegal under federal securities law.[24] Thus, in early disciplinary

---

decide whether to continue to extend discretion to his fiduciary—a decision that should theoretically be fully informed. *Id.* at 1257.

Thus, Professor Langevoort concludes that both doctrines serve to preclude the appropriation of value arising out of an exchange relationship to which one party would not have consented if fully informed. *Id.* at 1252. Viewed from this perspective, protecting the relational reliance interest at stake in a churning suit serves much the same transaction-encouraging objective as does the bargain-oriented duty of full disclosure in the transactional fraud setting. *Id.* at 1257, 1279-83.

19. Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. Unit A Feb. 1981); Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 704-06, 69 Cal. Rptr. 222, 233-34 (1968).

20. Section 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o(c)(1) (1982 & Supp. III 1985) provides in pertinent part:

> No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security . . . otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance. . . . The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

21. Rule 15c1-7 provides:

> (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 [sic] 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) (1986).

22. *Id.*

23. *See* rule 15c1-7 (rule limited to discretionary accounts); § 15(c)(1) of the 1934 Act (source of authority for rule 15c1-7; limitation of rule to transactions other than on national securities exchange).

24. *See In re* Grubbs, 28 S.E.C. 323, 328 n.10 (1948) (SEC considers churning violative of rule

proceedings against broker-dealers, the SEC firmly stated that whether a discretionary or a nondiscretionary account is involved, churning violates the general prohibition in section 15(c)(1) against fraudulent broker-dealer practices in the over-the-counter market, as well as the broader antifraud provisions in section 17(a) of the Securities Act of 1933,[25] section 10(b) of the 1934 Act,[26] and rule 10b-5[27] promulgated pursuant thereto.[28] Indeed, pri-

---

15cl-2 of 1934 Act, as well as of § 17(a) of 1933 Act); *In re* Behel, Johnsen & Co., 26 S.E.C. 163, 168 n.8 (1947) (same); *In re* Norris & Hirshberg, Inc., 21 S.E.C. 865, 890 & n.31 (1946) (same), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 380 n.48 (1945) (same).

25. Section 17(a) of the Securities Act of 1933 provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1982).

26. Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (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.

15 U.S.C. § 78j (1982).

27. Rule 10b-5, promulgated under § 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.

17 C.F.R. § 240.10b-5 (1986).

28. *See supra* note 24. Unlike § 15(c)(1) of the 1934 Act, the general antifraud provisions in § 17(a) of the 1933 Act, § 10(b) of the 1934 Act, and rule 10b-5 are not limited to fraudulent practices committed by broker-dealers in the over-the-counter market. These provisions reach fraud by *any person*. Assuming the requisite jurisdictional nexus can be established, they apply to fraud in *any* market, whether the securities are traded on a national securities exchange, in the over-

vate suits filed by dissatisfied customers under theories of implied civil liability arising from these broader antifraud provisions form the bulk of decisional precedent in this area.[29]

---

the-counter securities market, or in a private transaction. *See generally* R. JENNINGS & H. MARSH, SECURITIES REGULATION 809-10 (5th ed. 1982).

29. See, for example, the cases collected *supra* note 9 and *infra* note 39.

In contrast to various express causes of action provided to investors under the federal securities laws, such as those found in §§ 11 and 12 of the 1933 Act, 15 U.S.C. §§ 77(k)-(l) (1982), neither § 17(a) of the 1933 Act nor § 10(b) of the 1934 Act provides on its face for a private right of action. A private right of action was first implied under § 10(b) in Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). Relying upon general principles of tort law, in particular the RESTATEMENT OF TORTS § 286 (1939), the court reasoned that a person injured by violation of a statute designed for his benefit is entitled to a remedy. *Id.* at 513-14. The Supreme Court has expressly recognized the existence of an implied cause of action under § 10(b) and rule 10b-5. *See supra* note 17 (discussing Supreme Court's recognition of private right of action under § 10(b) and rule 10b-5). The existence of an implied private cause of action under § 17(a) of the 1933 Act, however, remains an open question.

Section 17(a), the general antifraud provision of the 1933 Act, is roughly analogous to rule 10b-5 of the 1934 Act except that § 17(a) applies to fraud in the *offer* or *sale* of a security and does not extend to fraud by the *purchaser* of a security. Compare the text of § 17(a), set forth *supra* note 25, with the text of rule 10b-5, set forth *supra* note 27. Part of the reason for promulgation of rule 10b-5, which applies to fraud in the purchase or sale of a security, was the one-sided nature of § 17(a). R. JENNINGS & H. MARSH, *supra* note 28, at 808.

Prior to 1971 most lower federal courts used reasoning analogous to rule 10b-5 cases to recognize the existence of an implied private cause of action under § 17(a). *Id.* at 817. At that time, recognizing a remedy under § 17(a) added little to what was already available under rule 10b-5. T. HAZEN, THE LAW OF SECURITIES REGULATION § 13.13, at 509 (1985). Recently, however, a number of courts have ruled against a private right of action under § 17(a). *Id.* at 507.

This change may be attributable in part to the Supreme Court's recent reluctance toward implying a private right of action from a federal statute. *See* Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) (no implied private cause of action for damages under § 206 of Investment Advisors Act of 1940; limited implied private cause of action to void an investment adviser's contract under § 215 of Act); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (no implied private cause of action under § 17(a) of the 1934 Act). *But cf.* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982) (implied private right of action recognized under Commodity Exchange Act). *See* R. JENNINGS & H. MARSH, *supra* note 28, at 817-18 (summarizing arguments against implied private right of action under § 17(a)); T. HAZEN, *supra*, at 509-11 (suggesting that courts are unlikely to find implied private right of action under § 17(a) in light of recent Supreme Court decisions).

The shift against implying a private cause of action may also be an attempt to avoid interpretative problems that now surround recognition of a cause of action under § 17(a). Because recent Supreme Court decisions have restricted the scope of the remedy afforded under rule 10b-5, § 17(a) may now offer relief beyond that available under the rule. For example, in Aaron v. SEC, 446 U.S. 680, 695-701 (1980), the Supreme Court held that the SEC must establish scienter as an element of a civil enforcement action to enjoin violation of § 10(b), rule 10b-5, or § 17(a)(1). The Court ruled, however, that the SEC need not establish scienter to enjoin a violation of §§ 17(a)(2) or (3) because of differences in language in the latter two subsections. In reaching this conclusion, the Court focused on the wording of the statute rather than on the nature of the relief sought. It seems likely, therefore, that negligence would support a private cause of action under §§ 17(a)(2) and (3). T. HAZEN, *supra*, at 510. If that is the case, it creates the anomalous situation of requiring a defrauded seller to prove scienter in order to recover under rule 10b-5, while allowing a defrauded buyer to circumvent the scienter requirement in rule 10b-5 by suing under §§ 17(a)(2) or (3). R. JENNINGS

In *Santa Fe Industries, Inc. v. Green,*[30] the Supreme Court held that a mere breach of fiduciary duty is not actionable under section 10(b) without the presence of fraud, misrepresentation, or deception.[31] Although the heart of a churning claim remains the breach of fiduciary duty committed by the broker against his customer, federal courts continue to recognize churning as actionable under section 10(b) and rule 10b-5 by characterizing the conduct as also involving the required element of deception.[32]

By borrowing heavily from securities law precedent, churning of a commodities account has been held to violate section 4b,[33] the general antifraud

---

& H. MARSH, *supra* note 28, at 818. Refusing to recognize a private cause of action under § 17(a) is one way to avoid such inconsistencies in the overall statutory scheme. *Id.*

30. 430 U.S. 462 (1977).

31. *Id.* at 470-74.

32. Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983); *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1405-07 (E.D. Pa. 1984); Yancoski v. E.F. Hutton & Co., 581 F. Supp. 88, 91-92 (E.D. Pa. 1983). *See generally* Langevoort, *supra* note 18 (discussing effect of *Santa Fe* on churning cases and other instances of broker-dealer misconduct).

In addition to violating statutory antifraud provisions, such as § 10(b) and rule 10b-5, churning of a securities account is also prohibited under § 15(a) of article III of the N.A.S.D. Rules of Fair Practice. N.A.S.D. Manual (CCH) ¶ 2165, at 2078 (1986) (prohibits churning by a member of a discretionary account). The New York Stock Exchange had a comparable rule at one time, but it was deleted in 1968. N.Y.S.E. Rule 435, 2 N.Y.S.E. Guide (CCH) ¶ 2435, at 3775 (1978). In the wake of recent Supreme Court decisions restricting implication of private causes of action, the weight of authority is against implication of a private cause of action for violation of the rules of a self-regulatory organization. R. JENNINGS & H. MARSH, *supra* note 28, at 863.

The Federal Securities Code proposed by the American Law Institute would also specifically prohibit churning. 2 FED. SEC. CODE § 1606 (Proposed Official Draft 1978).

Finally, churning may be actionable under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968 (1982 & Supp. III 1985), and under various state consumer protection statutes prohibiting unfair and deceptive practices. Applicability of state consumer protection statutes depends largely on the language of the particular statute. *See* Evanston Bank v. Conticommodity Servs., Inc., 623 F. Supp. 1014, 1024-26, 1029-30 (N.D. Ill. 1985) (upholding sufficiency of claim for churning commodities account under RICO and under the Illinois state statute for deceptive business practices); *cf. In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1422-37, 1441-44 (E.D. Pa. 1984) (upholding sufficiency of claim for churning of securities account under RICO but dismissing count under New Jersey Consumer Fraud Act because securities fall outside scope of Act). The applicability of RICO and state consumer protection statutes to churning claims is beyond the scope of this article.

33. Section 4b of the Commodity Exchange Act provides in pertinent part:

> It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or byproducts thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) deliv-

provision in the Commodity Exchange Act.[34] Such a violation may be subject to a disciplinary proceeding brought by the Commodity Futures Trading Commission (CFTC) under section 6b of the Act,[35] a reparations proceeding

---

ering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof—

(A) to cheat or defraud or attempt to cheat or defraud such other person;

(B) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(C) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person; or

(D) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person.

7 U.S.C. § 6b (1982).

34. 7 U.S.C. §§ 1-26 (1982 & Supp. III 1985). For early decisions recognizing churning of a commodities account as a violation of the Commodity Exchange Act, see Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 133 (8th Cir. 1970) (section 6b of Commodity Exchange Act permits private remedy for commodity account churning); Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764, 766 (S.D.N.Y. 1972) (churning constitutes fraud under § 4b of Commodity Exchange Act); Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105, at 24,453 (CFTC Sept. 3, 1980) (same).

The Commodity Futures Trading Commission (CFTC) proposed a customer protection rule in 1977 that would have expressly prohibited churning. Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742, 44,746 (1977) (proposed Sept. 6, 1977). The Commission decided not to adopt the proposed rule, however, reasoning that the rule would merely codify a prohibition already implicit in the antifraud provisions of the Commodity Exchange Act and might inadvertently narrow the coverage of these provisions in some manner. 43 Fed. Reg. 31,886, 31,889 (1978).

Some courts hold that a discretionary commodities account may be treated as an investment contract within the definition of security in § 2(1) of the 1933 Act, 15 U.S.C. § 77(b)(1) (1982), and § 3(a)(10) of the 1934 Act, 15 U.S.C. § 78c(a)(10) (1982). *See generally* 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 4.6. These courts may find that churning of a discretionary commodities account also states an actionable claim under the antifraud provisions of the federal securities laws. *See* Moody v. Bache & Co., 570 F.2d 523, 525-26 (5th Cir. 1978) (discretionary commodity futures accounts may be "investment contracts" subject to federal securities laws); Johnson v. Arthur Espey, Shearson, Hammill & Co., 341 F. Supp. 764, 765-66 (S.D.N.Y. 1972) (churning of discretionary commodities accounts states actionable claim under § 10(b)). *But see* Point Landing, Inc. v. Omni Capital Int'l Ltd., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,858, at 94,184-86 (5th Cir. July 25, 1986) (en banc) (1974 amendments to Commodity Exchange Act preempt application of § 10(b) to actions involving individual discretionary commodity accounts).

In addition, when a case involves churning of both a securities and a commodities account, some courts have held that a plaintiff may recover for churning of the commodities account under federal securities law if the transactions are part of a single fraudulent scheme. *See* Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1210 (9th Cir. 1970) (plaintiff may recover for entire loss under § 10(b) and rule 10b-5 when single fraudulent scheme involves churning of both securities and commodities accounts).

35. Commodity Exchange Act § 6b, 7 U.S.C. § 9 (1982). *See generally* 2 P. JOHNSON, COMMOD-

brought by a customer before the CFTC under section 14 of the Act,[36] or a private action for damages brought by a customer in federal district court.[37] Churning in the commodities context has also been held to involve inherent deception and thus has survived challenge under *Sante Fe*.[38]

II. THE CONTOURS OF A PRIVATE ACTION FOR CHURNING UNDER FEDERAL SECURITIES AND COMMODITIES LAW

To prevail on a churning claim under federal securities or commodities law, a customer must establish (1) that the broker controlled the level of trading in the account, (2) that the broker traded the account excessively to generate commissions for himself, and (3) that the broker engaged in this activity with the requisite state of mind.[39] A broker can be expected to assert a variety of affirmative defenses, all of which turn on the customer's failure to complain in a timely fashion about the trading.[40] Courts are divided as to the proper measure of damages in a churning case.[41]

A. CONTROL BY THE BROKER

Active trading in a securites or commodities account will not support a claim of churning if the trading is directed by the customer.[42] Therefore, a

---

ITIES REGULATION § 4.103 (1982) (description of enforcement remedies available to CFTC for violation of Commodity Exchange Act).

36. Commodity Exchange Act § 14, 7 U.S.C. § 18 (1982). Section 14 creates a reparations program administered by the CFTC that allows any person to seek relief against a registrant for injury caused by a violation of the Act or the regulations issued thereunder. *See generally* 2 P. JOHNSON, *supra* note 35, § 4.145-.149.

37. The Supreme Court, in one of its few recent opinions recognizing an implied cause of action under a federal statute, affirmed the existence of an implied antifraud remedy under the Commodity Exchange Act. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 356 (1982). The Court rejected arguments that the administrative reparations program under § 14 of the Act supplanted rather than supplemented the implied judicial remedy. *Id.* at 384-85. An express private right of action was also created by § 22 of the Commodity Futures Exchange Act, 7 U.S.C. § 25 (1982), enacted by Congress in the Futures Trading Act of 1982, Pub. L. No. 97-444, § 235, 96 Stat. 2294, 2322.

38. Roche v. E.F. Hutton & Co., 603 F. Supp. 1411, 1414-15 (M.D. Pa. 1984) (churning inherently involves deception and is more than mere breach of fiduciary duty). *See generally* Langevoort, *supra* note 18 (discussion of effect of *Santa Fe* on churning cases and other instances of broker-dealer misconduct).

39. *See, e.g.,* Shad v. Dean Witter Reynolds, Inc., 799 F.2d 525, 529 (9th Cir. 1986); M & B Contracting Corp. v. Dale, 795 F.2d 531, 533 (6th Cir. 1986); Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498, 1501 (11th Cir. 1985); Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 775 (9th Cir. 1984); Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 2 (1st Cir. 1983); Thompson v. Smith Barney, Harris Upham & Co., 709 F.2d 1413, 1416-17 (11th Cir. 1983); Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. Unit A Feb. 1981); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980).

40. *See infra* notes 60-63 and accompanying text.

41. *See infra* notes 64-73 and accompanying text.

42. *See* Fey v. Walston & Co., 493 F.2d 1036, 1048 (7th Cir. 1974) (if salesman conforms to

customer in a churning case must first establish that the broker controlled the account.[43] Proof that a customer opened an account as a discretionary account—one in which the customer gives the broker the authority to conduct trading in the account without prior consultation with the customer—establishes the necessary showing of broker control. By contrast, in a nondiscretionary account—one in which the broker is not authorized to execute a trade without obtaining the prior consent of the customer—the customer purports to retain control over the account. A customer who opens a nondiscretionary account, however, may attempt to show that the broker exercised de facto control over the account. Defining what constitutes "control" in this circumstance has become a veritable nightmare for the courts and is the central focus of this article.

B. EXCESSIVE TRADING

Churning involves excessive trading of a customer's account by a broker to generate commissions for himself without regard to the customer's best interests.[44] In one sense, excessiveness is a subjective determination.[45] A volume

---

customer's objectives, and fulfills fiduciary duty to furnish advice, additional motive of earning commissions does not convert transaction into violation of § 10(b) of 1934 Act); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 956-57 (E.D. Mich. 1978) (pattern of trading, even if excessive, was customer's sole responsibility because customer controlled account); Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 464 F. Supp. 528, 534 (D. Md. 1978) ("[i]n the absence of a fiduciary relationship excessive trading in an account in which the transactions are initiated by the customer is insufficient for direct liability under section 10(b) since the element of control is lacking"); *accord* Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 432 (E.D. Pa. 1972); Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968); *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 380 (1945).

43. *See* Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1978) ("[c]ontrol of trading is an essential element of churning"); Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1069-70 (2d Cir. 1977) (customer must show dealer exercised control over trading and manipulated account to his benefit), *cert. denied*, 434 U.S. 1035 (1978); M & B Contracting Corp. v. Dale, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984) (plaintiff failed to establish first essential element of churning—control), *aff'd*, 795 F.2d 531 (6th Cir. 1986); Williamsport Firemen Pension Bds. v. E.F. Hutton & Co., 567 F. Supp. 140, 144 (M.D. Pa. 1983) (essential element of churning is that broker had authority to exercise complete discretion over activity in account); Altschul v. Paine, Webber, Jackson & Curtis, Inc., 518 F. Supp. 591, 595 (S.D.N.Y. 1981) (control is essential element of churning case); Greenfeld v. D.H. Blair & Co., [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,239, at 98,254 (S.D.N.Y. July 18, 1975) (finding of control critical before liability may be premised on churning); Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 432 (E.D. Pa. 1972) (control essential to finding of churning).

44. For a general discussion of the excessive trading element of a churning case, see 1 S. GOLDBERG, *supra* note 1, § 2.9; 5B A. JACOBS, *supra* note 2, § 212, at 9-123 to -129; N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, ¶ 2.11, at 2-59; Lowe, *supra* note 2, at 332-43 (excessive trading of commodities accounts); Packard, *supra* note 1, at 232-44 (excessive trading of stock options); Comment, *The Lack of a Definite Standard to Measure Excessive Trading Activity in Over-the-Counter Customers' Securities Accounts*, 41 TEMP. L.Q. 116 (1967).

45. *See* Booth v. Peavey Co. Commodities Servs., 430 F.2d 132, 134 (8th Cir. 1970) (whether trading is excessive is question of fact that cannot be determined by any precise rule or formula).

and frequency of trading that might be acceptable for the account of a wealthy investor or an investor interested in short-term profits might be totally unacceptable for an investor of modest means who is interested in current income and conservation of capital.[46] Thus, excessiveness must be measured according to the customer's financial resources and investment objectives.[47]

Although a finding of excessive trading ultimately hinges on subjective considerations, a variety of objective tests aid courts in determining whether an account has been overtraded.[48] The most important test in securities cases is turnover ratio, i.e., the number of times within a specified period that a customer's account has been liquidated and reinvested.[49] The turnover ratio is computed by dividing the cost of securities purchased for the account by the average net equity in the account during the period under consideration.[50] Because determination of an excessive turnover rate depends on the nature of the account and the circumstances of the investor, it is impossible to state definitively how many times an account must be turned over during a given period before trading will be deemed excessive.[51]

---

46. *Compare* Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676 (9th Cir. 1982) (frequent trading not excessive when plaintiff was trader looking for profits on short-term swing transactions) *with In re* Samuel B. Franklin & Co., 42 S.E.C. 325, 327-29 (1964) (trading found excessive in accounts of two widows, in view of financial resources and character of accounts). *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983) (when customer's goals are aggressive or speculative, rather than conservative, easier to determine trading not excessive).

47. *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983) (customer's investment goals form standards by which allegations of excessiveness are measured); Mihara v. Dean Witter & Co., 619 F.2d 814, 820-21 (9th Cir. 1980) (question of excessive trading examined in light of customer's investment objectives); Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975) (structure and investment objectives of account considered to determine whether trading excessive); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 435 (N.D. Cal. 1968) (trading excessive when volume and frequency of transactions, considered in light of nature of account and customer's situation, needs, and objectives, was so excessive as to indicate broker's purpose was to derive profit for himself while disregarding client's interests), *modified in part and aff'd*, 430 F.2d 1202 (9th Cir. 1970).

48. *See* Booth v. Peavey Co. Commodity Servs., 430 F.2d 132, 134 (8th Cir. 1970) (SEC and courts often look to objective criteria of turnover ratio, nature of trading, and dealer's profits to determine excessiveness).

49. Carras v. Burns, 516 F.2d 251, 255 n.2 (4th Cir. 1975) ("turnover" is measure of volume of trading that changes holdings of portfolio without changing its size).

50. *Id.*; *see, e.g.,* Marshak v. Blyth, Eastman, Dillon & Co., 413 F. Supp. 377, 380 (N.D. Okla. 1975); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 842 (E.D. Va. 1968); *In re* Looper & Co., 38 S.E.C. 294, 297 n.6 (1958).

51. *See* Note, *supra* note 1, at 876 (concluding from review of turnover statistics in SEC enforcement cases that complete turnover once every two months (annual turnover rate of six) likely to be found excessive). This conclusion has been cited favorably by several courts. *See, e.g.,* Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. 1021, 1039 (S.D.N.Y. 1977), *aff'd in part and remanded*, 570 F.2d 38 (2nd Cir.), *cert. denied*, 439 U.S. 1039 (1978); Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 401 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2nd Cir. 1977).

Excessiveness, however, must ultimately be measured against the nature of the account and the

In addition to examining turnover ratio, courts often cite other mathematical criteria as helpful in establishing excessive trading in a securities account. Because churning involves overtrading an account to generate commissions, decisions frequently compare the commissions earned on an account to the equity in the account, or to the total commission revenue of the individual broker or the branch of the brokerage firm involved.[52]

Finally, the presence of certain patterns of trading may lend additional objective support to a finding of excessive trading in a securities account. Most of these practices involve frequent changes in the character or identity of securities in a customer's account with little or no price fluctuation between transactions. Trades of this nature are frequently difficult to explain in any terms other than the broker's desire to generate commissions. Churning decisions, therefore, frequently point to evidence of in-and-out trading, cross-

---

investment objectives of the customer. *See supra* note 47 and accompanying text (listing cases affirming importance of investor's objectives). For example, in Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1070 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978), the Second Circuit affirmed a finding that a customer's account had not been churned, notwithstanding the fact that the turnover rate averaged seven times a year. The court noted that while turnover ratio and amount of commissions are useful indicators, they must be examined in light of the character of the account. Since the plaintiff was interested in speculation, a greater amount of activity was to be expected. *Id.* Conversely, even a relatively low turnover rate does not per se insulate the broker. *See* Jenny v. Shearson, Hamill & Co., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,568, at 94,382 (S.D.N.Y. Oct. 6, 1978) (refusing to hold as matter of law that turnover rate of 1.84 could never amount to excessive trading; fuller development of nature of plaintiff's account and trading objectives required); *see also* Mihara v. Dean Witter & Co., 619 F.2d 814, 819 (9th Cir. 1980) (turnover of account 14 times in 30 months for annualized rate of 5.59 was excessive); Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. 1021, 1039 (S.D.N.Y. 1977) (annual turnover rate of 1.85 not excessive), *aff'd in part and remanded*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Marshak v. Blyth, Eastman, Dillon & Co., 413 F. Supp. 377, 380 (N.D. Okla. 1975) (turnover rate of 1.226 over duration of account not clearly excessive); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 842 (E.D. Va. 1968) (turnover rate of two or more times per year clearly excessive when broker should have treated account as investment account for unsophisticated plaintiff); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 436 (N.D. Cal. 1968) (turnover ratio between eight and 11.5 in period of six years and 10 months excessive), *modified in part and aff'd*, 430 F.2d 1202 (9th Cir. 1970).

52. *See, e.g.*, Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 212 (D. Mass. 1978) (comparing commissions earned on account to equity in account); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 840 (E.D. Va. 1968) (comparing commissions earned on account to individual broker's total commission revenue); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 436 (N.D. Cal. 1968) (comparing commissions earned on account to total income of branch, as well as to individual broker's total commissions), *modified in part and aff'd*, 430 F.2d 1202 (9th Cir. 1970).

One commentator has suggested that a more relevant use of commission statistics would be to compute the amount of return a customer would have to earn on his average net equity to pay commissions and other costs associated with trading. 1 S. GOLDBERG, *supra* note 1, § 2.9[b][5], at 2-60. CFTC decisions have sometimes used a similar test. *See In re* Lincolnwood Commodities, Inc., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986, at 28,248-49 (CFTC Jan. 31, 1984) (annualized commission-to-equity ratio adopted as useful factor in determining whether account has been churned; ratio designed to test whether commissions were incurred at such a rate that extremely high trading profits were necessary to break even).

trading, or switching of securities between customers as evidence of excessive trading.[53]

Although analysis of the control element of a plaintiff's claim has been virtually identical in securities and commodities cases, commodities decisions draw some distinctions with respect to findings of excessive trading.[54] Commodity futures contracts inherently involve a heavy turnover.[55] Noting the differences between the securities and commodities markets, commodities decisions borrow only some of the objective indices developed in securities cases and frequently require greater numerical showings for those indices they do use.[56] If a commodities customer makes a prima facie showing of

53. In-and-out trading refers to a pattern of purchases followed by quick resales and immediate reinvestment in other securities. Several cases cite evidence of in-and-out trading as indicative of churning. *See, e.g.*, Carras v. Burns, 516 F.2d 251, 258 (4th Cir. 1975); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 212 (D. Mass. 1978); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 842 (E.D. Va. 1968).

Cross-trading refers to multiple trading of the same securities—i.e., buying, selling, and repurchasing one or a small number of securities. Examples of cross-trading may be found in *In re* R.H. Johnson & Co., 36 S.E.C. 467, 470-71, 474, 479-80 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); *In re* Norris & Hirshberg, Inc., 21 S.E.C. 865, 891-94 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

Switching securities between customers refers to the practice of recommending that one customer sell a certain security, while simultaneously recommending that another customer buy that same security. *E.g.*, *In re* J. Logan & Co., 41 S.E.C. 88, 92, 99 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964).

54. *See* Griswold v. E.F. Hutton & Co., 622 F. Supp. 1397, 1407 (N.D. Ill. 1985) (although principles governing proof of churning claim are same for securities and commodities fraud, amount of trading deemed excessive in securities account may not be excessive in commodities account because of highly volatile and trading-oriented nature of commodities market).

55. There are at least three differences between securities and commodities trading that may affect a determination of excessiveness. First, commodity futures are by definition a short-term investment with a specified delivery date, generally not too removed in time. The trader must either close his position prior to the delivery date or perform the contract. Thus, the nature of a commodity futures contract necessitates turnover.

Second, a commodities customer may purchase a commodity futures contract with a smaller deposit than is required to purchase securities. When coupled with the fact that commodities traders make their money solely from price changes and not from any periodic payments during the life of the investment (such as dividends on stock or interest on bonds), this high leverage increases sensitivity to price fluctuations and may impel quick trading activity to cut losses or to add to favorable positions.

Finally, commissions on commodities transactions are computed differently than securities transactions. *See generally* 2 P. JOHNSON, *supra* note 35, § 5.45; Lowe, *supra* note 2, at 326-27.

56. The CFTC has commented that the various objective indicators used to measure excessive trading in a securities account may also be applied to a commodities account, provided due regard is given to the economic differences between securities and commodities transactions. McGaughey v. Hogan-Orr, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,076, at 24,348 & n.3 (CFTC July 31, 1980), *aff'd in part and modified, rev'd in part on other grounds*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,479 (CFTC Jan. 2, 1985); Standards of Conduct for Commodity Trading Professionals for the Protection of Customers, 42 Fed. Reg. 44,742, 44,746 (1977) (proposed Sept. 6, 1977), *withdrawn as to churning*, 43 Fed. Reg. 31,886, 31,889 (1978)).

The one objective indicator the CFTC does not use, however, is turnover ratio. The CFTC has ruled that fundamental differences between securities and futures contracts make turnover ratio, as excessiveness, the burden shifts to the broker to rebut the objective evidence by demonstrating that the account was traded according to a system.[57]

C. BROKER'S STATE OF MIND

To justify imposing liability on the broker for excessive trading, a customer must establish the state of mind normally required for recovery under the particular antifraud section serving as the basis for the suit.[58] This has

developed in securities cases, inherently inappropriate for determining excessive trading in a commodities account. *In re* Lincolnwood Commodities, Inc., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,986, at 28,247 (CFTC Jan. 31, 1984).

At least one commentator has argued that the objective tests used to measure excessiveness in securities cases have no meaning at all in a commodities context, not just that the numbers must be higher to be significant. *See* Lowe, *supra* note 2, at 338. Lowe contends that in light of the economic differences between securities and commodities trading, the CFTC and courts should abandon recognition of a cause of action for churning in commodities cases and substitute instead a trade-by-trade suitability inquiry. *Id.* at 341-43. Numerous decisions, however, have rejected the existence of a suitability standard under the Commodity Exchange Act. *See generally* Phacelli v. Conticommodity Servs., Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,674 (CFTC Sept. 5, 1986) (futures merchant not in violation of Commodity Exchange Act merely because of failure to determine whether customer suitable for commodities trading).

Several commentators have argued that economic differences and complexities in the options market suggest the need for differences in approach with respect to determining excessive trading in churning claims of stock option accounts as well. *See generally* Packard, *supra* note 1, at 232-44; Poser, *supra* note 1, at 607-08.

57. Dunn v. Contemporary Fin. Corp., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,955, at 31,779-80 (CFTC Feb. 25, 1986) (defendants carry burden of demonstrating legitimate basis for trading strategy and showing strategy was reasonably consistent with the customer's trading objectives); Parciasepe v. Shearson Hayden Stone, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,464, at 30,067 (CFTC Jan. 2, 1985) (once customer establishes prima facie showing of excessive trading based on objective evidence, burden shifts to broker to produce evidence of legitimate basis for trading strategy).

58. Most private claims for churning of a securities account are brought under the general antifraud provisions found in § 10(b) and rule 10b-5 of the 1934 Act. *See supra* notes 26-27 for the text of § 10(b) and rule 10b-5. In the wake of the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), a plaintiff must establish scienter on the part of the defendant to recover under these provisions. A showing of negligence is insufficient. *Id.* at 193. Whether reckless conduct will suffice remains an open question. *Id.* at 194 n.12; *see supra* note 39 (appellate cases applying *Hochfelder* in churning context and endorsing either intent or recklessness as sufficient).

A customer may also attempt to bring an implied private cause of action for churning of a securities account under § 17(a) of the 1933 Act. There is some question, however, as to whether such a cause of action exists under § 17(a). *See supra* note 29 (discussing decisions recognizing or denying private right of action under § 17(a)). If an implied cause of action is recognized under § 17(a), it seems likely that negligence may well be sufficient for recovery under either § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1982), or § 17(a)(3), 15 U.S.C. § 77q(a)(3) (1982). For a discussion of the importance of the Supreme Court's holding in Aaron v. SEC, 440 U.S. 680 (1980), on this question, see *supra* note 29.

A customer may bring a reparations proceeding before the CFTC (under § 14 of the Commodity Exchange Act) or a private cause of action in federal district court for churning of a commodities account in violation of the general antifraud provision in § 4b of the Commodity Exchange Act. *See supra* notes 33-34, 36-37 and accompanying text. The CFTC has held that negligence is sufficient for liability under § 4b. *See* Gordon v. Shearson Hayden Stone, Inc., [1980-1982 Transfer generally not been problematic since the nature of a churning offense is such that proof of the substantive violation almost invariably establishes the requisite state of mind. Once the customer has proven control of the account by the broker and excessive trading, proof that the broker intended to reap profits for himself and therefore possessed the necessary level of culpability is virtually a foregone conclusion.[59]

D. AFFIRMATIVE DEFENSES

If a customer establishes a prima facie showing of churning, a broker can assert a variety of affirmative defenses, including ratification, estoppel, waiver, failure to mitigate damages, laches, and statute of limitations.[60] In the context of a churning suit, all of these defenses revolve around the effect, if any, of a customer's failure to act in the face of regular receipt of trade confirmation slips and account statements.[61] While many of these defenses share a common theme of delay by the plaintiff in objecting, they each represent distinct legal theories with different elements of proof.[62] These subtle-

Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,016, at 23,981 (CFTC Apr. 10, 1980) (breach of fiduciary duty, even if committed negligently, constitutes fraud under § 4b), *aff'd on other grounds sub nom.* Shearson Loeb Rhoades, Inc. v. CFTC, 673 F.2d 1339 (9th Cir. 1982). This approach has not met with great approval in the courts. Focusing on the language of § 4b, the legislative history, and the Supreme Court's analysis in *Hochfelder*, numerous courts have held that more than negligence is required for liability under § 4b. *See* Hill v. Bache, Halsey, Stuart, Shields, Inc., 790 F.2d 817, 821-23 (10th Cir. 1986) (no liability under § 4b based upon mere negligence, mistake, or inadvertence); McIlroy v. Dittmer, 732 F.2d 98, 102 (8th Cir. 1984) (proof of more than mere carelessness required for § 4b violation); Evanston Bank v. Conticommodity Servs., Inc., 623 F. Supp. 1014, 1022-24 (N.D. Ill. 1985) (scienter or recklessness required for § 4b violation); McCarthy v. Paine Webber, Inc., 618 F. Supp. 933, 938-41 (N.D. Ill. 1985). *See generally* 2 P. JOHNSON, *supra* note 35, § 5.39 (discussing application of scienter standards in § 4b cases).

59. *See* Shad v. Dean Witter Reynolds, Inc., 799 F.2d 525, 530 (9th Cir. 1986) (scienter usually not established by direct evidence, but rather inferred from finding of excessive trading and control). The opinion of the Second Circuit in Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983), is illustrative of the conclusory treatment normally given to this element of the plaintiff's case. In *Armstrong*, the court simply stated that "[c]hurning, in and of itself, may be a deceptive and manipulative device under section 10(b), the scienter required by section 10(b) being implicit in the nature of the conduct." *Id.* at 91.

For a rare example of a more extensive discussion of the scienter element in a churning case, see Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 401-02 (S.D.N.Y. 1976) (rejecting finding of fraudulent intent where millionaire plaintiff sued broker of 17 years for churning after substantial losses resulted from the use of trading system that had previously produced gains), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

60. *See, e.g.*, Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 774 (9th Cir. 1984) (failure to mitigate damages); Costello v. Oppenheimer & Co., 711 F.2d 1361, 1370 (7th Cir. 1983) (waiver, estoppel, laches, ratification); Dzentis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 171-73 (10th Cir. 1974) (statute of limitations); Landry v. Hemphill, Noyes & Co., 473 F.2d 365, 373-74 (1st Cir.) (estoppel), *cert. denied*, 414 U.S. 1002 (1973).

61. *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1370 (7th Cir. 1983) (investor who fails to object upon receipt of trading confirmations may be barred by waiver, estopppel, laches, or ratification).

62. *See generally* 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 §§ 235.01-

ties, however, often disappear in judicial decisions, especially in churning cases. Churning opinions invariably treat the various affirmative defenses in a lump sum fashion with little or no differentiation.[63]

E. DAMAGES

Courts have struggled to fashion the proper measure of damages for a customer injured by churning.[64] The method devised in early securities cases, and probably still most frequently used in both the securities and commodities context, awards damages in the amount of commissions and interest paid to the broker during the period of the offense.[65] Since churning is excessive trading of a customer's account for the purpose of generating commissions,

---

237.04 (1985) (discussing and differentiating defenses of statute of limitations, laches, waiver, estoppel, and ratification).

63. *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1370 (7th Cir. 1983) (treating waiver, estoppel, laches, and ratification in aggregate on review of jury verdict); Sutton v. Shearson Hayden Stone, Inc., 490 F. Supp. 99, 100-01 (S.D.N.Y. 1980) (treating waiver and estoppel together for purposes of passing on motion to dismiss complaint); Rankl v. Elkins, Stroud, Suplee & Co., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,827, at 90,119 (E.D. Pa. June 12, 1980) (treating ratification, waiver, and estoppel in group fashion for purposes of evaluating motion for summary judgment); Powers v. Francis I. DuPont & Co., 344 F. Supp. 429, 433 (E.D. Pa. 1972) (finding customer barred from recovery under principles of waiver, estoppel, and laches without differentiation).

For a rare example of precise differentiation between defenses, compare the trial court opinion in Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 422 (N.D. Cal. 1968) (holding customer barred as to suitability claims, but not as to churning, under principles of waiver, estoppel, and laches treated without differentiation), *modified in part on other grounds and aff'd*, 430 F.2d 1202 (9th Cir. 1970), with the opinion of the Ninth Circuit in the same case on review, 430 F.2d at 1207-09 (differentiating the three theories and holding that although trial court failed to make findings necessary to support defense of waiver, findings were sufficient to support application of estoppel and laches).

64. *See* Fey v. Walston & Co., 493 F.2d 1036, 1054 n.26 (7th Cir. 1974) (unlikely that rule can be designed to cover all combinations of facts and complications beyond generalization that damages should compensate customer approximately for losses sustained as proximate result of churning); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 216 (D. Mass. 1978) (difficult to fashion general rule for all situations). *See generally* Brodsky, *Measuring Damages in Churning and Suitability Claims*, 6 SEC. REG. L.J. 157, 165-66 (1978) (proposing introduction of expert testimony to compare actual trading results in churned account with results of hypothetically well managed account); Poser, *supra* note 1, at 577 n.44 (analyzing methods of calculating damages); Note, *Measuring Damages in Suitability and Churning Actions under Rule 10b-5*, 25 B.C.L. REV. 839, 859-63 (1984) (endorsing modified rescissory approach); Note, *supra* note 1, at 883-85 (endorsing loss of bargain recovery); Comment, *Churning and the Death of Low Risk Larceny: Calculating Damages to Redress the Churning Client's Loss in Portfolio Value*, 21 CAL. W.L. REV. 149, 163-73 (1984) (endorsing modified rescissory approach).

65. Mihara v. Dean Witter & Co., 619 F.2d 814, 826 (9th Cir. 1980); Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975); Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1211-12 (9th Cir. 1970); Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68, 73 (S.D.N.Y. 1981); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 216 (D. Mass. 1978); *see* Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,870 (CFTC Nov. 13, 1984) (traditional quasi-contractual theory limits damages to commissions, fees, taxes, and interest incurred by overtrading).

this mode of recovery focuses on the unjust enrichment of the broker and strips him of his gains.[66]

While this quasi-contractual approach is appealing because of its ease of application,[67] it is not without some obvious shortcomings. An award based on the broker's gain may bear little relation to the customer's loss. Some securities churning cases recognize that churning may adversely affect the underlying value of a customer's portfolio. These courts adopt an out-of-pocket measure of damages to compensate the customer for decline in portfolio value.[68] Under this theory of damages, the customer essentially receives a

---

66. *See* Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 216 (D. Mass. 1978) (quasi-contractual method most appropriate because broker required to return all benefits received).

The quasi-contractual theory of damages may be criticized in one sense as overinclusive. Decisions utilizing this method of recovery make no effort to determine how much of the broker's gain is ill gotten. They simply award damages based upon the entire amount of commissions paid. *Id.* The customer, however, has been damaged with respect to commissions only to the extent that the commissions paid were excessive. Thus, it would seem more appropriate theoretically to calculate an award of commissions based on the difference between commissions actually paid and the amount of commissions that would have been paid if the account had not been churned. Admittedly, such an award would be more difficult to estimate. *See* Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 440 (N.D. Cal. 1968) (award of commissions theoretically should be limited to those attributable to "excessive" transactions, as opposed to transactions not excessive under the circumstances; however, because of difficulty in making this distinction with precision, wrongdoer cannot complain of award based on total commissions), *modified in part and aff'd*, 430 F.2d 1202, 1211-12 (9th Cir. 1970); *see also* Note, *supra* note 64, at 844 (quasi-contractual award may overcompensate plaintiff); Note, *supra* note 1, at 884 (award of commissions theoretically should be confined to commissions paid in excess of those which would have been earned from a legitimately managed account; however, because of difficulty of estimating this figure, award of total commissions is more sensible).

In focusing solely on commissions, however, the quasi-contractual measure of damages can also be criticized as underinclusive because no damages are awarded for declines in portfolio value proximately caused by churning. *See infra* notes 68-71 and accompanying text (discussing out-of-pocket measure of damages in securities cases).

67. *See* Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975) (awarding commissions rather than lost equity because former easy to ascertain, while latter indeterminable on facts of case and speculative).

68. *See* Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 730-33, 69 Cal. Rptr. 222, 249-51 (1968) (awarding lost equity, computed as starting value of account plus assumed earnings, reduced by ending value of account and cash distributions to customer).

In *Twomey* the court awarded out-of-pocket damages as an alternative to a quasi-contractual award. *Id.* Other courts have recognized that a customer may suffer both types of injury from churning and use the out-of-pocket method to supplement an award of commissions. *See infra* notes 72-73 and accompanying text (discussing decisions applying both remedies).

Whether used as an alternative to a quasi-contractual award or as a supplement, the out-of-pocket theory has most often been invoked in securities churning cases that also involve suitability violations—i.e., allegations by the customer that the broker not only overtraded the account in terms of the volume and frequency of transactions, but also violated his duty to make trades qualitatively suited to the customer's financial situation and needs. *See Twomey*, 262 Cal. App. 2d at 730-33, 69 Cal. Rptr. at 249-51 (defendants negligently advised plaintiff to switch into unsuitable investments in breach of fiduciary duty); *see also* Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. Unit A Feb. 1981) (customer harmed by broker's conclusion of transactions unsuitable for investor); Mihara v. Dean Witter & Co., 619 F.2d 814, 826 (9th Cir. 1980) (plaintiff's claim of rescissory award, calculated as the difference between the starting value of his account and its ending value.[69] In contrast to the quasi-contractual approach, the out-of-pocket theory attempts to focus on the actual harm to the customer; however, it is not without its own analytical difficulties.[70] A pure out-of-pocket award essentially restores the plaintiff to the full starting value of his account as if the account had been dormant. It operates on the assumption that all transactions in the account were invalid and thus fails to take into consideration any factors extrinsic to the churning that may have caused the account to decline in value.[71]

---

unsuitability of securities purchased encompasses trading losses). See *infra* note 140 for a discussion of the suitability doctrine in securities cases.

The CFTC has consistently declined to read into § 4b of the Commodity Exchange Act a requirement that commodity professionals determine a customer's suitability to trade futures contracts. *See* Phacelli v. Conticommodity Servs., Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,674 (CFTC Sept. 5, 1986) (commodity professional does not violate § 4b by mere failure to determine customers' suitability for commodity trading); *accord* Schofield v. First Commodity Corp., 793 F.2d 28, 34 (1st Cir. 1986) (no cause of action against broker for failure to advise customer that particular investment unsuitable). This does not mean, however, that the CFTC has entirely ruled out the possibility of awarding damages under an out-of-pocket approach.

The CFTC recognizes the quasi-contractual theory as the normal measure of recovery in reparations proceedings. Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,871 (CFTC Nov. 13, 1984). Given the highly volatile nature of the commodities markets and the fact that many well managed accounts lose money, the CFTC believes it is improper to assume that a broker's churning is necessarily the proximate cause of a customer's trading loss. *Id.* at 29,871. However, if a customer can establish the necessary causal connection by proving that such losses would not have occurred if the account had not been churned, then a customer may be entitled to recover trading losses. *Id.*; *see* McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254, 1256-58 (8th Cir. 1984) (acknowledging potential for recovery of trading losses in addition to commissions in context of implied private cause of action for churning under § 4b).

69. *E.g.,* Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 730-33, 69 Cal. Rptr. 222, 249-51 (1968).

70. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. Unit A Feb. 1981) (criticizing pure out-of-pocket approach and adopting modified rescissory approach to take into account general market decline as measured by standard market index); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 849-50 (E.D. Va. 1968) (criticizing pure out-of-pocket approach and adopting quasi-contractual approach as more certain). *See generally* Note, *supra* note 64, at 846-48; Note, *supra* note 1, at 884.

71. The out-of-pocket approach presents two other theoretical problems. First, in the context of securities churning cases, out-of-pocket recovery has frequently been tied to the presence of suitability violations. Under this theory, churning of suitable securities might not warrant an award of trading losses unless it could be established that the churning itself somehow caused the decline in account value. *See* Brodsky, *supra* note 64, at 159. If the out-of-pocket approach is used as an alternative rather than a supplement to an award of commissions, it is possible under this scenario that an investor would recover no damages. In such a case it seems likely that a court would revert to a quasi-contractual remedy.

Second, a pure out-of-pocket approach could also theoretically result in no damages if used in lieu of the quasi-contractual model, when the customer's account experiences a net profit. *See* Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 849 (E.D. Va. 1968) (criticizing out-of-pocket theory in this regard). *See generally* Note, *supra* note 64, at 847-48. In this circumstance, a court would also likely resort to the quasi-contractual remedy because the existence of a net profit

To remedy the problems inherent in both approaches, other courts have attempted blends and modifications of the two theories of recovery. These courts recognize that a churning victim may suffer both excessive commissions and decline in portfolio value and thus award a judgment based on both the quasi-contractual approach and the out-of-pocket theory.[72] Moreover, several opinions attempt to refine the out-of-pocket theory by adjusting the difference between the customer's starting and ending account balance to reflect general market decline as measured by one of the standard securities market indices.[73] The measure of damages in churning cases, however, remains a fertile area of litigation.

F. THE SIGNIFICANCE OF THE CONTROL ELEMENT IN A CHURNING CASE

Control of trading by the broker is the threshold issue in a churning case and the very heart of a churning claim.[74] Control is the driving force behind the broker's fiduciary duty to place the customer's interest ahead of his own. Abuse of that control is the gravamen of a churning offense.

Most discussions of the control element in churning cases, however, simply state that the issue of control is a question of fact to be determined in

---

has never been regarded by the SEC or the courts as a defense to a churning claim. *See* Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68, 73 (S.D.N.Y. 1981) (court rejected broker's contention that customer's complaint insufficient for failure to plead actual damages as to churning count because of net gain in portfolio value; quasi-contractual measure of damages would be appropriate relief).

72. *See* Hatrock v. Edward D. Jones & Co., 750 F.2d 767, 773-74 (9th Cir. 1984) (in securities churning case investor may recover excessive commissions charged by broker and decline in portfolio value caused by broker's fraudulent transactions; jury verdict that did not exceed commissions paid plus loss on fraudulently-induced transaction upheld); McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254, 1256-58 (8th Cir. 1984) (acknowledging potential for recovery of trading losses, in addition to commissions, in implied private cause of action for churning under § 4b of Commodity Exchange Act); *see also* Miley v. Oppenheimer & Co., 637 F.2d 318, 326-28 (5th Cir. Unit A Feb. 1981) (churning of unsuitable securities results in two distinct harms—excessive commissions and decline in portfolio value; jury verdict allowing recovery for both, with latter adjusted to take into account general market decline, affirmed).

73. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 328 (5th Cir. Unit A Feb. 1981) (affirming trial court's instruction to reduce out-of-pocket damages award by average percentage decline in value of Dow Jones Industrials or Standard & Poor's Index); Rolf v. Blyth, Eastman, Dillon & Co., 424 F. Supp. 1021, 1045 (S.D.N.Y. 1977) (*Rolf I*) (plaintiff cannot recover net losses for violation of suitability and supervision rules; damages awarded based on quasi-contractual theory), *aff'd in part and remanded*, 570 F.2d 38, 48-50 (2d Cir.) (*Rolf II*) (developing method that adjusts out-of-pocket losses by considering market indices and remanding to district court to recompute damages), *cert. denied*, 439 U.S. 1039 (1978); Rolf v. Blyth, Eastman, Dillon & Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,919 (S.D.N.Y. 1979) (*Rolf III*), *aff'd in part and remanded*, 637 F.2d 77, 84-85 (2d Cir. 1980) (*Rolf IV*) (recognizing discretion of district court on remand to use Standard & Poor's Low Price Index for period in question). *See generally* Note, *supra* note 64, at 848-62.

74. For previous discussions of the control element in a churning case, see 1 S. GOLDBERG, *supra* note 1, § 2.8; 5B A. JACOBS, *supra* note 2, § 212.01, at 9-120 to -123; N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, ¶ 2.11, at 2-56 to -57; Hyman, *supra* note 1, at 6-8; Lowe, *supra* note 2, at 331-32; Packard, *supra* note 1, at 224; Poser, *supra* note 1, at 579-81; Note, *supra* note 1, at 871-74; Comment, *supra* note 1, at 281-84.

light of the circumstances surrounding the relationship between the broker and his customer. Apart from describing factual scenarios presented in various cases, few commentators have attempted to analyze the rationale underlying the decisions in this area. The failure to do so is understandable since the case law is in considerable disarray.

To say that the issue of control is a question of fact is not to say that this issue cannot be subjected to a mode of analysis against which the question of control may be answered with some degree of consistency. Such analysis necessarily begins with an examination of the judicial and administrative evolution of the concept of control. In this history lie the seeds of a possible solution.

III. JUDICIAL AND ADMINISTRATIVE DEVELOPMENT OF THE CONCEPT OF CONTROL

A. THE EARLY SEC ENFORCEMENT CASES

Initial definition of the elements of a churning violation took place largely in the context of SEC disciplinary proceedings against brokers.[75] As one might expect in an enforcement context, these early cases present relatively egregious factual situations in which churning is frequently only one of several violations committed by the broker. A recurring fact pattern involves a registered representative who creates a relationship of trust and confidence with an unsophisticated customer, characterized by overtones of acting on the customer's behalf. The registered representative then engages in transactions with the customer purportedly as a principal, charging prices not reasonably related to the market price and excessively trading the account.[76]

In the excessive markup portions of these opinions, the SEC uses two analytical constructs to support a finding of fraudulent conduct by the broker-dealer: the shingle theory and the fiduciary theory. Although these two theories rest on different premises, they tend to blur in actual application. Both place a heavy emphasis on the fact that the broker-dealer induced the customer's reliance. This focus on customer reliance with respect to markups is central to the Commission's churning analysis as well.[77]

---

75. *See* Note, *supra* note 1, at 869 (commenting that as of late 1960s churning was primarily dealt with by SEC through its enforcement of general broker-dealer antifraud provisions).

76. *See, e.g., In re* J. Logan & Co., 41 S.E.C. 88 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied,* 377 U.S. 937 (1964); *In re* Looper & Co., 38 S.E.C. 294 (1958); *In re* R.H. Johnson & Co., 36 S.E.C. 467 (1955), *aff'd per curiam,* 231 F.2d 523 (D.C. Cir.), *cert. denied,* 352 U.S. 844 (1956); *In re* Grubbs, 28 S.E.C. 323 (1948); *In re* Behel, Johnsen & Co., 26 S.E.C. 163 (1947); *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).

77. See, for example, the discussion of the SEC's analysis in *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347 (1945), *infra* in text accompanying notes 97-116.

Under the shingle theory the SEC maintains that regardless of his legal capacity as an agent or principal, a broker-dealer implicitly represents by "hanging out his shingle" that he will deal fairly with his customers in accordance with the standards and practices of his profession.[78] One aspect of this implied representation of fair dealing is that a dealer who functions as a principal represents that he is trading at a price which bears some reasonable relation to the market. If an unreasonable spread exists between the market price and the dealer's trading price that is not disclosed to the customer, the dealer breaches this implied representation and violates the antifraud provisions of the federal securities laws.

Charles Hughes & Co. v. SEC[79] is an early case articulating the shingle theory in the context of excessive markups. The SEC revoked the license of the securities firm on the ground that the firm had charged unreasonable spreads to a group of customers comprised of unsophisticated single women and widows without adequate disclosure.[80] In affirming the Commission's action, the Second Circuit judicially endorsed the shingle theory and noted:

> An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those which petitioner charged here must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level. Even considering petitioner as a principal in a simple vendor-purchaser transaction (and there is doubt whether, in several instances at least, petitioner was actually not acting as broker-agent for the purchasers, in which case all undisclosed profits would be forfeited), it was still under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in the customers. Once that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device. When nothing was said about market price, the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. The law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other.[81]

In this passage, the Second Circuit assumed, *arguendo,* that the securities firm was entitled to function as a principal with respect to its customers. The

78. *In re* Duker & Duker, 6 S.E.C. 386, 388 (1939). *See generally* 5B A. JACOBS, *supra* note 2, § 210.03, at 9-12 to -20; L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 951-58 (1983); N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, ¶ 2.03, at 2-14, ¶ 2.09, at 2-43, ¶ 2.10.

79. 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

80. *Id.* at 435-36.

81. *Id.* at 436-37 (footnote omitted).

court also noted, however, that this assumption was open to some question. The court's reservation in this regard refers to the second theory frequently employed by the SEC to bring unreasonable spreads in principal transactions within the aegis of the antifraud provisions—the fiduciary theory.[82]

The fiduciary theory is perhaps best articulated in another SEC opinion sustained on judicial review involving a broker-dealer also coincidentally named Hughes. In *In re Arleen W. Hughes,*[83] the Commission held that if a broker-dealer creates a relationship of trust and confidence with his customer in which the customer relies on the broker-dealer, the broker-dealer cannot negate the fiduciary overtones of this relationship simply by purporting to confirm as principal.[84] In such circumstances, the SEC will disregard the form of the transaction and imply the existence of an agency relationship.[85] When the parties' relationship is restructured in this fashion, undisclosed markups become ill-gotten secret profits.[86] The dealer-turned-broker violates his fiduciary duty to disclose his adverse interest to the customer and act in the customer's best interest.[87]

The shingle theory outlaws excessive markups through the fiction of an implied representation of fair dealing.[88] Through this mechanism it creates a case that is analogous to the typical transactional fraud suit in which a plaintiff complains about some misrepresentation or omission on the part of the defendant.[89] Technically, the shingle theory flows not from the existence of any agency obligation, but from the status of the broker-dealer as a trading professional.[90] Thus, as posited by the court in *Charles Hughes,* the shingle theory theoretically could apply even to a dealer operating at arm's length with a customer.[91] By way of contrast, the fiduciary theory reaches the problem of excessive markups by converting the dealer from a principal into an implied agent.[92]

---

82. *See generally* 5B A. JACOBS, *supra* note 2, § 210.03, at 9-20; L. LOSS, *supra* note 78, at 958, 963-68; N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, ¶ 2.03, at 2-14, ¶ 2.09, at 2-40 to -41.

83. 27 S.E.C. 629 (1948), *aff'd,* 174 F.2d 969 (D.C. Cir. 1949).

84. 27 S.E.C. at 634-39.

85. *Id.* at 638-39; *e.g., In re* Allender Co., 9 S.E.C. 1043, 1053-55 (1941).

86. *Allender Co.,* 9 S.E.C. at 1053-55.

87. *Id.*

88. *See* 5B A. JACOBS, *supra* note 2, § 210.03, at 9-18 ("The approach is a fiction—you imply a representation (which the broker has no intention of making) and then impose liability when it is breached.").

89. *See supra* note 17 and accompanying text (discussing transactional fraud suits).

90. L. LOSS, *supra* note 78, at 951 ("This has nothing to do with any agency obligation. The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public.").

91. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

92. *See* 5B A. JACOBS, *supra* note 2, § 210.03, at 9-20 n.31 ("This approach is also referred to as the implied agency theory.").

Notwithstanding these analytical differences, the two doctrines share one important theme in application—the presence of customer reliance. While the shingle theory could theoretically be used to reach a dealer operating at arm's length with his customer, in practice the doctrine has most often been invoked in cases that place considerable import on the fact that the dealer garnered the customer's trust and confidence even though he purported to act for his own account.[93] As the Second Circuit emphasized in *Charles Hughes,*[94] it was the fact that the securities firm fostered an environment of trust and confidence on the part of its customers which justified implication of certain representations under the shingle theory. Similarly, creation of a relationship of trust and confidence with the customer is what justifies the implied agency status of a dealer under the fiduciary theory.[95]

Thus, although analytically different, the shingle theory and fiduciary theory often dovetail in application and frequently appear alternatively in the same case.[96] Used in this fashion, both doctrines focus on exploitation by the broker of the confidence placed in him by the customer in the context of their ongoing relationship. This emphasis on the relational reliance of the customer—developed in the context of excessive markups—carries over significantly into the SEC's churning analysis as well.

In determining the existence of a churning violation, early SEC enforcement opinions never actually articulate the question as one of control over the account. Instead, the inquiry is phrased in terms of relational reliance. For example, in the Commission's very first churning case, *In re E.H. Rollins & Sons, Inc.,*[97] the SEC brought disciplinary proceedings against the firm of E.H. Rollins and one of its salesmen, Walter Rawls, for mismanagement of

93. *See id.* § 210.03, at 9-14 to -15 & n.13 (noting that application of shingle theory to dealers turns on whether dealer gained customer's confidence, but arguing that shingle theory should apply to dealers across the board); L. Loss, *supra* note 78, at 954-55 (noting that most cases involve element of advice by dealer and disparity in degree of knowledge possessed by dealer and customer, but arguing that shingle theory should apply regardless of such factors); N. Wolfson, R. Phillips & T. Russo, *supra* note 5, ¶ 2.03, at 2-15 (shingle theory originated in cases involving trust and confidence relationship with customers but has been expanded).

94. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied,* 321 U.S. 786 (1944).

95. *See supra* text accompanying notes 83-85 (discussing cases in which SEC implied existence of agency relationship).

96. For examples of cases employing both the shingle theory and the fiduciary theory, see *In re* Norris & Hirshberg, Inc., 21 S.E.C. 865, 881-90 (1946), *aff'd,* 177 F.2d 228 (D.C. Cir. 1949), and *In re* Allender Co., 9 S.E.C. 1043, 1053-58 (1941). *See* 5B A. Jacobs, *supra* note 2, § 210.03, at 9-20 to -21 & nn. 32-34 (noting overlap between two theories and tendency of SEC to rely more heavily on shingle theory); L. Loss, *supra* note 78, at 968 (arriving at same conclusion, but arguing that better approach would be greater use of fiduciary theory); N. Wolfson, R. Phillips & T. Russo, *supra* note 5, ¶ 2.03, at 2-15 (noting lack of distinct boundaries between two theories and arguing that cumulative effect is to eliminate common law distinction between broker-agent and dealer-principal; conduct of broker-dealer and relationship to customer determine duties owed).

97. 18 S.E.C. 347 (1945).

accounts opened to invest monies belonging to two special work funds of the Board of Missions of the Methodist Episcopal Church.[98] The firm had obtained the accounts because Rawls' brother was treasurer of one of the funds.[99] Rawls dealt with his brother when engaging in transactions with that fund and with a Mrs. Fulton when trading with the other fund.[100] As in many of the enforcement cases that followed, the Commission pointed to multiple violations of the securities laws. In particular, the respondents were charged with taking excessive spreads in principal transactions, churning the accounts, extending credit for periods greater than permitted by the Federal Reserve Board, engaging in fictitious transactions, and falsifying ledger accounts.[101] In addition, Rawls was charged with increasing prices on certain trades and secretly rebating the increase to his brother.[102] The Commission found against the respondents on all charges.[103]

In the portion of the opinion dealing with excessive markups, the evidence established that Mrs. Fulton placed complete trust and confidence in Rawls and E.H. Rollins.[104] Rawls assured her that he had a special interest in the accounts of the missions because of their religious nature and that he was giving the funds his best thought and attention.[105] When the funds had money available to invest, Rawls submitted recommendations that the funds invariably followed.[106] Indeed, Rawls often engaged in transactions with the funds without prior consultation with the customer, confident that his recommendations would be accepted.[107] On this record, the SEC raised the specter of the fiduciary theory.[108] Although the firm confirmed all transactions with the funds as principal, the Commission questioned whether the respondents were entitled to deal with the funds as principal or obligated to act as agents.[109] The Commission, however, chose not to answer this question because the evidence was somewhat mixed. Instead, it rested its finding of violation with respect to the markups on the shingle theory.[110]

Without determining the precise character of the legal relationship between the parties, the Commission noted that in light of the trust and confi-

98. *Id.* at 349.
99. *Id.* at 350.
100. *Id.* at 352.
101. *Id.* at 349.
102. *Id.*
103. *Id.* at 374-75 (excessive spreads); *id.* at 378-79 (fictitious transactions and falsified ledgers); *id.* at 380 (churning); *id.* at 385 (secret rebates); *id.* at 386 (credit violations).
104. *Id.* at 353.
105. *Id.*
106. *Id.* at 353-54.
107. *Id.* at 354.
108. *Id.*
109. *Id.*
110. *Id.* at 354-55.

dence instilled by respondents and the reliance that they had induced, the firm and Rawls were obligated to adhere to a course of fair dealing with the funds.[111] This obligation included an implicit representation that their trading prices would bear some reasonable relation to the market.[112] When the respondents charged prices that were excessive, they breached this representation and violated the antifraud provisions in section 17(a) of the 1933 Act and section 15(c)(1) of the 1934 Act.[113]

The emphasis on the respondents' exploitation of the customer's confidence in the markup discussion also dominates the Commission's treatment of the churning aspects of the case. Evidence of in-and-out trading and a statistical analysis of the portfolios satisfied the agency that the accounts had been overtraded.[114] The SEC assessed responsibility for this overtrading in terms of relational reliance. In finding the respondents liable for a violation of section 15(c)(1), the Commission stated:

> Of course a dealer cannot be held guilty of overtrading in an account where transactions are initiated by the customer. In that case the profit drain on the account is the responsibility of the customer and not the dealer. On the other hand, in order to determine a dealer's culpability for overtrading it is not necessary that we find him to have a discretionary power over the account in a formal sense. The heart of the inquiry is not nomenclature or form but fact. Does the dealer occupy such a status with respect to the customer that he may be held responsible for excessive trading in such customer's account? . . . On the basis of what has already been said we think there is no doubt that Rawls occupied that status with respect to Woman's Work.[115]
>
> . . . .
>
> As we have noted, Rawls habitually took the initiative in trades effected for Woman's Work, and Mrs. Fulton placed great reliance on him, pursuant to his solicitation, throughout the period under discussion . . . . On the basis of all the evidence we find that Rawls induced excessive trading in the Woman's Work account, in pursuance of a scheme that operated as a fraud thereon . . . .[116]

The enforcement cases involving churning subsequent to *Rollins* mirror the structure and language of that opinion. Almost all of the proceedings involve relatively unsophisticated customers and allege at a minimum unreasonable spreads in principal transactions and churning on the part of the dealer. In each case, the SEC notes that the dealer induced the reliance of

---

111. *Id.*
112. *Id.* at 362.
113. *Id.* at 374-75.
114. *Id.* at 380-81.
115. *Id.* at 380.
116. *Id.* at 382.

the customer and then invokes the shingle theory, the fiduciary theory, or both to support a finding of violation with respect to the markups.[117] If an analysis of the portfolio also shows excessive trading, the Commission then recites that the broker-dealer initiated most trading activity, that the customer invariably accepted his investment recommendations, and that the customer relied on the broker-dealer.[118]

The litany-like nature of the Commission's discussion sometimes makes it unclear whether it regards initiation of trades by the broker, routine acceptance of recommendations by the customer, and lack of customer sophistication as factors bearing on a finding of reliance and subsumed therein or as factors separate from the issue of customer reliance.[119] This may be the source of the confusion in early judicial decisions that used SEC precedents to fashion the control element in private damage actions brought by customers. The former view, that these are factors bearing on a finding of customer reliance, is clearly the correct interpretation.

Customer reliance induced by the broker is the *sine qua non* needed to impose liability for overtrading. Evidence that a customer was unsophisticated, that the broker initiated trading, and that the customer invariably followed the broker's recommendations is highly relevant to a finding of reliance. No one of these facts, however, is a prerequisite for liability or independently determinative thereof. These factors assume significance only to the extent that they bear on the question of reliance.

As might be expected in an enforcement context, most of the early disciplinary proceedings did involve customers with a very low degree of sophistication in business and financial matters, who blindly followed their broker's

---

117. *See, e.g.*, cases cited *supra* note 76. The case of *In re* Norris & Hirshberg, Inc., 21 S.E.C. 865 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949), is illustrative. The SEC revoked the registration of a brokerage firm for extensive cross-trading of unlisted, closely-held stocks in an artificial market composed almost entirely of itself and its customers. The SEC based its findings that the respondent's pricing practices were unreasonable on both the shingle and fiduciary theories. *Id.* at 881-86.

118. *See, e.g.*, cases cited *supra* note 76. *Norris & Hirshberg* is again illustrative. In addition to pricing violations, the SEC found that the brokerage firm had churned its customers' accounts. Although the Commission confined its specific findings to accounts in which the firm held express discretionary power, it noted that churning may arise in nondiscretionary accounts "whenever the broker or dealer is in a position to determine the volume and frequency of transactions by reason of the customer's willingness to follow the suggestions of the broker or dealer and he abuses the customers [sic] confidence by overtrading." 21 S.E.C. at 890.

119. *See, e.g.*, cases cited *supra* note 76. See, in particular, *In re* Grubbs, 28 S.E.C. 323, 325 (1948) (SEC notes that customer testified she had no experience in business world, she had great trust and confidence in broker, she relied on his judgment almost completely, and he kept in frequent touch with her, making numerous trading suggestions that she almost always followed); *In re* Behel, Johnsen & Co., 26 S.E.C. 163, 165 (1947) (SEC notes firm's churning activities were directed at investment accounts of three women, including two elderly widows; all women were uninformed as to investment matters, relied completely on broker's advice, and almost always accepted broker's recommendations).

advice.[120] Even when the customer was arguably more sophisticated or active, however, the SEC nonetheless sustained a churning violation if other evidence established that the broker had induced the reliance of the customer. For example, in *In re Cea,*[121] the Commission rejected the contentions of two salesmen that they did not have de facto discretionary power over the accounts of a comptroller and an engineer.[122] Notwithstanding that the customers' occupations may have suggested a higher degree of sophistication than that typically found in enforcement cases, the Commission accepted the customers' testimony that they placed complete reliance on the judgment of their brokers.[123] Conversely, the only enforcement proceeding to reject a finding of churning did so because of a lack of reliance on the part of the customers even though by background they appeared to be relatively unsophisticated.[124]

A careful reading of the SEC enforcement cases shows that the presence of customer reliance induced by the broker is the touchstone of the agency's analysis.[125] Initiation of trading by the broker, acceptance of recommenda-

---

120. *See, e.g.,* cases cited *supra* note 76. The case of *In re* R.H. Johnson & Co., 36 S.E.C. 467 (1955), *aff'd per curiam,* 231 F.2d 523 (D.C. Cir.), *cert. denied,* 352 U.S. 844 (1956), is particularly illustrative. The customers whose accounts were chosen by the SEC for scrutiny included an elderly widow and her daughter, *id.* at 470, a disabled veteran and former house painter with little education, *id.* at 472, a retired secretary, *id.* at 474, the postmistress and operator of a general store in a small rural town, *id.* at 476, a steamfitter who had no prior trading experience, *id.* at 477, and a retired college administrator and his retired schoolteacher sister, *id.* at 479.

121. 44 S.E.C. 8 (1969).

122. *Id.* at 18-20.

123. *Id.*

124. *In re* Thomson & McKinnon, 35 S.E.C. 451, 456-57 (1953). In *Thomson & McKinnon,* the SEC affirmed a finding that the respondent brokerage firm had not induced the high volume of trading found in two customers' accounts. *Id.* at 454. One customer had been a railroad brakeman, an elementary school teacher, and an operator of a small interstate trucking business. He opened an account with the firm about six months after obtaining a $58,000 judgment against the railroad for personal injuries. *Id.* The Commission noted that the customer relied on his own judgment in making trades, that he did not receive recommendations from the firm, that he subscribed to outside market services, and that he made daily visits to the respondent's office during which he frequently offered advice to other customers. On this evidence, the Commission held that the firm was not responsible for the activity in the customer's account. *Id.* at 456.

The other customer was a widow who had been in the restaurant business with her husband. *Id.* at 455. The SEC noted that although the firm made recommendations to her regarding trading, she was responsible for the frequency of her transactions. She switched from a cash to a margin account to purchase more securities without any suggestion from the firm. Moreover, she gave discretionary power over her account to an accountant recommended by the firm. The accountant executed almost half of the transactions in her account. The SEC held on these facts that the firm had not induced the active trading in her account. *Id.* at 456-57.

125. It should be noted that this emphasis on customer reliance in SEC churning opinions arises from the fact that excessive trading must be induced by the broker to be wrongful at all, not from any general requirement that the SEC prove customer reliance before imposing disciplinary sanctions. The SEC usually is not required to prove customer reliance in an enforcement context. For example, although a private plaintiff generally must establish reliance to recover for transactional fraud in an implied cause of action under rule 10b-5, the SEC is not required to prove customer

tions by the customer, and the degree of customer sophistication are factors that bear on the ultimate inquiry of reliance, but they are not independently determinative thereof.

The early enforcement cases exhibit one final tendency worth mentioning: in reaching a finding with respect to churning, other aspects of the case frequently influence the Commission.[126] Disciplinary proceedings invariably involve multiple violations, and the presence of other misconduct by the broker clearly hurts defense of the churning claim. In *Rollins,* for example, the Commission noted that although reasonable prices would not have been a defense to the churning claim, the excessive nature of the markups did serve to underscore the evil of overtrading.[127] Similarly, in *In re Grubbs,*[128] the SEC held that while the volume and frequency of transactions might not necessarily require a conclusion of churning, when coupled with a secret profits problem, the overall method of handling the account supported a finding of excessive trading.[129] This tendency to interrelate theoretically distinct aspects of the suit is less explicit, but nonetheless present in subsequent judicial opinions involving churning.[130]

B. JUDICIAL DEVELOPMENT OF THE CONCEPT OF CONTROL

The main arena for defining the elements of a churning violation soon became private actions rather than SEC disciplinary proceedings. Building on the Commission's recognition of churning as a violation of the general antifraud provisions in section 17(a) of the 1933 Act and section 10(b) of the 1934 Act, dissatisfied customers began filing suits seeking damages for churning under theories of implied civil liability. As might be expected, the first significant judicial decision in this area borrowed heavily from SEC precedents. In *Hecht v. Harris, Upham & Co.,*[131] the plaintiff was an elderly widow who emigrated from England as a young woman following two years of education at a teacher's college. She held a variety of positions in her

reliance to sanction misrepresentations or omissions in violation of the antifraud provisions in enforcement proceedings. *See In re* Cea, 44 S.E.C. 8, 15 (1969) (no requirement to show reliance to establish violations of antifraud provisions). *See generally* N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, at ¶ 2.06.

126. *See* Note, *supra* note 1, at 869 ("[f]ew of the cases in which the SEC has considered the question have concerned churning alone; typically, the offense is committed in conjunction with other violations so that it is not possible to isolate its effects either on the customer's account or on the Commission's choice of sanctions").

127. *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 381 n.50 (1945) (discussed *supra* text accompanying notes 97-116).

128. 28 S.E.C. 323 (1948).

129. *Id.* at 329-30.

130. *See infra* note 283 and accompanying text (discussing judicial tendency to interrelate theoretically distinct parts of case when deciding control issue).

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

adult life, generally as either a saleswoman or private tutor. Around the age of fifty she accepted employment as a housekeeper and tutor in the home of Herbert Hecht, an import-export businessman. The plaintiff worked for Mr. Hecht for fourteen years and married him two years prior to his death.[132]

Long before she began to work for Mr. Hecht and throughout her employment in his home, plaintiff allocated a considerable portion of her modest earnings to investment in the stock market. Over the years she built up an equity of $65,000 on relatively inactive trading.[133] Following the death of her husband, Mrs. Hecht deposited $7,500 with defendant Asa Wilder to open a commodities account. Mrs. Hecht was acquainted with Wilder because he had done some trading on behalf of her husband. She instructed Wilder to start her in soybeans when he thought the time was right. Shortly after opening the commodities account, Mrs. Hecht also transferred her existing securities account to Wilder, together with $500,000 worth of stock distributed from Mr. Hecht's estate.[134]

Mrs. Hecht traded through Wilder for approximately seven years, first with the firm of Hooker & Fay and then with defendant Harris, Upham & Co.[135] Wilder telephoned her almost every morning, and she often called him during the day. She also reviewed her copies of confirmation slips with him during weekly visits that he made to her home. After these visits, however, Wilder would take the account information back to his home even though he already had duplicates for his own use.[136] In addition to the monthly account statements generated by the office, Wilder prepared for Mrs. Hecht annual summaries of her accounts. The court found, however, that these summaries were designed to emphasize gain and allay fears of excessive trading.[137]

Throughout the seven years that she traded through Wilder, Mrs. Hecht retained outside accountants, who prepared her annual tax returns based upon schedules of capital gains and losses provided by Wilder.[138] At the end of that time, the accountants informed Mrs. Hecht that her portfolio had deteriorated substantially and was worth approximately half of its beginning balance.[139] Mrs. Hecht sued Harris, Upham & Co. and Wilder under section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and rule 10b-5, alleging suitability violations and churning.[140]

---

132. 283 F. Supp. at 423.
133. *Id.* at 423-24.
134. *Id.* at 424.
135. *Id.*
136. *Id.* at 426.
137. *Id.* at 434.
138. *Id.* at 426.
139. *Id.* at 424.
140. *Id.* at 426-27. Suitability refers to a broker-dealer's obligation to know the customer. The

The defendants contended that Mrs. Hecht was an experienced and informed trader who was conversant with the risks of the market by virtue of her prior trading experience, her association with Mr. Hecht, and her regular reading of the financial papers.[141] The court dismissed Mrs. Hecht's suitability claims, holding that her knowledge and experience, coupled with her regular receipt of account information, were sufficient to estop her from complaining about the speculative nature of the transactions in her account.[142] The court, however, sustained the charge of churning,[143] finding that Mrs. Hecht's knowledge and experience were insufficient for determining whether the frequency and volume of trading in her account were excessive.[144] The Ninth Circuit affirmed.[145]

In defining the elements of a private action for churning, the district court in *Hecht* made only passing reference to reliance.[146] It phrased the question

---

NASD requires that in recommending a purchase or sale of a particular security to a customer, the broker-dealer must 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 situations and needs." N.A.S.D. RULES OF FAIR PRACTICE art. III, § 2, N.A.S.D. Manual (CCH) ¶ 2152, at 2051 (1985).

On its face the rule does not mandate that the broker conduct an investigation of the customer's objectives. It simply states that the broker must act reasonably based on the information, if any, that the customer does provide. Whether a broker has an affirmative duty of inquiry under the NASD's suitability rule is a disputed issue. *See* 5B A. JACOBS, *supra* note 2, § 211.01[b], at 9-54 to -56 & n.11.

Both the New York Stock Exchange and the American Stock Exchange impose an affirmative obligation on member brokers to know their customers. *See* N.Y.S.E. Rule 405, 2 N.Y.S.E. Guide (CCH) ¶ 2405, at 3697-3701 (1982) (requires members and member firms to use "due diligence to learn the essential facts relative to every customer and to every order or account accepted"); A.S.E. Rule 411, 2 A.S.E. Guide (CCH) ¶ 9431, at 2647 (1978).

In the wake of recent Supreme Court opinions restricting implication of private causes of action, the weight of authority is against the existence of a private remedy for violation of the rules of self-regulatory organizations. R. JENNINGS & H. MARSH, *supra* note 28, at 863. If, however, the suitability violation amounts to fraud and the customer can establish the normal elements of a rule 10b-5 claim, then a violation of the suitability requirements of the various self-regulatory organizations may be actionable in an implied private cause of action under rule 10b-5. T. HAZEN, *supra* note 29, § 10.7, at 277. *See generally* 5B A. JACOBS, *supra* note 2, § 211.01[b]; N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 5, ¶ 2.08; Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445.

141. *Hecht*, 283 F. Supp. at 428.

142. *Id.* at 429-31.

143. *Id.* at 436 (defendant Wilder); *id.* at 439 (defendant Harris, Upham & Co.).

144. *Id.* at 433-35.

145. 430 F.2d at 1209-10.

146. 283 F. Supp. at 432. The court stated:

> Where a customer so relies upon the recommendations of the broker that the broker is in a position to control the volume and frequency of transactions and the broker, abusing the confidence reposed in him, recommends and induces an excessive number of transactions . . . then there is a device, scheme or artifice to defraud . . . .

Id.

at issue as whether the broker was in control of Mrs. Hecht's account.[147] It then answered this question largely in terms of the extent to which Mrs. Hecht followed the recommendations of her broker. The court stated:

> Although control by the representative over the account is essential to a finding of churning, such control need not amount to a formal vesting of discretion in the representative. A degree of control sufficient to warrant protection may be inferred from evidence that the customer invariably relied on the dealer's recommendations, especially when the customer is relatively naive and unsophisticated . . . .[148]
>
> . . . .
>
> So far as Wilder's control over the account is concerned, there can be no doubt that (except in two or three instances where plaintiff had read or heard something about some company . . .) the volume and frequency of the security trading was left to Wilder. Plaintiff did not insist upon trading in any particular volume or with any particular frequency. On the contrary, Wilder made the recommendations in these matters and she invariably followed them.[149]

By focusing on the frequency with which a customer accepts the recommendations of his broker, the district court emphasized probably the most frequently cited factor in early SEC enforcement opinions supporting a finding of reliance.[150] The *Hecht* decision could be interpreted, however, as elevating this factor to the status of an independent determinant, divorced from the underlying question of the customer's reliance.

This is perhaps best illustrated by another case in which the Ninth Circuit addressed the question of churning. In *Mihara v. Dean Witter & Co.*,[151] plaintiff was a thirty-eight-year-old supervisory engineer for McDonnell-Douglas Corporation with both a bachelor of science and a master's degree in engineering. At the time he opened his account with Dean Witter, he had $30,000 in savings, $16,000 in an employee savings account with McDonnell-Douglas, $15,000 of equity in his home, and holdings in McDonnell-Douglas stock purchased through an employee payroll deduction plan. Prior to opening his account with Dean Witter, Mihara traded in securities through several other firms for approximately ten years. He deposited $30,000 with Dean Witter to be invested in accordance with the recommendations of his account executive but subject to his approval.[152]

---

147. *Id.* at 432-33.

148. *Id.* at 433 (citation omitted).

149. *Id.* at 435.

150. See, for example, *In re* E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 353-54, 382 (1942) (discussed *supra* text accompanying notes 97-116); *see also supra* notes 118-19 (cases discussing factors necessary for a finding of reliance).

151. 619 F.2d 814 (9th Cir. 1980).

152. *Id.* at 817.

Over a period of two years, Mihara experienced a substantial loss in equity based on heavy trading in speculative stock, including extensive margin trading.[153] At the end of that time, he filed suitability and churning claims against Dean Witter and his account executive under section 10(b) and rule 10b-5.[154]

Mihara testified that he lacked a finance and economics background. He stated that at the time he opened his account with Dean Witter, he was concerned about possible cutbacks in personnel at McDonnell-Douglas and wanted to provide educational and financial security for his two daughters.[155] The broker's recollection of the plaintiff's investment objectives differed substantially. The broker testified that Mihara was not concerned about a layoff, that he was interested primarily in growth, and that he was knowledgeable about margin accounts and broker call rates.[156] The defense called a broker from one of the firms through which Mihara had previously traded to corroborate this testimony. The broker from the other firm also testified that Mihara was interested in growth stocks, that he had discussed but had not opened a margin account, and that he had a good knowledge of the stock market.[157]

The Ninth Circuit affirmed the validity of a jury instruction patterned after the district court decision in *Hecht* and upheld a verdict in favor of plaintiff.[158] In a cursory discussion, the court simply noted that the requisite degree of control is present when the client routinely follows his broker's recommendations.[159]

Hecht involved a plaintiff who was at least arguably more sophisticated than the clients involved in the SEC enforcement cases. Mrs. Hecht's prior market experience, her regular review of confirmation slips over a period of seven years, and her receipt of outside accounting advice in connection with preparation of tax returns that reflected changes in her portfolio, distinguish her somewhat from the totally naive and dependent customers duped by their brokers in the early SEC disciplinary proceedings.[160] Ultimately, however, the *Hecht* court found the plaintiff's knowledge of the market superfi-

153. *Id.* at 817-18.
154. *Id.* at 816-17.
155. *Id.*
156. *Id.*
157. *Id.* at 820.
158. *Id.* at 820, 824-25.
159. *Id.* at 821.
160. Compare the portrait of Mrs. Hecht that emerges in *Hecht, supra* text accompanying notes 131-38, with the profiles of the customers in *In re* R.H. Johnson, 36 S.E.C. 467 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956), discussed *supra* note 120 and accompanying text, and in *In re* Behel, Johnsen & Co., 26 S.E.C. 163 (1947), discussed *supra* note 119.

cial.[161] Moreover, the court placed considerable import on the defendant-broker's actions in removing account information from her home and preparing misleading account summaries.[162] Whatever one might conclude as to the propriety of the findings in *Hecht*, the background of the plaintiff in *Mihara* presents a much murkier case with respect to control. Under the *Hecht* standard, however, the mere fact that Mihara accepted his broker's recommendations was sufficient to carry the day for Mihara.

Focusing solely on the frequency with which a customer follows his broker's recommendations could lead to anomalous results. A sophisticated or active customer, involved in the management of his account, could attempt to disclaim control by establishing that he generally agreed with his broker's recommendations. Subsequent judicial opinions naturally reject this result.[163] In an effort to obviate the dilemma posed by literal adherence to *Hecht,* they offer a variety of alternative tests for determining whether the broker or the customer controlled the account. However, they continue the trend begun in *Hecht* of attempting specific formulations that focus on one or more factors as dispositive of the issue of control. This trend somewhat loses sight of the fact that these factors assume significance only to the extent that they bear on the ultimate question of customer reliance and the broker's role in inducing that reliance.

For example, the Fourth Circuit addressed the question of de facto control in *Carras v. Burns.*[164] In *Carras,* a customer died leaving a margin account with Merrill Lynch as the principal asset in his estate. The customer had been an active investor who traded in growth stocks on a highly leveraged basis. The customer named a son and daughter as executors of his estate. The daughter had little knowledge of the stock market, but the son had experience in the restaurant and real estate business and had maintained a margin account in his own name with Merrill Lynch for ten years. He followed stock prices in general and tracked his own account in particular. While executor of his father's estate, the son also continued trading in his own account, sometimes buying stocks that were later purchased by the estate.[165] After the estate suffered substantial losses, the executors sued Merrill Lynch and the account executive, alleging among other things tha. the defendants churned the estate's account.[166] The executors disparaged their own experience and knowledge of the market. The defendants, on the other hand, in-

161. 283 F. Supp. at 433.
162. *Id.* at 434.
163. *See* Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 3 (1st Cir. 1983) (following broker's recommendations not dispositive as to control); Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 676-78 (9th Cir. 1982) (same).
164. 516 F.2d 251 (4th Cir. 1975).
165. *Id.* at 254.
166. *Id.* at 253.

sisted that the son was fully competent to manage the account and had made the investment decisions.[167]

The trial court instructed the jury to determine first whether the executors lacked the intelligence, knowledge, and experience necessary to manage the account.[168] If the jury answered this question in the affirmative, it was then to determine whether the executors gave the broker control over the account.[169] The jury answered the first question in the negative, finding that the executors did not lack competence to manage the account. The Fourth Circuit indicated that this finding would ordinarily dispose of the churning claim.[170]

However, because the case was remanded for a new trial due to other errors, the Fourth Circuit proceeded to examine the trial court's two-step instruction on control.[171] The court found it defective, noting that the structure of the instruction erroneously suggested that liability for churning can only be imposed when a customer who lacks the competence to manage an account expressly gives the broker sole authority and control over the account.[172] The court stated that the instruction should instead be phrased so that lack of customer competence may in itself suggest control by the broker.[173] The court remarked:

> Control of trading is an essential element of churning. In the absence of an express agreement, control may be inferred from the broker-customer relationship when the customer lacks the ability to manage the account and must take the broker's word for what is happening. However, a customer retains control of his account if he has sufficient financial acumen to determine his own best interests and he acquiesces in the broker's management. The issue is whether or not the customer, based on the information available to him and his ability to interpret it, can independently evaluate his broker's suggestions. Contrary to the phrasing of the questions in the special verdict, the executors did not have to prove both that they lacked the competence to manage the account and also that they gave control to Burns. Lack of competence itself may give rise to an inference of control.[174]

The Ninth Circuit had occasion to revisit the question of control in *Follansbee v. Davis, Skaggs & Co.*[175] Merrill Follansbee had a bachelor of

167. *Id.* at 258.
168. *Id.* at 257.
169. *Id.* at 257-58.
170. *Id.* at 258.
171. *Id.*
172. *Id.*
173. *Id.* at 259.
174. *Id.* at 258-59 (citations omitted).
175. 681 F.2d 673 (9th Cir. 1982).

arts degree in economics and a divinity degree. He became an ordained Presbyterian minister and, after some early pastorates, assumed a position as administrator of education programs for the United Presbyterian Church. Follansbee inherited a substantial block of stock from his father. After trading for a year with Dean Witter, he read and was impressed by a book entitled *Stock Market Blueprints*. He subsequently switched his account to Chester Bjerke at Merrill Lynch because Bjerke had helped write the book. Follansbee indicated that he wanted his account handled more actively than it had been handled at Dean Witter.[176] Follansbee initially prospered with Bjerke and touted him highly.[177] When Bjerke left Merrill Lynch to join Davis, Skaggs & Co., Follansbee transferred his account to Davis, Skaggs and shortly thereafter agreed to an even more aggressive strategy in his portfolio. He frequently attended weekly investment seminars conducted by Bjerke, kept meticulous records of his purchases and sales, read reports from various financial services, and from time to time made suggestions to Bjerke about further investigation of potential investment prospects.[178]

Following substantial losses in his account, Follansbee sued Bjerke after six years of trading, also naming Davis, Skaggs & Co. as a defendant.[179] Follansbee alleged both suitability violations and churning.[180] The trial court denied the suitability claims but granted judgment in favor of the plaintiff with respect to the churning charge.[181] Reversing the churning award,[182] the Ninth Circuit held that the amount of trading in Follansbee's account was not excessive in light of his aggressive investment goals and further held that the evidence did not support a finding that the broker controlled the account.[183]

Although the Ninth Circuit cited *Hecht* and *Mihara* as stating the applicable standard of control, the panel apparently recognized the difficulties inherent in a literal application of the two prior decisions.[184] The court characterized the emphasis in *Mihara* on the frequency with which a customer follows the broker's recommendations as a "shorthand means of ex-

176. *Id.* at 674.

177. *Id.* at 674-75.

178. *Id.* at 675.

179. *Id.* at 674, 676.

180. *Id.* at 674.

181. *Id.* The decision of the district court is unreported but is mentioned in the Ninth Circuit's Opinion. *Id.* at 674, 678.

182. *Id.* at 678.

183. *Id.* at 676-77.

184. *Id.* at 676-77. *See supra* notes 131-50 and accompanying text (discussing Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970)); *supra* notes 151-59 and accompanying text (discussing Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980)).

pressing a more complicated concept."[185] It indicated that neither decision intended to suggest that a nonprofessional investor who usually follows his broker's advice cannot be found in control of his account. The court candidly acknowledged that a customer can usually be expected to accept the recommendations of his broker, or he is likely to begin shopping for a new broker in whom he has more confidence.[186]

Quoting favorably from *Carras v. Burns,*[187] the Ninth Circuit framed the real question as whether the customer is able to evaluate independently the recommendations of the broker.[188] In this regard, the court noted:

> The touchstone is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations and to reject one when he thinks it unsuitable. . . . As long as the customer has the capacity to exercise the final right to say "yes" or "no", the customer controls the account.[189]

Carras and *Follansbee* represent a marked improvement over the almost exclusive focus in *Hecht* and *Mihara* on the degree to which a customer accepts his broker's recommendations.[190] *Follansbee* in particular attempts to correct the incongruous result that literal adherence to the *Hecht* standard can produce in the case of a sophisticated or active customer who, although involved in management of his account, generally agrees with his broker. Both *Carras* and *Follansbee,* however, still fall somewhat short of fully capturing the fundamental issue of reliance.

Carras and *Follansbee* essentially substitute customer sophistication as the key issue with respect to control in place of the focus in *Hecht* and *Mihara* on the frequency with which the customer follows the recommendations of his broker. Like general acceptance of a broker's advice, a lack of sophistication on the part of the customer is one factor that frequently recurs in many of the early SEC enforcement proceedings.[191] As those cases demonstrate, however, it is a factor that must be examined within the larger framework of reliance. For example, a relatively unsophisticated customer could be sufficiently active with his account to be found in control.[192]

---

185. *Follansbee,* 681 F.2d at 677.

186. *Id.*

187. 516 F.2d 251 (4th Cir. 1975).

188. 681 F.2d at 677.

189. *Id.*

190. *See supra* notes 131-50 and accompanying text (discussing Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970)); *supra* text accompanying notes 151-59 (discussing Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980)).

191. *See supra* note 120 and accompanying text (describing characteristics of victims of churning activity in early cases).

192. *See supra* note 124 and accompanying text.

Moreover, both *Carras* and *Follansbee* focus on only half of the equation—the customer. In articulating a standard for de facto control that emphasizes the financial acumen of the customer, neither decision mentions the conduct of the broker in actively inducing the customer's dependency. This may be attributable to the jury's rejection in *Carras* of the executors' contention that they lacked the intelligence to manage the account, and the Ninth Circuit's similar rejection of Mr. Follansbee's claim. Thus, neither case ever reached the question of the broker's conduct. The broker's role in inducing customer reliance, however, is a key factor in the early SEC disciplinary proceedings, as well as in *Hecht,* and it should not be ignored.[193]

A number of other circuits have also tackled the question of what constitutes de facto control. In *Karlen v. Ray E. Friedman Co. Commodities,*[194] the Eighth Circuit upheld a jury verdict in favor of a cattle rancher who alleged unauthorized trading and churning of his commodities account.[195] On the control issue, the court noted that the customer followed most of the broker's recommendations, that the customer lacked experience in commodities trading, and that the customer had difficulty understanding the transactions in question even when the broker tried to explain them.[196]

In *Tiernan v. Blyth, Eastman, Dillon & Co.,*[197] the First Circuit endorsed a detailed instruction on control that advised the jury to consider whether the customer or the broker initiated trading in the account, whether the customer ever purchased stock not recommended by the broker, whether the customer acted on his own or with the advice of another investment service, and whether the customer ever rejected recommendations from the bro-

---

193. For example, in Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970), the district court noted, among other things, (1) that the broker cultivated both a business and social relationship with Mrs. Hecht, befriending her at the time of her husband's death, 283 F. Supp. at 424; (2) that he visited her home at least once per week, *id.* at 426; (3) that during these visits he reviewed her confirmation slips with her and then removed the slips to his home, even though he had duplicates at his office, *id.* at 426; and (4) that he prepared account summaries designed to suggest gain and allay fears of excessive trading, *id.* at 434. Thus, the court premised its finding with respect to control not solely on Mrs. Hecht's shortcomings with respect to market sophistication, but also on the broker's conduct in fostering her dependency.

If courts focus only on the customer's financial acumen and ignore the issue of whether the broker actively induced customer reliance, the control portion of a churning claim begins to merge with the notion of suitability. Although claims of suitability violations under rule 10b-5 frequently accompany a charge of churning in securities cases, the two doctrines have traditionally been theoretically distinct. *See supra* note 140 (discussing suitability doctrine). The CFTC has consistently declined to read a suitability requirement into § 4b of the Commodity Exchange Act. *See* Phacelli v. Conticommodity Servs., Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,250, at 32,674 (CFTC Sept. 5, 1986).

194. 688 F.2d 1193 (8th Cir. 1982).

195. *Id.* at 1196, 1205.

196. *Id.* at 1203.

197. 719 F.2d 1 (1st Cir. 1983).

ker.[198] In addition, the trial court instructed the jury to consider the customer's general business acumen, his investment background, and his knowledge of the broker's investment activities.[199] The First Circuit rejected the customer's claim that the trial court committed reversible error when it refused to supplement this instruction with an instruction patterned after the holding in *Hecht*.[200] Affirming a jury verdict in favor of the defendants, the court stated that routinely following a broker's recommendations, though an important consideration, is not by itself determinative in deciding the question of control.[201] Alluding to the problems presented by a literal application of *Hecht* and *Mihara,* the court noted that to hold otherwise would prevent imputing control to a sophisticated investor who actively monitors his account, but who does not generally disagree with his broker.[202] The court stated that considerations of the investor's sophistication and ability to independently evaluate the handling of his account are at least as important as the frequency with which a customer follows his broker's advice.[203] The court felt that the trial court's instruction adequately encompassed the latter without putting undue emphasis on it.[204]

Most recently, in *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[205] the Eleventh Circuit affirmed a jury award for churning of an options account in favor of a college-educated customer in a middle-management position who had prior experience in options trading.[206] At the time the customer opened the options account in question, he signed an account agreement that included a risk disclosure statement. The plaintiff denied, however, that the broker ever discussed the risks of options trading with him.[207] The plaintiff admitted that he was aware of the volume of trading in his account, that he had received confirmation slips, and that he had remained in frequent contact with the broker during the approximately two years the account was open.[208]

Characterizing the case as a classic jury trial with conflicting testimony,

---

198. *Id.* at 3.
199. *Id.*
200. *Id.* at 3-4
201. *Id.* at 3.
202. *Id.* at 3 & n.2.
203. *Id.* at 3.
204. *Id.* at 4.
205. 767 F.2d 1498 (11th Cir. 1985).
206. *Id.* at 1500. Mr. Arceneaux graduated from Louisiana State University in 1954 with a degree in mechanical engineering. Beginning in 1970, he was employed by Walter Kidde & Co. as a regional sales manager. He opened an options account with the Dallas office of Merrill Lynch in 1977 and opened another account when he moved to Mobile, Alabama. In 1980, Arceneaux moved to Clearwater, Florida, and opened the account in question. *Id.*
207. *Id.* at 1500-01.
208. *Id.* at 1501.

the court found sufficient evidence to support the finding of control by the broker.[209] The defendants contended that Arceneaux was a well educated and experienced options trader with sufficient financial acumen to determine his own best interests.[210] Affirming the jury's verdict in favor of Arceneaux, the Eleventh Circuit simply stated in a cursory fashion that although the plaintiff apparently discussed his account frequently with the broker, the jury could have concluded from his testimony that he was somewhat intimidated by the broker and that he was reluctant to make any suggestions or to contradict any suggestions from the broker.[211]

C. CFTC INTERPRETATIONS OF THE CONCEPT OF CONTROL

The CFTC has been a relatively recent participant in the development of the concept of control in churning cases.[212] Although the CFTC makes some distinctions with respect to measuring the excessive trading portion of a churning claim, it regards proof of the control element in commodities cases as analytically identical to securities cases.[213] The CFTC thus has formulated its definition of de facto control largely within the framework of existing securities law precedent.

In *Smith v. Siegel Trading Co.,*[214] the first reparations proceeding involving churning that the CFTC accepted for review,[215] a customer filed a pro se complaint against his broker alleging unauthorized trading.[216] At the initial hearing the administrative law judge rejected the customer's unauthorized trading claim, concluding that the customer had acquiesced in the challenged transactions.[217] The administrative law judge, however, proceeded to find that the evidence adduced at the hearing supported a charge of churning, even though the customer had not alleged churning in his complaint. In ruling favorably for the customer on this ground, the administrative law

---

209. *Id.*

210. *Id.* at 1502.

211. *Id.*

212. The CFTC was created under the Commodities Future Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified as amended at 7 U.S.C. §§ 1-26 (1982 & Supp. III 1985)). Prior to creation of the CFTC as an independent federal regulatory agency, regulatory authority over futures trading rested primarily with the Department of Agriculture. For a brief history of commodities futures regulation, see 2 P. JOHNSON, *supra* note 35, §§ 4.01-.02; Lowe, *supra* note 2, at 327-28.

213. *See* Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105, at 24,453-54 & nn.4-5 (CFTC Sept. 3, 1980) (noting that dissimilarities between securities and commodities markets affect proof of excessive trading element of churning claim, but framing definition of control by citing existing securities law); *see also supra* notes 54-56 and accompanying text (discussing similarities and dissimilarities between securities and commodity churning cases).

214. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 (CFTC Sept. 3, 1980).

215. *Id.* at 24,453.

216. *Id.* at 24,451.

217. *Id.* at 24,451-52.

judge relied on the standard for de facto control articulated in *Hecht*.[218]

On review, the CFTC reversed the initial decision of the administrative law judge with respect to churning.[219] The Commission noted that even though the churning charge had not been pleaded, it could have been tried with the express or implied consent of the parties.[220] The CFTC found, however, that the respondents had not consented to trial on the churning claim and had not been accorded a full and fair hearing on this issue.[221] It remanded the case for further evidentiary findings, stating that the initial hearing failed to develop adequately both the excessive trading and the control elements of the case.[222]

In ordering a new hearing on the churning claim, the Commission drew on existing securities law precedent to identify six factors probative of de facto control in a nondiscretionary commodities account. In this regard the Commission stated:

> The element of control, which involves an inquiry entirely apart from the element of excessive trading, must, of course, also be proven before churning may be found. In general, '[s]uch a finding of control is not dependent on the account being formally labeled discretionary but is based rather on who in fact was making the decisions.' Of course, whether such control exists is a question of fact which can only be decided based upon the particular circumstances present in each case . . . . There are, however, certain generally recognized factors which the trier of fact should consider in determining whether control has been proven. Among the factors which tend to demonstrate control are 1) a lack of customer sophistication 2) a lack of prior commodity trading experience on the part of the customer and a minimum of time devoted by him to his account 3) a high degree of trust and confidence reposed in the associated person by the customer 4) a large percentage of transactions entered into by the customer based upon the recommendations of the associated person 5) the absence of prior customer approval for transactions entered into on his behalf 6) customer approval of recommended transactions where the approval is not based upon full, truthful and accurate information supplied by the associated person.[223]

The CFTC indicated that the factors listed are not intended to be exhaustive on the question of control.[224] It characterized the list as setting forth certain well recognized criteria that at a minimum should be considered in determining this issue.[225] The Commission emphasized that each factor need

218. *Id.* at 24,452.
219. *Id.* at 24,455.
220. *Id.* at 24,455-56.
221. *Id.* at 24,456.
222. *Id.* at 24,455.
223. *Id.* at 24,454 (citations omitted).
224. *Id.* at 24,454 n.6.
225. *Id.*

not be present in every case and stated that the probative value of any single factor will depend on the facts and circumstances of a particular case.[226] Finally, it cautioned administrative law judges to identify the criteria utilized in arriving at a finding of control and to articulate the analytical reasoning behind an ultimate finding of churning.[227]

The factors identified by the CFTC in *Smith* represent a compilation of various factual criteria frequently cited by appellate and district court opinions in the securities law area to substantiate a finding of de facto control. The failure to tackle the problem of relative probative weight, however, has resulted in a state of disarray in commodities reparations proceedings similar to that found in the securities law area.

Commodities reparations opinions frame the control inquiry in terms of whether the customer or the broker is responsible for the level of trading in the customer's account.[228] They then answer this question with a conclusory reference to the list of factors in *Smith*.[229] With little or no further analysis, they pick and choose among these criteria and find the presence or absence of the particular factor or factors chosen as dispositive in the case at hand.[230]

---

226. *Id.*

227. *Id.* at 24,455 n.8.

228. *See* DeAngelis v. Shearson/American Express, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,753, at 31,137 (CFTC Sept. 30, 1985) (essential question is whether broker and not customer is responsible for level of trading); Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,866 (CFTC Nov. 13, 1984) (discussing importance of who controls level of trading).

229. *See* DeAngelis v. Shearson/American Express, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,753, at 31,137 (CFTC Sept. 30, 1985) (factors in *Smith* tend to demonstrate existence of de facto control); Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,866 (CFTC Nov. 13, 1984) (same); Ball v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,184, at 24,874 (CFTC Apr. 2, 1981) (discussing factors of control in *Smith*).

230. *See* DeAngelis v. Shearson/American Express, Inc., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,753, at 31,138 (CFTC Sept. 30, 1985) (reversed finding of administrative law judge that customer was in control of accounts during opening months of trading prior to express grant of discretionary authority to broker; notwithstanding evidence that customer sometimes ordered entry of additional positions in contracts originally recommended by broker, customer's lack of sophistication, coupled with volume and variety of trading, suggest control by broker); Piskur v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,493, at 30,186 (CFTC Jan. 2, 1985) (affirmed finding of administrative law judge that broker was in de facto control of account of unsophisticated customer who invariably followed broker's recommendations); Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,867 (CFTC Nov. 13, 1984) (affirmed finding of administrative law judge that broker exercised de facto control over account of two brothers, self-employed television repairman, and local businessman; although customers had some prior commodities trading experience, CFTC found broker in control where customers relied completely on advice of broker, never instructed broker to enter positions against broker's advice, and invariably acquiesced in trades made by broker without advance authorization); Ball v. Shearson Hayden Stone, Inc., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,184, at 24,874-75 (CFTC Apr. 2, 1981) (sustained finding of administrative law judge that customer who was experienced commodities

They offer little rationale, however, for why one factor as opposed to any other is selected for attention and found to be controlling in a given case. Moreover, like the securities opinions, the reparations decisions tend to examine the factor chosen for scrutiny in isolation from the underlying framework of relational reliance that provides the necessary context.[231]

IV. PROBLEMS PRESENTED BY EXISTING INTERPRETATIONS OF DE FACTO CONTROL

The proliferation of different formulas for determining control in the case of a nondiscretionary account, coupled with the variety of procedural contexts in which this question may arise, has led to a good deal of confusion and uncertainty in the case law. Trial courts, faced with a plethora of standards on de facto control, frequently find themselves reversed because an appellate court either favors a slightly different formulation of the concept of control or opts to construe the standard chosen by the trial court as not applicable in a procedural context different from that in which it was originally framed.

---

trader was in control of own account; customer's capability to exercise independent trading judgment evidenced by rejection of several proposed trades; customer registered no complaint in response to letter and telephone calls from branch manager apprising him of commission charges).

231. The churning cases reviewed by the CFTC have frequently involved customers who might be characterized as polar unsophisticates in terms of employment and educational background. *See* Piskur v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,493, at 30,185-86 (CFTC Jan. 2, 1985) (customer was 69-year-old retiree without prior trading experience in commodities or precious metals, whose formal education was limited to grade school; employment history included variety of blue-collar occupations and 10 years as owner/operator of flower shop).

Although the opinions frequently list the multiple criteria articulated in *Smith*, the cases often turn almost solely on the degree of customer sophistication. In this sense, the approach in the reparations opinions resembles that of the Fourth Circuit in Carras v. Burns, 516 F.2d 251 (4th Cir. 1975) (discussed *supra* at notes 164-74 and accompanying text). *See* Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,867 (CFTC Nov. 13, 1984) (citing *Carras* with approval). A focus on customer sophistication alone, however, removed from the larger framework of reliance and divorced from consideration of the broker's conduct in fostering customer dependency, presents some difficulties. See *supra* notes 191-93 and accompanying text criticizing this aspect of *Carras*.

There is one Commission decision which does a better job of capturing the relational reliance interest at stake in the control portion of a churning claim. *See* Gatens v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,636, at 30,706 (CFTC June 18, 1985). In *Gatens*, the CFTC was presented with another case involving customers whose backgrounds suggested a low level of sophistication. William Gatens was employed as a laborer and blast furnace operator. His wife had been employed as a shirt presser and cleaning woman. Both were high school graduates with no prior experience in trading commodities or leveraged contracts. Their annual income was approximately $26,000. *Id.* at 30,704. Although placing a good deal of emphasis on the customer's lack of sophistication, the opinion examined this factor within the context of the more important question of reliance. It discussed the interrelationship between the customers' background and the dependency that they developed on their broker and mentioned the broker's actions in fostering this dependency. *Id.* at 30,706-07.

The recent opinion of the Third Circuit in *Bowley v. Stotler & Co.*[232] provides an excellent illustration. In *Bowley*, the customer opted to bring a claim for churning of a nondiscretionary commodities account in federal district court as an implied cause of action under section 4(b) of the Commodities Exchange Act, rather than as a reparations proceeding before the CFTC.[233] At trial, the customer requested an instruction on control that tracked the compilation of factors suggested by the CFTC in *Smith v. Siegel Trading Co.*[234] The district court declined the plaintiff's requested instruction.[235] Instead, it gave an instruction that focused on whether the customer or the broker had the right to refuse to trade and the willingness to exercise that right if the customer's objectives would not be fulfilled.[236] The trial court's instruction was partially erroneous since a broker generally cannot refuse to execute a trade in a nondiscretionary account.[237] The balance of the instruction, however, focusing on the customer's right and ability to refuse to trade, was directly in line with the Ninth Circuit's holding in *Follansbee v. Davis, Skaggs & Co.*[238] Nonetheless, the Third Circuit ruled that the trial court's instruction constituted reversible error.[239]

In remanding the case for a new trial, the Third Circuit stated that quite apart from the defective part of the charge, the instruction was deficient in omitting specific reference to the factors that the CFTC regards as relevant to the issue of control.[240] The court rejected the broker's reliance on *Follansbee* as support for the charge.[241] The Third Circuit distinguished *Follansbee* from the case at bar by noting that the former case involved a trial court's decision that was reversed for clearly erroneous findings of fact in favor of the customer on the issue of control, whereas the latter involved the adequacy of a jury instruction under circumstances in which the evidence on control had been found sufficient to submit to a jury.[242]

Bowley exemplifies the mixed signals exchanged between appellate and

---

232. 751 F.2d 641 (3d Cir. 1985).

233. *Id.* at 643 & n.1.

234. [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105, at 24,454 (CFTC Sept. 3, 1980).

235. *Id.* at 645. The broker prevailed in the district court. *Id.* at 643.

236. *Id.* at 645.

237. *Id.* at 645, 648.

238. 681 F.2d 673, 677 (9th Cir. 1982).

239. 751 F.2d at 649.

240. *Id.* at 648.

241. *Id.*

242. *Id.* The Third Circuit also felt that the plaintiff's requested instruction was consistent with the standard for control articulated in *Follansbee. Id.* at 648-49.

For another example of a situation in which a court pointed to differences in procedural context in distinguishing a case with respect to the control issue, see Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 3 n.2 (1st Cir. 1983) (in affirming trial court's instruction on control, court notes that plaintiff's claim to entitlement of an instruction based on *Mihara* is misguided; standard for trial courts as a result of the present disparity in standards on de facto control. This kind of confusion in the case law, however, is only one of the problems created by existing interpretations of control. Far more troublesome is the tendency under present standards to pigeonhole every case into one polar extreme or the other with respect to the control question.

Admittedly, some cases lend themselves to black and white characterizations with respect to control. They generally involve customers who can easily be classified in terms of their ability or inability to fend for themselves. For example, in *Stevens v. Abbott, Proctor & Paine,*[243] the court had no difficulty finding that a broker controlled the account of a housewife with a high school education who differentiated stocks from bonds on the basis that "stocks have names and bonds don't."[244] At the other end of the spectrum, but equally as clear, are decisions such as *M & B Contracting Corp. v. Dale,*[245] in which the court rejected a corporate customer's claim of de facto control by the broker where the company's account was closely monitored by its own vice president of finance.[246] The vice president, a certified public accountant with extensive business experience, maintained close contact with the broker and individually evaluated each trading recommendation.[247]

Far more often, however, the cases present mixed control situations in which the plaintiff is neither a naive unsophisticated customer completely

---

control articulated in *Mihara* must be read within context of fact that court was only considering whether there was sufficient evidence to support jury finding of control).

243. 288 F. Supp. 836 (E.D. Va. 1968).

244. *Id.* at 838; *see* Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 206 (D. Mass. 1978) (plaintiff was young, single, elementary school teacher who shortly after arriving in Boston deposited all $18,000 of her assets with defendant broker, whom she began dating; plaintiff did not know meaning of basic stock trading terms and relied completely upon defendant, who guaranteed he would reimburse her for any losses and became angry anytime she questioned him regarding the account); Gatens v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,636, at 30,706-07 (CFTC June 18, 1985) (plaintiffs were unsophisticated high school graduates who placed great trust in broker); Piskur v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,493, at 30,189 (CFTC Jan. 2, 1985) (noting plaintiff's lack of education and experience).

245. 795 F.2d 531 (6th Cir. 1986).

246. *Id.* at 535.

247. *Id.*; *see* Follansbee v. Davis, Skaggs & Co., 681 F.2d 673, 677-78 (9th Cir. 1982) (customer with economics degree who meticulously followed investments held in control of his account); Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 632 F. Supp. 471, 484 (D. Me. 1986) (customer who was lawyer and former city treasurer held in control of options account; customer monitored account constantly and was in frequent contact with broker, who explained and discussed all trades prior to execution); Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951, 956 (E.D. Mich. 1978) (customer who was accountant and tax consultant with prior trading experience and who understood mechanics of market, maintained frequent contact with broker, and understood account statements held in control of securities account); Horne v. Francis I. duPont & Co., 428 F. Supp. 1271, 1274-75 (D.D.C. 1977) (customer who was corporate executive in charge of company health and pension plans and who was intimately familiar with mathematical trading system used in his account held in control of securities account).

detached from operation of his account, nor a savvy market-wise investor responsible for all of his own trading decisions. Such cases involve customers who are not as naive or passive as they seek to establish in courts, or as sophisticated or active as their brokers seek to portray them. As more candid courts have acknowledged, the truth probably lies somewhere in the middle.[248] The existing standards of de facto control, however, make no provision for a finding of mixed control. The result is that the decisions are difficult to reconcile.

For example, in the *Hecht* case discussed previously,[249] the district court admitted that Mrs. Hecht was neither as ignorant with respect to brokerage accounts as she sought to appear, nor as informed as the defendants painted her.[250] While finding her knowledge and experience sufficient to estop her suitability claims, the court nonetheless held that the broker controlled her account for purposes of sustaining the churning charge.[251] The court ultimately concluded that her seeming familiarity with the market was more bravado than actual knowledge.[252]

On the other hand, in *Shorrock v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[253] a twenty-one-year-old college student deposited with Merrill Lynch $50,000 worth of securities that she received upon termination of a minority guardianship set up by her deceased father.[254] Based on discussions held at the time she opened her account, the account executive marked boxes on the firm's customer information forms indicating that plaintiff's investment objectives were relative safety of principal, growth, and good quality investments.[255] In the eighteen months that followed, the account engaged in a high volume of margin trading in speculative securities.[256] The account executive made recommendations to the plaintiff that she accepted in virtually every case.[257] Many of the trades with the plaintiff were executed by the firm as principal for its own account.[258] The account executive did furnish the

---

248. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 325 (5th Cir. Unit A Feb. 1981) (where customer claimed to be unsophisticated investor and broker claimed customer desired aggressive trading, court stated "probable that the truth lay somewhere in between the two conflicting stories"); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 429 (N.D. Cal. 1968) (customer neither as naive as she claimed nor as sophisticated as broker claimed), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970).

249. 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970).

250. 283 F. Supp. at 429.

251. *Id.* at 429-31 (suitability); *id.* at 433-34 (churning).

252. *Id.* at 433.

253. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,251 (D. Or. Nov. 18, 1977).

254. *Id.* at 92,676.

255. *Id.* at 92,674.

256. *Id.* at 92,675-76.

257. *Id.* at 92,675.

258. *Id.*

plaintiff with a booklet about margin trading and enclosed research reports with her confirmation slips.[259] Plaintiff ultimately lost two-thirds of her opening balance.[260]

In what it characterized as a difficult case, the court held that Ms. Shorrock was in control of her account.[261] The court determined that the plaintiff had some business experience, albeit limited, by virtue of her part-time employment, maintenance of a checking account, and experience in traveling to Europe.[262] Although the court acknowledged that the plaintiff was somewhat unsophisticated in the management of her personal financial affairs, it nevertheless found her intelligence, education, and judgment sufficient to amount to control of her account.[263]

The obvious counterpoint between the findings in *Hecht* and *Shorrock* illustrates the dilemma posed by existing interpretations of de facto control. Increasingly the cases involve difficult mixed control situations in which the facts do not fall neatly at one end of the spectrum or the other with respect to the control issue; yet the existing standards for determining control require exactly this kind of categorization.

More and more frequently, the portrait of the plaintiff that emerges in churning cases is that of a moderately successful, college-educated customer with middle-management business experience and some prior trading history, who is not totally inactive in monitoring his account. This was the nature of the plaintiffs in *Mihara* and *Arceneaux,* who successfully maintained claims of de facto control by the broker.[264] A similarly situated customer in *Thompson v. Smith Barney, Harris Upham & Co.*[265] did not fare as well. The trial court acknowledged that the plaintiff did not fully comprehend the risks involved in some of the sophisticated stock and options transactions recommended to him by his young and inexperienced broker,[266] but

259. *Id.* at 92,675-76.
260. *Id.* at 92,675.
261. *Id.* at 92,679.
262. *Id.* at 92,674.
263. *Id.* at 92,674, 92,676.
264. *See* Mihara v. Dean Witter & Co., 619 F.2d 814, 817 (9th Cir. 1980) (customer was 38-year-old engineer with 10 years of investment experience); Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 767 F.2d 1498 (11th Cir. 1985) (customer was regional sales manager with three years of investment experience).
265. 539 F. Supp. 859 (N.D. Ga. 1982), *aff'd,* 709 F.2d 1413 (11th Cir. 1983). The plaintiff in *Thompson* was a salaried middle-management employee of a paper company, who also ran a part-time sales business of his own. At one time he had run for mayor of Atlanta. He had some limited experience with stock market transactions and had also invested in speculative real estate. He met the defendant broker, who had been out of college only two years, at the swimming pool in the apartment complex where they both lived. 539 F. Supp. at 860.
266. 539 F. Supp. at 863. Originally Thompson opened a cash account with the broker to trade securities and entered his own orders. As rapport between the two men grew, however, the broker made suggestions, and Thompson became more confident of his judgment. *Id.* at 860. After three

the court ultimately concluded that the plaintiff was an experienced businessman, generally able to recognize and capitalize on investment opportunities, who was "playing the market."[267]

The cases discussed above clearly demonstrate that current standards for testing control force an all-or-nothing decision with respect to the very threshold issue in a churning case on facts that frequently defy such classification. Faced with this problem, churning decisions exhibit a few pronounced tendencies. First, although the decisions pay lip service to the proposition that the customer must prove the element of control as part of his prima facie case, the tenor of the opinions suggests that many courts begin with a subtle predisposition in favor of the customer on this issue. In part this may be attributable to the fiduciary overtones normally equated with the role of a broker.[268] However, when a customer opts to open a nondiscretionary account, by definition he purports to retain legal control over the account.[269] Courts have long recognized that the fiduciary duties owed by a broker with respect to a nondiscretionary account are significantly narrower than the duties owed in the case of a discretionary account.[270]

---

months of trading, Thompson converted to a margin account at the suggestion of the broker. *Id.* at 860-61.

At about this same time, Thompson signed an options account agreement. Although he and his broker had never specifically discussed opening an options account, the court found that they had mutually decided to seek more aggresive investments for Thompson. Thompson did not read the options account agreement prior to execution. The agreement contained boilerplate language acknowledging his suitability for options trading and acknowledging receipt of an Options Clearing Corporation prospectus. In fact, Thompson did not receive a prospectus. Moreover, the broker filled out the account information sheet with salary and net worth figures for Thompson which he did not obtain from Thompson, but which he selected simply to satisfy internal firm guidelines. *Id.* at 861.

Thereafter, the broker took the initiative in recommending securities and options trades to Thompson, and the securities trading became short-term in nature. *Id.* At the time the broker recommended the initial option transaction, he did not advise Thompson that put options are an unusually risky form of investment. *Id.* at 862. Moreover, the court found that Thompson did not understand the nature of a put option. *Id.* The court further found, however, that the broker did not realize Thompson's lack of comprehension. The court noted that the plaintiff's demeanor was bold and assertive such that he was unlikely to admit his uncertainties. *Id.*

267. *Id.* at 860-61.

268. *See supra* note 5 and accompanying text.

269. *See* Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,866 (CFTC Nov. 13, 1984) ("Unless a customer executes a power of attorney or equivalent instrument granting another the authority to trade his account, the account is nondiscretionary and the customer retains the legal right to control the trading.").

The customer, of course, can seek to establish that notwithstanding the form of the account, the broker maintained actual control. The customer, however, should bear the burden of overcoming the presumption of legal control suggested by the form of his account.

270. *See* Hill v. Bache, Halsey, Stuart, Shields, Inc., 790 F.2d 817, 824 (10th Cir. 1986) (fiduciary duty owed in nondiscretionary accounts is "very narrow—primarily not to make unauthorized trades"); Caravan Mobile Home Sales, Inc. v. Lehman Brothers Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985) (agency relationship in nondiscretionary account terminates when transaction is

Nevertheless, most de facto control decisions phrase their inquiry simply in terms of whether the customer or the broker controlled the nondiscretionary account, not in terms of whether the customer has proven that the broker usurped the control that the form of the account suggests the customer retained.[271] Given the fiduciary overtones normally associated with the bro-

---

complete); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) (broker handling discretionary account becomes fiduciary of customer in broad sense unlike broker handling nondiscretionary account).

The *Leib* opinion articulates the difference in the scope of duties owed by a broker in a nondiscretionary, as opposed to a discretionary, account. In a nondiscretionary account, the customer determines which purchases and sales to make. Thus, the broker owes only limited transactional duties, which cease when a given transaction is closed. *Id.* at 952-53. According to the *Lieb* court, these duties include: (1) a duty, if making a recommendation, to make an informed recommendation; (2) a duty of prompt execution; (3) a duty to inform the customer of risks involved in purchasing or selling a particular security; (4) a duty to refrain from self-dealing or failing to disclose any personal interest the broker may have in a recommended security; (5) a duty not to misrepresent any fact material to the transaction; and (6) a duty not to transact business without prior authorization from the customer. *Id.* at 953. A broker in a nondiscretionary account owes no continuing duty to keep abreast of financial information that may affect his customer's portfolio or to inform his customer of developments that might influence his investments. Moreover, he has no duty to engage in any particular course of trading. *Id.*

In contrast, a broker handling a discretionary account becomes the fiduciary of his customer in a broad sense. *Id.* In particular, the broker of a discretionary account must: (1) manage the account in a manner consistent with the needs and objectives of the customer; (2) keep informed of, and act responsively to, market changes that affect the customer; (3) keep the customer informed as to each completed transaction; and (4) explain forthrightly the practical effect and potential risks of the course of dealing in which the broker is engaged. *Id.*

271. It is not surprising that after carefully differentiating the fiduciary relationships involved in nondiscretionary versus discretionary accounts, the *Lieb* court is one of the few courts to phrase the de facto control issue in terms of whether the broker usurped control from the customer.

Following its discussion of the limited transactional duties owed in a nondiscretionary account, as opposed to the broader and continuing relational duties owed in a discretionary account, the court in *Leib* states:

> Between the purely non-discretionary account and the purely discretionary account there is a hybrid-type account which plaintiff claims existed in this case. Such an account is one in which the broker has usurped actual control over a technically nondiscretionary account. In such cases the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation.

Id. at 954.

Phrased in this fashion, the de facto control issue gives appropriate weight to the legal control that the customer's choice of account suggests. This approach properly requires the customer to prove that he relinquished, and the broker assumed, control over the account. Giving initial weight to the form of the account assures that the burden of proof on the issue of control rests with the plaintiff in practice as well as in theory. A plaintiff would still be free to argue in appropriate circumstances that his choice of account was uninformed and thus entitled to no weight.

See M & B Contracting Corp. v. Dale, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984), *aff'd,* 795 F.2d 531 (6th Cir. 1986) (noting that broker did not usurp control from customer and citing *Leib* with approval); Williamsport Firemen Pension Bds. v. E.F. Hutton & Co., 567 F. Supp. 140, 144-45 (M.D. Pa. 1983) (dismissing complaint where plaintiffs failed to plead or otherwise establish that they relinquished control of accounts to defendants and citing *Leib* with approval); Lehman v.

ker's role, phrasing the issue in the former fashion often results in decisions that seem to approach the issue of control as if the broker must negate it.[272]

Courts also tend to confuse the issue of who controlled the account with the issue of whether the customer's recovery is barred by an affirmative defense based on failure to act in the face of regular receipt of account information.[273] The decisions often treat the issues in tandem as if they were synonymous.[274] Thus, a finding that the broker exercised de facto control almost invariably results in summary rejection of any affirmative defenses based on the customer's receipt of account information.[275] In fact, these two issues are not identical. For example, when a churning claim involves a discretionary account, the broker necessarily concedes his control. Nevertheless, a broker may still be able to establish an affirmative defense based upon a customer's knowing acquiescence to the volume and frequency of trading in the face of regular receipt of confirmation slips and account statements.[276]

Similarly, proof that a broker exercised de facto control over a nondiscre-

---

Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,866 (CFTC Nov. 13, 1984) (customer retains legal right to control trading in nondiscretionary account; factfinder must determine whether customer retained actual, as well as legal, control over trading or effectively surrendered de facto control to broker).

272. In contrast, it is interesting to note that in each of the securities opinions discussed *supra* note 271 in which the court phrased its inquiry in terms of whether the broker usurped control from the customer, the customer failed with respect to the control issue. Each of these decisions, however, also involved a plaintiff whose background and activity with respect to the account apparently placed him in the category of sophisticated customers.

273. *See supra* notes 60-63 and accompanying text (discussing affirmative defenses raised in churning actions).

274. *See, e.g.*, Fey v. Walston & Co., 493 F.2d 1036, 1049-51 (7th Cir. 1974) (failing to give defendant broker's requested instruction on waiver and estoppel not prejudicial error under circumstances of case; estoppel and waiver so merged with issue of control that separate treatment redundant, if not confusing); Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 211 (D. Mass. 1978) (treating in tandem control and affirmative defenses of ratification, waiver, and estoppel; finding broker in control and rejecting affirmative defenses); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 433-35 (N.D. Cal. 1968) (discussing control and affirmative defense of estoppel in tandem; finding broker in control and rejecting estoppel on churning claim), *modified in part and aff'd*, 430 F.2d 1202, 1209 (9th Cir. 1970) (discussing estoppel only).

275. *See, e.g.*, Kravitz v. Pressman, Frohlich & Frost, Inc., 447 F. Supp. 203, 211 (D. Mass. 1978) (rejecting ratification, waiver, and estoppel); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 433-35 (N.D. Cal. 1968) (rejecting ratification, waiver, and estoppel), *modified in part and aff'd*, 430 F.2d 1202, 1209 (9th Cir. 1970); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 729, 69 Cal. Rptr. 222, 248-49 (1968) (rejecting ratification and laches).

Conversely, a finding that a customer controlled his account is frequently buttressed by tandem reference to principles of waiver, estoppel, or ratification that also bar recovery. *See* Altschul v. Paine, Webber, Jackson & Curtis, Inc., 518 F. Supp. 591, 594-95 (S.D.N.Y. 1981) (couple whose son is broker's employee held in control of account and also barred from relief by ratification); Powers v. Francis I. duPont & Co., 344 F. Supp. 429, 432-33 (E.D. Pa. 1972) (customer found in control of account and also barred from relief because his knowledge and experience gave him notice that his account was not being managed in accordance with his alleged instructions).

276. *See* Van Alen v. Dominick & Dominick, Inc., 441 F. Supp. 389, 393, 400-01 (S.D.N.Y. 1976) (when plaintiff alleges churning of discretionary account by broker who had traded it accord-

tionary account should not necessarily preclude the possibility of a valid affirmative defense based on a customer's failure to object. Obviously, evidence relating to control of trading by the broker may be highly relevant to assessment of the customer's duty to complain. For instance, a finding that the customer lacked the necessary sophistication to be found in control of the pattern of trading in his account may in some circumstances also support a conclusion that he lacked the requisite intelligence and understanding to detect excessive trading from account information for purposes of registering a complaint.[277] This result, however, does not follow automatically. The two issues are different, and resolution of the latter requires an independent evaluation of the particular circumstances of the plaintiff, the nature and clarity of the account information furnished by the broker, and the complexity of the trading involved.[278]

---

ing to technical system for 17 years, court rejects any finding of excessive trading, invoking principles of estoppel), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

An interesting twist in the context of a discretionary account is found in Smith v. Sade & Co., [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,846 (D.D.C. Oct. 27, 1982), which illustrates the tendency of courts to confuse and coalesce the issues of control over the account and affirmative defenses. In *Smith* the trial court held that the defendant broker did not control discretionary accounts opened and actively monitored by highly sophisticated plaintiffs, a former U.S. ambassador and the ambassador's wife. *Id.* at 94,364. While the facts of the case clearly justify the court's rejection of any liability for churning, the court's analysis is questionable. Because the accounts were discretionary, the decision might have been better framed in terms of application of affirmative defenses such as waiver, estoppel, or ratification.

277. *See* Gatens v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,636, at 30,709-10 (CFTC June 18, 1985) (blue collar worker/flower shop operator with no prior commodities knowledge unable to detect pattern of overtrading from notices of entry into trades); Piskur v. International Precious Metals Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,493, at 30,189 (CFTC Jan. 2, 1985) (advice that particular trades have been entered does not put blast furnace laborer and cleaning woman with no commodities experience on notice that account being overtraded); Lehman v. Madda Trading Co., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,869 (CFTC Nov. 13, 1984) (relatively unsophisticated customers cannot recognize pattern of overtrading from confirmation slips).

278. Thus, for example, the CFTC has generally found the defenses of ratification and estoppel to be of limited practical use in reparations proceedings for churning of commodity futures contracts or leverage transactions. Noting that churning is an ongoing, continuous offense that is difficult to detect, the Commission has held the defenses of ratification and estoppel unavailing unless the evidence demonstrates that the customer possessed sufficient sophistication and experience to enable him to discover that his account was being overtraded. The Commission usually cites the same evidence used to support a finding of de facto control by the broker to reject applicability of such affirmative defenses.

The Commission's analysis is no doubt correct, and its application of these principles to the cases with which it has dealt is also justified. In *Piskur*, for example, the customer was a 69-year-old retiree with no prior trading experience. He had held a variety of blue-collar jobs for most of his life, and his formal education was limited to grade school. The defendant brokerage firm failed to provide regular statements that would have permitted the customer to understand the status of his accounts. The customer's expert witness testified that even he had difficulty determining the status of the account at any given time from the information provided. *Id.* at 30,189. On this record the Commission had no difficulty rejecting the defenses of ratification and estoppel.

This should not mean, however, that such defenses may not succeed if asserted against a plaintiff

The courts' tendency to treat the control issue and affirmative defenses in a lump sum fashion may contribute to the predilection in favor of the plaintiff discussed earlier.[279] The customer carries the burden of proof with respect to control; the broker bears the burden of proof with respect to affirmative defenses.[280] However, because courts often treat the two issues together, the tone of their opinions often suggests that the broker is required to negate a finding of control.[281]

Finally, although the decisions purport to treat the control element as a discrete part of the plaintiff's claim, the results suggest that the finder of fact may be influenced by other parts of the case in determining control—particularly in the difficult mixed control situations.[282] Because the existing standards on de facto control force an all-or-nothing decision, when the case presents a close question of control, such factors as the amount of trading, the size of the customer's losses, and the presence or absence of other broker misconduct may tip the scales on the control issue.[283]

V. A Suggested Framework for De Facto Control: Return to an Emphasis on Reliance

As discussed earlier, the relational nature of a churning claim is somewhat different in focus than the transactional orientation of the ordinary securities or commodities fraud suit.[284] In the typical suit under section 10(b) and rule 10b-5, for example, the plaintiff generally complains about some inadequacy in disclosure that influenced his decision to purchase or sell a particular security. The plaintiff usually must prove (1) that the defendant made a mate-

---

who is not totally unsophisticated and who receives regular account information in a clear and comprehensible format about less complex types of trading.

279. *See supra* notes 268-72 and accompanying text.

280. *See* 5C A. Jacobs, *supra* note 60, § 295, at 12-56 (plaintiff bears burden of proving elements of his cause of action; defendant bears burden of proving any affirmative defense).

281. *See supra* note 272 and accompanying text.

282. *See supra* notes 126-30 and accompanying text (discussing antecedents of this tendency in early SEC enforcement decisions).

283. Compare, for example, the success of the customers on the control issue in Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980), discussed *supra* notes 151-59 and accompanying text, and Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970), discussed *supra* notes 131-50 and accompanying text, with the failure of the customer to establish de facto control in Marshak v. Blyth, Eastman, Dillon & Co., 413 F. Supp. 377 (N.D. Okla. 1975) (plaintiff's prior trading experience, membership in stock club, occasional subscription to *Wall Street Journal,* and visits to broker's office sufficient to establish control).

All three cases involved customers whose educational background, occupational history, prior trading experience, and/or activity in monitoring their accounts arguably removed them from the spectrum of churning cases involving financially unsophisticated investors. The customers in *Hecht* and *Mihara,* however, prevailed on the control issue in the presence of evidence of high turnover ratios, large commissions, and, in *Hecht,* active broker misconduct. The customer in *Marshak* failed where the turnover ratio and the ratio of commissions to net equity were low.

284. *See supra* notes 16-18 and accompanying text.

rial misrepresentation or omission of fact, (2) in connection with the plaintiff's purchase or sale of a security, (3) that the plaintiff relied on this information in making his investment decision, (4) that the defendant acted with scienter, and (5) that as a result, the plaintiff has been damaged.[285]

Plaintiff's reliance on the defendant's disclosure provides part of the necessary causal connection between the wrongdoing of which he complains, i.e., the misrepresentation or omission, and his right to recover.[286] Plaintiff expected that the disclosure furnished by the defendant was accurate. If that information affected the plaintiff's decision and was inaccurate, plaintiff's expectation has been disappointed. Assuming the defendant acted with the requisite state of mind, the plaintiff is entitled to damages flowing from injury to this informational reliance interest.[287]

By contrast, the gist of the wrong in a churning suit is not inadequate disclosure and deception in the context of a particular transaction, but the broker's abuse of his fiduciary relationship with his customer by putting his own self-interest ahead of his customer's.[288] The plaintiff must prove (1) that the broker excessively traded an account (2) over which he exercised control (3) in order to generate commissions for himself to the detriment of the plaintiff, and (4) that the broker possessed the requisite state of mind.

---

285. *See supra* note 17 and accompanying text (discussing elements of typical securities fraud action).

286. Admittedly, this is a simplistic description of the function of one of the most complex portions of a plaintiff's prima facie case under rule 10b-5 in situations involving inadequate disclosure; it will suffice, however, for purposes of comparing the control portion of a churning claim.

Causation in a transactional fraud case under rule 10b-5 can be viewed as having three different facets. The rule's requirement that the fraud be "in connection with the purchase or sale of a security" dictates that there be some relationship between the alleged deception and the purchase or sale in question. *See* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971) (interpreting this language broadly during era of expansive judicial construction of rule 10b-5 to require only that alleged fraud "touch" purchase or sale). The reliance requirement focuses on whether the alleged misrepresentation or omission induced the plaintiff to purchase or sell. This is sometimes referred to as transaction causation and may be analogized to common law tort principles of "but for" causation or "causation in fact." Additionally, some courts require that the plaintiff establish that his actual monetary injury was directly attributable to the inadequate disclosure. This is sometimes referred to as loss causation and may be analogized to the common law tort concept of proximate cause.

For an excellent overview of the multi-faceted causation requirements in a rule 10b-5 action, see *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1414-17 (E.D. Pa. 1984). *See generally* 5A A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 §§ 64.01-.02 (1985); T. HAZEN, *supra* note 29, §§ 13.5-.6.

Additionally, while this discussion speaks of misrepresentations and omissions collectively with respect to the reliance requirement in a transactional fraud case under rule 10b-5, the reliance requirement has been relaxed in cases involving omissions by granting a presumption in favor of reliance upon proof of materiality and duty to disclose. Moreover, some courts have also relaxed the reliance requirement by allowing a plaintiff to establish reliance on the integrity of the market, as opposed to reliance on the disputed information. *See supra* note 17, at (5).

287. *See* Langevoort, *supra* note 18, at 1251-52.

288. *See supra* notes 14, 15, 18 and accompanying text.

A high volume of trading directed by the customer is not wrongful. It is the broker's control over the account that supplies the necessary causal connection between the alleged wrongdoing—the excessive trading—and the plaintiff's right to recover.[289] In delegating control over investment decisions to the broker, the customer expects that the broker will act in the customer's best interests. If instead the broker acts in his own self-interest, the customer's expectation has been disappointed, his relational reliance interest has been damaged, and he has been deceived. Such a situation is analogous to the informational reliance interest injured in the more typical transactional fraud setting.[290] Thus, the control portion of a churning claim is the functional equivalent of the reliance element in a more typical transactional fraud suit.

The early SEC enforcement cases focus on the relational reliance interest at stake in a churning claim. Many of the subsequent judicial decisions that devise tests for de facto control can be viewed as painfully struggling to articulate this reliance interest. These later decisions, however, seem to lose touch with the underlying question of reliance in the process of rephrasing the question as one of control over the account and attempting specific articulations of what constitutes control.

Whether phrased in terms of the *Hecht* standard of invariably following

---

289. *See* Langevoort, *supra* note 18, at 1281.

290. Professor Langevoort comes to this conclusion in his excellent comparative discussion of the law of breach of fiduciary duty and fraud under common law. *See* Langevoort, *supra* note 18.

As Professor Langevoort notes after differentiating between breaches of fiduciary duty and fraud:

> [T]he more significant point is how conceptually similar the two doctrines really are. An antifraud prohibition encourages reliance on others by preventing one person from taking undue advantage of another's lack of information, generally in the contract formation process (*ex ante*). Fiduciary responsibility law furthers precisely the same objective by extending the protection against cheating *ex post* and by recognizing that in any relational contract setting similar opportunities to take advantage of the other party's reliance continue throughout the relationship. Thus, both doctrines serve to proscribe the appropriation of value arising out of an exchange relationship to which one party would not consent and could avoid if fully informed.

Id. at 1252.

Moving on to address the overlap between the law of fiduciary duty and fraud in those breaches of fiduciary duty labeled constructive fraud, Professor Langevoort concludes:

> Despite a tendency to link active fraud with active principal decisions and constructive fraud with passivity, deception is present to some extent in all the examples set forth above. The principal is misinformed, to his detriment. In such cases, not to decide is to decide; even the passive principal is at least implicitly faced with the decision of whether to continue to grant, or instead to preempt, the fiduciary's discretion—a decision that in theory should be adequately informed. In other words, the two doctrines [active fraud and constructive fraud] are conceptually inseparable. Protecting a relational reliance serves much the same transaction-encouraging objective as does the bargain-oriented duty of full disclosure.

Id. at 1257 (footnotes omitted).

the recommendations of the broker,[291] the *Carras* standard of whether the customer has sufficient financial acumen to determine his own best interest,[292] the *Follansbee* standard of whether the customer has the ability to evaluate suggestions and refuse to trade,[293] or the *Tiernan* and CFTC multiple criteria approaches that examine the customer's sophistication, prior trading experience, and activity in connection with the account,[294] the ultimate question in the control portion of a churning claim is whether the customer relied on the broker. Reliance on the broker supplies the necessary causal link between the alleged wrongdoing in this relational setting and the plaintiff's right to recover for that wrongdoing, just as reliance on faulty or inadequate disclosure is required for recovery in a transactional fraud case.

Reorienting the control portion of a churning suit to a more explicit focus on the relational reliance concerns that dominate the early SEC opinions would substitute a conceptual framework with which courts are more familiar in fraud cases. Courts are used to treating reliance in a transactional fraud suit as part of plaintiff's prima facie case, as to which plaintiff bears the burden of proof. Furthermore, a reliance framework may provide more workable solutions in the difficult mixed control situations. In the transactional fraud area, courts are accustomed to dealing with claims of multiple misrepresentations and omissions. A plaintiff may be able to establish some but not all of the claimed inadequacies in disclosure and his reliance on these inadequacies. In such a case, the plaintiff is entitled to recover those damages that flow from the misrepresentations or omissions on which he relied. In contrast, courts have traditionally characterized churning as a unified offense, for which a trade-by-trade analysis is inappropriate.[295] This approach is no doubt appropriate in polar cases of control by the broker where the plaintiff's reliance is virtually absolute. If reliance is recognized as the underlying inquiry and causal link, however, then in mixed control cases those trades that can be clearly segregated as initiated by the customer or made

291. Hecht v. Harris, Upham & Co., 283 F. Supp 417 (N.D. Cal. 1968), *modified in part and aff'd,* 430 F.2d 1202 (9th Cir. 1970) (broker controls if customer invariably follows advice).

292. Carras v. Burns, 516 F.2d 251 (4th Cir. 1975) (customer controls if he has financial acumen to determine financial best interest).

293. Follansbee v. Davis, Skaggs & Co., 681 F.2d 673 (9th Cir. 1982) (customer controls if he has capacity to say "yes" or "no" to broker's advice).

294. Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1 (1st Cir. 1983) (multiple factors assessed to determine control); Smith v. Siegel Trading Co., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,105 (CFTC Sept. 3, 1980) (CFTC multiple factor approach to issue of de facto control).

295. *See* Shad v. Dean Witter Reynolds, Inc., 799 F.2d 525, 530 (9th Cir. 1986) (churning is unified offense identified only by analysis of entire history of broker's management of account); Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. Unit A Feb. 1981) (stating that churning is unified offense, but rejecting argument that necessary corollary is that damage award may not include trading losses because they are impossible to compute exactly).

with the customer's informed consent should be excluded from the computation of damages.

The Seventh Circuit came to this conclusion in *Fey v. Walston & Co.*[296] The court remanded a difficult mixed control case for a new trial in part because the original damage award, calculated under the out-of-pocket theory, included compensation for several trades that the plaintiff had clearly directed.[297] In light of evidence that plaintiff had independently initiated some transactions, the court questioned the propriety of a control instruction patterned after *Hecht*.[298] Correlating this evidence with its review of the damage award, the court noted:

> Plaintiff would have the damage instruction sustained on the basic premise that churning is a unified offense to be established and recompensed not on evidence of individual transactions but by the extended course of operations . . . .
>
> In an uncomplicated churning case, where a general discretionary power is abused merely to generate commissions, or where through breach of fiduciary duty a broker induces a trusting customer to generally overtrade, we think the plaintiff's position may be the sounder one . . . . The difficulty here, already adverted to in another connection, is that uncontradicted testimony from plaintiff herself indicated that certain transactions which patently were considered in the jury verdict . . . were independently instigated by the plaintiff. As it is, there can be no assurance that the jury did not determine that as to some of the most sizable transactions entering into the

296. 493 F.2d 1036 (7th Cir. 1974).

297. *Id.* at 1054-55. One might argue whether Mrs. Hecht in Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *modified in part and aff'd*, 430 F.2d 1202 (9th Cir. 1970), presented a case involving a naive and dependent widow, as the trial court found, or a more difficult mixed control situation. There seems little question, however, that Mrs. Fey presented a mixed control case.

Mrs. Fey, a widow, had been employed since her husband's death in 1956, having inherited little or no assets. At the time she opened her account with defendants, she had approximately $12,000 in assets that she had accumulated in part through some investments. 493 F.2d at 1042. Plaintiff's complaint alleged that she reposed complete trust and confidence in the defendants. She also admitted at trial, however, that either she or her son—to whom she had given a general power of attorney to trade her account for a disputed period of time—initiated a number of transactions not recommended to her by the defendants. The evidence also established that she engaged in trading through at least one other brokerage house while her account was open with defendants. *Id.* at 1043.

The appellate court stated that the general effect of plaintiff's testimony was to represent herself as a customer with some fixed ideas of her own, relying somewhat on her son and occasionally on other brokers, but otherwise generally relying on the defendants. *Id.* at 1044.

Defendants denied having control over plaintiff's account. In remanding for a new trial, the appellate court noted that the trial court improperly restricted defendants from exploring plaintiff's earlier trading experience, her investment objectives, and a line of inquiry designed to show that plaintiff's son wanted to trade her account to cover his gambling losses. *Id.* at 1045.

298. *Id.* at 1048-49.

> computation of damages the defendant had no part, either by way of initiation, inducement or encouragement.
>
> It is now elementary that when precise damage measurements are precluded by wrongful acts, the wrongdoer cannot insist upon exact measurements and the precise tracing of causal lines to an impractical extent; fair approximations are in order. But the unified nature of the typical churning offense does not render the element of causation immaterial. Granting that transaction by transaction appraisals in churning cases often will be inconsistent with the unified nature of the offense, or impractical and sometimes unfair . . . the facts here are exceptional. Where, as here, there is strong indication that certain substantial damage components arose independent of the acts or conduct of the defendants, they may not be lumped in for the jury's consideration without at least affording some guide by which they can be eliminated from consideration upon a determination that, indeed, the defendants had nothing to do with them.[299]

The opinion in *Fey* better captures the reliance interest at stake in the control portion of a churning claim and its key role as a causal link in establishing plaintiff's right to recover. Focusing on reliance in this fashion might well produce fairer and more consistent results in churning cases than have to date been achieved.

If the control question is recognized as one in which the underlying inquiry is reliance and causation, courts can continue to treat polar cases of control in an all-or-nothing fashion. When control is present in such circumstances, it is appropriate to compute damages in the aggregate based on the entire course of trading.[300] At the same time, a focus on reliance may better accommodate the more difficult mixed control cases in which the customer is neither a totally unsophisticated passive investor nor a savvy market player independently making his own trading decisions or actively monitoring his account. In such cases, a focus on reliance will provide a familiar concept with which to determine whether the customer should recover at all. Where that determination is made favorably to the plaintiff, reliance may furnish a helpful analytical framework for fashioning a finely tuned recovery that excludes those trades directed by the customer or made with his informed consent.

---

299. *Id.* at 1054-55 (citation omitted).

300. *See id.* at 1054-55 (churning damages measured over entire course of trading when broker abused general discretionary authority to generate commissions or induced a trusting customer to generally overtrade).