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ARTICLES

ARBITRATION AND LITIGATION OF PUBLIC CUSTOMERS' CLAIMS AGAINST BROKER-DEALERS AFTER *McMAHON*

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I. INTRODUCTION

As increasing numbers of the public have begun investing in the securities markets in the past few years, complaints against securities professionals have risen correspondingly.[1] Additionally, in the aftermath of "Black Monday" it appears inevitable that an even greater number of claims will be made by public customers against broker-dealers, investment advisers, and financial planners.[2] Even before the recent stock market crash, however, there was widespread public perception that the sales practices of the securities industry were less than scrupulously ethical.[3] Similar concerns about the industry's abil-

1. As one commentator has observed, "Broader public involvement in financial markets has led to increased litigation between the public and members of the securities industry." Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 279 (1984). According to one report, the Securities and Exchange Commission (SEC) received 10,392 customer complaints in 1986 concerning broker-dealers, a 121% increase over the number of such complaints filed in 1981. Ingersoll, *Sleepy Watchdogs*, WALL ST. J., July 21, 1982, at 1, col. 6. Similarly, the number of enforcement actions commenced by the SEC increased by more than 61% from 1981 to 1986. U.S. Securities and Exchange Commission, *Fifty-Second Annual Report* 7 (1986). Although insider trading cases have generated far more publicity, cases involving regulated entities, such as broker-dealers and investment advisers, have accounted for the majority of the SEC's enforcement actions in the past three years. *Id.* at 12; U.S. Securities and Exchange Commission, *Fifty-First Annual Report* 4 (1985); U.S. Securities and Exchange Commission, *Fiftieth Annual Report* 4-5 (1984).

2. Sontag, *The Week That Was on Wall Street*, NAT'L L.J., Nov. 2, 1987, at 3, col 1. "Brokers, large and small, are the most likely targets. Accusations from investors will probably include failure to execute sell orders, making inappropriate investment recommendations and 'churning' accounts—buying or selling securities rapidly to increase commissions." *Id.* at 28, col. 1. Criminal prosecutions are also expected to follow. Sontag, *Post-Crash Prosecutions on Tap?*, NAT'L L.J., Jan. 18, 1988, at 3, col. 1.

3. Ingersoll, *Sleepy Watchdogs*, WALL ST. J., July 21, 1987, at 1, col. 6 "The biggest surge in complaints to the SEC involves unauthorized trading, high pressure sales pitches and 'churning.' "

ity to police itself have also been raised.[4] These concerns continue to heighten.[5]

Given the public's apprehension of the securities industry, as well as questions concerning the basic fairness of the industry's arbitration procedures,[6] many investors will be dismayed to learn that their disputes with industry members will now be resolved in a forum chosen, and largely staffed, by members of the industry. Probably few investors, however, realized that when they signed an agreement with their broker, authorizing him to effect transactions for their account, they also agreed to arbitrate "any and all" disputes they might later have with him based on his handling of their account. Yet following the United States Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*,[7] most, though clearly not all, customer claims will be arbitrated in accordance with the procedures of the registered exchanges and the National Association of Securities Dealers (NASD).[8] In *McMahon*, the Court overruled an established body of case law,[9] and held that predispute arbitration clauses contained in a broker-dealer's customer agreement are enforceable, even if the customer's claims are based on section 10(b) of the Securities Exchange Act of 1934 [10] and rule 10b-5.[11] Coupled with the Court's previous decision in *Dean Witter Reynolds, Inc. v. Byrd*,[12] which held that pen-

4. *Id.* at 11, col. 1; Ferrara & Shapiro, *Danger Points and Defenses For Broker-Dealers*, NAT'L L.J., Nov. 9, 1987, at 23, col. 1; *see, e.g.*, Shearson Lehman Bros., Exchange Act Release No. 34-23640, [1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,116 (Sept. 24, 1987).

5. As one leading periodical has observed, the securities industry has a "credibility gap." *Wall Street's Credibility Gap*, BUS. WK., Nov. 23, 1987, at 92. Indeed, the cover of *Business Week's* November 23, 1987 edition rhetorically asked in bold print: "SHOULD YOU BELIEVE YOUR BROKER?"

6. *See* Shearson/American Express, Inc. v. McMahon, ___ U.S. ___, ___, 107 S. Ct. 2232, 2346, 96 L. Ed. 2d 185, 215-16 (1987)(Blackmun, J., dissenting).

7. *Id.*

8. Not all broker-dealers require customers to execute written agreements before opening an account. Furthermore, even those firms that require written customer agreements do not invariably include pre-dispute arbitration clauses in those agreements. Many firms, for example, do not include arbitration clauses in their cash account agreements. Arbitration clauses, however, are routinely included in margin agreements and options accounts. *See* Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 447 nn.347-349 (1987); Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 292 n.86 (1984).

9. *See* Shearson/American Express, Inc., ___ U.S. at ___, 107 S. Ct. at 2359, 96 L. Ed. 2d at 220 (Stevens, J., dissenting).

10. 15 U.S.C. § 78j(b) (1981).

11. 17 C.F.R. § 240.10b-5 (1987).

12. 470 U.S. 13 (1985).

dent state law claims joined with nonarbitrable federal securities law claims must be arbitrated pursuant to a written agreement to do so, nearly every claim a customer may assert against his broker may now be arbitrated.[13]

In light of *McMahon*, and the procedural differences between litigation and arbitration of a securities claim, it is appropriate to explore those differences, and the manner in which they impact upon investors' claims against broker-dealers. In order to understand the significance of these distinctions, however, one must first understand the bases of the broker's liability to its customer under federal and state law. Accordingly, this article focuses on the substantive elements of liability under section 10(b) and state law for breach of fiduciary duty, the two claims that are typically asserted in litigation, as well as two of the most common grounds of recovery, churning and unsuitability.

The article also discusses arbitration of customer claims against broker-dealers, the basic requirements of an agreement to arbitrate. Assuming that the broker demands arbitration based on a written agreement to arbitrate, the question is whether the investor is bound by the terms of that agreement. As Justice Blackmun's dissent in *McMahon* indicates, litigation concerning the validity of standardized arbitration clauses will likely increase. Furthermore, this article addresses substantive and procedural issues likely to confront the attorneys for both investors and brokers: whether punitive or exemplary damages may be awarded by arbitrators; whether the extensive plead-

13. In *Wilko v. Swan*, 346 U.S. 427 (1953), the Court held that a customer's agreement to arbitrate future disputes with his broker could not be enforced so as to deprive him of the right to bring a civil action under section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) (1981). Prior to *Byrd*, the circuit courts uniformly held that *Wilko* applied with equal force to claims asserted under section 10(b) of the 1934 Act. *See* Shearson/American Express, Inc., __ U.S. at __ n.6, 107 S. Ct. at __ n.6, 96 L. Ed. 2d at 207 n.6 (Blackmun, J., dissenting)(collecting cases). Although the Court did not overrule *Wilko* in *McMahon*, its continued validity remains suspect. As the Fifth Circuit has recognized, *McMahon* "undercuts every aspect of *Wilko v. Swann*," and "a formal overruling of *Wilko* appears inevitable—or, perhaps, superfluous." Nobel v. Drexel, Burnham, Lambert, Inc., 823 F.2d 849, 850 n.3 (5th Cir. 1987). Indeed, less than one month after *McMahon*, was decided, one district court concluded that an investor's § 12(2) claims were arbitrable. Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 673 F. Supp. 1009, 1011(C.D. Cal. 1987). Similarly, prior to *McMahon*, rule 15c2-2, 17 C.F.R. § 240.15c2-2 (1987), prohibited broker-dealers from requiring their customers to sign agreements purporting to require the customer to arbitrate future disputes arising under the federal securities laws. The SEC, however, has rescinded rule 15c2-2. Exchange Act Release No. 34-35034, 52 Fed. Reg. 39216 (1987). In *Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 833 F.2d 545, 547 (5th Cir. 1987), moreover, the Fifth Circuit held that the SEC's decision to rescind the rule applies retroactively.

ing, motion and discovery practice developed in litigation has any relevance in arbitration; and whether the courts will have any substantial role in the future in reviewing arbitration awards.

The article concludes that the securities industry, which has long sought to remove customer complaints from the courts, may not find arbitration to be the panacea it desired. Conversely, investors who have found courts increasingly willing to summarily dismiss their complaints, may actually benefit from arbitration.

II. Sources of Broker-Dealer Liability

The securities industry is one of the most heavily regulated industries in the United States.[14] With few and limited exceptions, the Securities and Exchange Commission (SEC) regulates the conduct of securities professionals, such as broker-dealers,[15] investment advisers,[16] and other persons providing financial services to the investing public.[17] The Commission's regulation of broker-dealers is particularly extensive.

14. Because the scope of this article is limited to "securities" litigation and arbitration, claims under the Commodities Exchange Act (CEA), 7 U.S.C. §§ 1-24 (1982), are not discussed. A discretionary commodities account, however, may fall within the definition of a security under the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1982). *See* Messer v. E. F. Hutton & Co., 833 F.2d 909, 915 (11th Cir. 1987). Similarly, disappointed commodities speculators have an express remedy under § 22 of the CEA. *See* 7 U.S.C. § 25 (1982).

15. Under the 1934 Act, a "broker" is defined as "any person engaged in the business of effecting transactions insecurities for the account of others . . . ." 15 U.S.C. § 78c(a)(4) (1982). A "dealer" is "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise . . . ." *Id.* § 78c(a)(5). A brokerage firm's salespersons, or as they are usually called, registered representatives and account executives, are included within the statutory definition of "associated persons." *Id.* § 78c(a)(18).

16. The Investment Advisers Act of 1940 defines an "investment adviser" as "any person engaged in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." *Id.* § 80b-2(a)(11). The Act excludes broker-dealers from the definition of an investment adviser so long as the performance of advisory services is "solely incidental to his business as a broker or dealer," and the broker-dealer receives "no special compensation" for such services. *Id.* § 80b-2(a)(11).

17. While the securities laws do not specifically regulate financial planners, pension consultants, or sports or entertainment representatives, these persons may be included within the statutory definition of investment adviser. *See* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Release No. IA-1092, 52 Fed. Reg. 38400 (1987).

All broker-dealers, for example, must register with the SEC[18] and must be members of the National Association of Securities Dealers.[19] Section 15 of the 1934 Act and the Commission's rules,[20] as well as the NASD's Rules of Fair Practice and the rules of the exchanges of which the broker-dealer is a member, govern virtually every aspect of a broker-dealers' dealings with its customers.[21] Customer claims against broker-dealers and other investment professionals are often based on violations of these standards of conduct.

For example, churning and the recommendation, purchase, or sale of unsuitable securities are two of the most prevalent practices that lead to customer disputes. Investors, moreover, frequently claim that their brokers have misrepresented and failed to disclose material information, usually the risks pertaining to a particular investment. Typically, disappointed investors employ a "shotgun" approach in litigation, asserting claims under every conceivable federal and state statute, and common law theory of recovery. Complaints filed by investors often include claims for relief under section 206 of the Investment Advisers Act of 1940,[22] section 17(a) of the Securities Act of 1933,[23] and state consumer protection laws, such as the Texas Deceptive Trade Practices-Consumer Protection Act (DTPA).[24] These stat-

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18. 15 U.S.C. § 78*o*(a)(1) (1982).

19. *Id.* § 78*o*(b)(8).

20. SEC rules, for example, require the disclosure of specific information in confirmation slips, 17 C.F.R. §§ 240.10b-10 (1987), and credit terms in margin transactions. *Id.* § 240.10b-16. Similarly, the Commission has prohibited specific practices, which are deemed to be fraudulent under § 15(c) of the 1934 Act. *Id.* §§ 240.15cl-1 to 240.15c2-11.

21. Both the NASD and the exchanges are self-regulatory organizations (SRO's). In order to become registered as a national securities association under § 15A(b)(6) of the 1934 Act, the NASD was to promulgate rules that, among other things, "are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest . . . ." *Id.* § 78*o*-3(b)(6). In addition, the rules of the association must provide a mechanism for disciplining members. *Id.* § 78*o*-3(b)(8). Similarly, § 5 of the 1934 Act makes it unlawful for any broker to effect any transaction on a national exchange unless the exchange is registered as such with the SEC or qualifies for an exemption. *Id.* § 78e. In order to be registered, the exchange must, among other things, promulgate rules that "are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest . . . ." *Id.* § 78f(b)(5). The rules of the exchange, moreover, must provide a mechanism for disciplining members of the exchange for violations of the securities laws, SEC rules, and the rules of the exchange. *Id.* § 78f(b)(6). Every SRO's disciplinary proceedings are subject to review by the SEC. *See id.* § 78s(d)(2).

22. 15 U.S.C. § 80b-6 (1987).

23. *Id.* § 77q(a).

24. TEX. BUS. & COM. CODE ANN. §§ 17.41-17.63 (Vernon 1987).

utory provisions, however, have no place in a well-pleaded complaint.

In *Transamerica Mortgage Advisors, Inc. v. Lewis*,[25] the Supreme Court held that there is no implied cause of action for damages under section 206 of the Investment Advisers Act. Instead, a private plaintiff may only seek rescission of the investment adviser's contract and restitution of payments to him under section 215 of the Act.[26] Similarly, the weight of recent authority holds that there is no implied private cause of action under section 17(a) of the 1933 Act.[27] Finally, most courts have held that state consumer protection laws, such as the DTPA, do not apply to transactions involving securities.[28] As a practical matter, therefore, most claims against brokers are based on section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5,[29]

25. 444 U.S. 11 (1979).

26. 15 U.S.C. § 80b-15 (1982). This type of relief is rarely of any benefit to the investor since it does not provide a basis for recovery of damages for the decline in the value of his portfolio. *In re* Catanella & E.F. Hutton & Co. Inc. Sec. Litig., 583 F. Supp. 1388, 1419 (E.D. Pa. 1984). Investment advisers, however, are fiduciaries and can be sued under state law for breach of their fiduciary duty. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 198 (1963).

27. Landry v. All Am. Assurance Co., 688 F.2d 381 (5th Cir. 1982); *see also In re* Washington Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1352-53 n.5 (9th Cir. 1987)(en banc)(collecting case).

28. Allais v. Donaldson, Lufkin & Genrette, 532 F. Supp. 749, 752 (S.D. Tex. 1982); E.F. Hutton & Co. v. Youngblood, 30 Tex. Sup. Ct. J. 508, 509-10 (June 27, 1987)(collecting cases), *opinion withdrawn on motion for rehearing on other grounds*, 31 Tex. Sup. Ct. J. 65 (Nov. 14, 1987)(per curiam); *see also* Swenson v. Englestad, 626 F.2d 421, 428 (5th Cir. 1980)(DTPA not applicable because securities are neither goods nor services).

Investors also frequently attempt to assert churning and unsuitability claims under § 12(2) of the 1933 Act, which provides an express remedy to any person who purchases a security offered or sold "by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . ." 15 U.S.C. § 77*l*(2) (1982). Although § 12(2) will unquestionably apply in cases involving claims against broker-dealers based upon affirmative misrepresentations and material nondisclosures, it will rarely apply in customer disputes based on churning and unsuitability because these practices do not involve specific representations or omissions, but a breach of a general relationship between the parties. *See* Steinberg v. Illinois Co., 659 F. Supp. 58, 61 (N.D. Ill. 1987)(investor's unsuitability claim not actionable under § 12(2)). Similarly, since many state Blue Sky laws are based on § 12(2), they, too, will not always afford investors with a remedy in churning and unsuitability cases. For example, § 33A(2) of the Texas Securities Act, TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 1988), is expressly modeled on § 12(2) of the 1933 Act. *See* Huddleston v. Herman & MacLean, 648 F.2d 534, 551 n.28 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983); Committee on Securities and Investment Banking of the Section on Corporation, Banking and Business Law of the State of Texas, *Comment—1977 Amendment, reprinted following* TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 1986).

29. Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or and breach of fiduciary duty.[30]

There are, however, two principal differences between a rule 10b-5 claim and one for common law fraud. First, under rule 10b-5, the fraud must occur "in connection with the purchase or sale" of securities,[31] a requirement usually—but not invariably—satisfied in claims by investors against broker-dealers. Second, the broker's fraudulent conduct must consist of a misstatement, an omission, manipulation or deception.[32] A simple breach of a fiduciary duty is not actionable.[33]

A. *Section 10(b) and Rule 10b-5*

To state a claim for relief under section 10(b) and rule 10b-5(2), "the plaintiff must establish (1) a misstatement or omission (2) of material fact (3) made with scienter (4) on which the plaintiff relied (5) that proximately caused his injury."[34] The investor must also prove that he acted with due diligence.[35] A claim under rule 10b-5 is,

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> 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 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(b) (1982). Rule 10b-5 implements § 10(b) and provides:

> It shall be unlawful for any persons, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1987).

30. Common law fraud claims are also frequently asserted. As the Fifth Circuit has observed, however, "all of the requirements of a Rule 10b-5 cause of action are included within the elements of fraud under Texas law." Meyers v. Moody, 693 F.2d 1196, 1214 (5th Cir. 1982). Accordingly, fraud claims are not discussed independently of claims under rule 10b-5.

31. *See In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1407-13 (E.D. Pa. 1984).

32. *Id.* at 1402 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977)).

33. *Id.*

34. Huddleston v. Herman & MacLean, 640 F.2d 534, 543 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

35. G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 954 (5th Cir. 1981).

in many important respects, similar to a common law tort claim for deceit.[36]

1. Materiality

As in a common law fraud case, liability under rule 10b-5 turns on the materiality of the information misrepresented or undisclosed. A fact is "material" if there is a "substantial liklehood" that a reasonable investor "*would*—not *might*—consider it important."[37] The test for materiality is "whether a reasonable man would attach importance to the fact misrepresented in determining his course of action."[38] Thus, "there must be a substantial likelihood that the disclosure of the omitted fact," or correct representation in the case of an affirmative misrepresentation, "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[39]

Materiality is generally a question of fact. Certain risks are so basic, however, that knowledge of their existence is imputed to the investor.[40] Similarly, certain representations are treated as "puffery," rather than material misstatements.[41]

Materiality embraces more than representations and omissions regarding the securities purchased, and may include representations and omissions concerning the broker-dealer's expertise,[42] experi-

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36. Finkel v. Docutel/Olivetti Corp., 817 F.2d 356, 359 (5th Cir. 1987); Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986); *see also* D. DOBBS, R. KEETON, D. OWEN & P. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 108, at 728 (5th ed. 1985)(element of common law deceit); RESTATEMENT (SECOND) OF TORTS § 525 (1977).

37. Huddleston, 640 F.2d at 543.

38. *Id.* at 543 (citing Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.) *cert. denied*, 419 U.S. 873 (1974)).

39. *Id.* at 543(quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438,499 (1976)(investor expected to know of possibility of market fluctuation)).

40. Zerman v. Ball, 735 F.2d 15, 20 (2d Cir. 1984); Newman v. Rothschild, 651 F. Supp. 160, 164 (S.D.N.Y. 1986)(investor imputed with knowledge of certain degree of rises in stock market investments).

41. *See, e.g.*, Frota v. Prudential-Bache Sec., Inc., 639 F. Supp. 1186, 1190 (S.D.N.Y. 1986)(promises of proper and prudent management, that transactions would be carried out in reasonable manner, and that customer could trust broker not actionable as misrepresentation); Rotstein v. Reynolds & Co., 359 F. Supp. 109, 113 (N.D. Ill. 1973)(investment was "red hot," actionable puffery); Bowman v. Hartig, 334 F. Supp. 1323, 1328 (S.D.N.Y. 1971)(statement that broker would make money for investor is common puffing of salesman).

42. Marbury Management, Inc. v. Kohn, 629 F.2d 705, 707-08 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980).

ence,[43] and past history of customer complaints and securities law violations.[44] Failure to disclose the broker-dealer's interest in the transaction is also a material omission.[45] Nonetheless, misrepresentations and material omissions which do not induce "specific investment decision" may not be "in connection with" the purchase of the security.[46] For example, some courts have held that a broker's indefinite promise of conservative management of the investor's account is in connection with the broker's attempt to secure the customer's business, not the purchase or sale of a security.[47] Other courts, however, have taken a broader view, holding that a misrepresentation of or failure to disclose a material fact pertaining to the broker-dealer "touchs" every transaction effected by the broker for the customer.[48] Similarly, some courts hold that fraud which induces a customer to open a discretionary account, or to place additional funds into the account, is not "in connection with" a later purchase of securities.[49]

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43. Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 48 (2d Cir.)(reassurances of broker's competence sufficient representation for basis of fraud claim), *cert. denied*, 439 U.S. 1039 (1978).

44. *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1404 (E.D. Pa. 1984)(failure to disclose previous complaints actionable). Investment advisers are required to disclose to their clients material disciplinary actions brought against them in the past. *See* Financial and Disciplinary Information That Investment Advisers Must Disclose to Clients, 52 Fed. Reg. 36,915 (1987)(to be codified at 17 C.F.R. § 275.206(4)-4).

45. Under rule 10b-10, broker-dealers must disclose whether they are acting as principal or agent in the transaction, and whether they are acting as a market maker. *See* 17 C.F.R. § 240.10b-10 (a)(1)(1987); *see also* Chasins v. Smith Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970)(disclosure of possivle conflicts of interest necessary); Cant v. A.G. Becker & Co., 374 F. Supp. 36, 46-47 (N.D. Ill. 1974). Compliance with rule 10b-10, however, does not necessarily immunize a broker-dealer from liability under rule 10b-5. *See* Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,571, 97,547-48 (3d Cir. Dec. 23, 1987)(market maker's failure to disclose mark-up). Whether an individual representative's failure to disclose his commission is material depends on the circumstances of the case. *See* Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885, 892 (5th Cir. 1987).

46. *See, e.g.*, Siegel v. Tucker, Anthony & R.L. Day., Inc., 658 F. Supp. 550, 553 (S.D.N.Y. 1987). To be "in connection with" the purchase or sale of securities, the fraud must "taint" the complained of transaction. Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971).

47. *See, e.g.*, *Siegel*, 658 F. Supp. at 553 (citing Darrell v. Goodson, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,349, 97,325 (S.D.N.Y. April 10, 1980))(inducement to invest is not fraudulent misrepresentation of particular securities transaction).

48. *In re* Cantanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. at 1412(churning, failure to disclose risk incumbent in margin trading, purchase of unsuitable securities; it deals with purchase, sale of stocks).

49. *See* Capalbo v. Paine Webber, Inc., [1987 Transfer Binder] ¶ 93,353, 96,798 (N.D. Ill. Aug. 7, 1987); Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1239 (S.D.N.Y. 1981)(induce-

Others, however, have rejected this dichotomy on the basis that granting a broker discretionary control over an account is "tantamount to the choice of securities" purchased for the account itself.[50]

2. Scienter

Because a claim under rule 10b-5 is based on the common law tort of deceit, the investor must establish that the broker acted with " 'scienter'—intent to deceive, manipulate, or defraud."[51] Although the Supreme Court has twice avoided the issue,[52] the circuit courts have held that severe recklessness satisfies the requirement of scienter.[53] Severe recklessness consists of "highly unreasonable omissions or misrepresentations," and requires more than simple or even inexcusable negligence.[54] Rather, it is an extreme departure from the standards of ordinary care.[55] Thus, the broker's conduct must present a known danger of misleading investors, or one which is so obvious that he must have been aware of it.[56]

For example, in *Rolf v. Blyth, Eastman Dillon & Co.*,[57] the investor's broker was aware that the customer's investment adviser was effecting transactions in securities that were unsuitable to the cus-

ment to retain account is not inducement to purchase or sell security); Troyer v. Karcagi, 476 F. Supp. 1142, 1148 (S.D.N.Y. 1979)(rule 10b-5 claim cannot be supported on inducement to retain discretionary account).

50. *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. at 1413; *see also* Levine v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,841, 94,090 (S.D.N.Y. July 26, 1986)(complete discretion over account is "investment contract" and so a security); *cf.* Cruse v. Equitable Sec., [1987 Transfer Binder] ¶ 93,290, 96,434 (S.D.N.Y. June 22, 1987)(representations preceding investor's opening of a *nondiscretionary* account were not in connection with purchase of securities).

51. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

52. Herman & MacLean v. Huddleston, 459 U.S. 375, 378 n.4; *Hochfelder*, 425 U.S. at 193 n.12 (1976)(not addressing whether recklessness is sufficient to impose liability under §§ 10(b) or rule 10b-5).

53. *See, e.g.*, Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961 (5th Cir.)(en banc), *cert. denied*, 454 U.S. 965 (1981); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir.)(where fiduciary duty owed to defrauded party, recklessness fulfills scienter requirement), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1039-40 (7th Cir.)(reckless recognized as form of intent sufficient to impose liability for some acts), *cert. denied*, 434 U.S. 875 (1977).

54. *Broad*, 642 F.2d at 961-62.

55. *Id.*

56. *Id.* Because scienter requires an examination of the defendant's conduct, it "cannot be established by a mere assertion of plaintiff's confused state of mind." Warren v. Reserve Fund, Inc., 728 F.2d 741, 745 (5th Cir. 1984).

57. 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

tomer's needs. In addition, the broker's representative and the customer's adviser were in contact with each other on a daily basis. The firm, which had recommended the adviser, undertook a "hand-holding" operation and would reassure the customer anytime he questioned the adviser's competence. The court had no trouble concluding that the broker's representations concerning the adviser's competence and handling of the account were made with the requisite scienter.[58] By contrast, in *Shivangi v. Dean Witter Reynolds, Inc.*,[59] the court found that compliance with SEC rules regarding disclosure, together with evidence that the broker's fraudulent conduct did not effect the price the investor paid for the security, negates any inference that the omission presents an "obvious danger" of misleading investors.[60]

3. Reliance

Whether the investor must prove actual reliance depends upon whether his claim is based on affirmative misrepresentations or nondisclosure of material information. In the ordinary misrepresentation or omission case brought under rule 10b-5(2), reliance is an essential element of the investor's claim. The burden of proving or disproving the investor's reliance, however, may shift depending on the facts of the case.[61] Under some circumstances, "positive proof" of reliance is not a prerequisite to the investor's recovery.[62] Instead, reliance may be presumed where the customer "could justifiably expect" that his broker would disclose material information.[63] This is known as the "*Ute* presumption" of reliance. Under these circumstances, breach of an obligation to disclose material facts establishes "the requisite element of causation in fact."[64]

The *Ute* presumption, however, does not eliminate altogether the

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58. *Id.* at 47-48. According to the court, these conclusory representations were made "without any investigation and with utter disregard for whether there was a basis for the assertions." *Id.*

59. 825 F.2d 885 (5th Cir. 1987).

60. *See id.* at 889.

61. Shores v. Sklar, 647 F.2d 462, 468 (5th Cir. 1981)(en banc), *cert. denied*, 459 U.S. 102 (1983)(reliance presumed when one could justifiably expect disclosure).

62. Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972)(omissions case).

63. *Shores*, 647 F.2d at 468.

64. *Affiliated Ute*, 406 U.S. at 154.

reliance requirement from a rule 10b-5 case.[65] Instead, "[t]he difference between misrepresentation and nondisclosure cases relates only to whether proof of reliance is prerequisite to recovery or whether proof of nonreliance is an affirmative defense."[66] As the Fifth Circuit explained in *Rifkin v. Crow*:[67]

> [W]here a 10b-5 action alleges defendant made positive misrepresentations of material information, proof of reliance by the plaintiff upon the misrepresentation is required. Upon an absence of proof on the issue, plaintiff loses. On the other hand, where a plaintiff alleges deception by defendant's nondisclosure of material information, the *Ute* presumption obviates the need for plaintiff to prove actual reliance on the omitted information. Upon a failure of proof on the issue, defendant loses. But this presumption of reliance in nondisclosure cases is not conclusive. If defendant can prove that plaintiff did not rely, that is, that plaintiff's decision would not have been affected even if defendant had disclosed the omitted facts, then plaintiff's recovery is barred.[68]

Unlike misrepresentation and omission cases brought pursuant to rule 10b-5(2), however, claims for relief under rule 10b-5(1) and (3) do not require the investor to prove reliance on a specific representation.[69] In *Shores v. Sklar*,[70] for example, the issuer allegedly placed worthless securities on the market. The investor also alleged that the issuer misrepresented and failed to disclose material facts in the offering circular accompanying the securities, but admitted that he did not rely upon the offering circular in purchasing the security.[71] The Fifth Circuit affirmed the district courts's dismissal of the investor's 10b-5(2) claim on the grounds that his admission negated his reliance on the misrepresentation, as well as the materiality of the omission.[72]

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65. Herman & MacLean v. Huddleston, 640 F.2d at 547, (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 459 U.S. 375 (1983).

66. *Id.* at 548.

67. 574 F.2d 256 (5th Cir. 1978).

68. *Id.* at 262. In any case, the plaintiff's reliance must be "reasonable." *Huddleston*, 640 F.2d at 548. Reasonable reliance, however, is not the same as "justifiable reliance," which "requires an objective or 'reasonable man' test." Instead, the reasonable reliance test "contemplates a subjective standard, tempered by the requirement of due diligence on the part of the plaintiff, rather than the objective reliance test applicable under the justifiable reliance concept." *Id.*

69. Shores v. Sklar, 647 F.2d 462, 469, 471 (5th Cir. 1981)(en banc)(required reliance on marketability of securities, not on statements made), *cert. denied*, 459 U.S. 102 (1983).

70. *Id.* at 468.

71. *Id.*

72. *Id.* at 470-72.

The court, however, reversed the dismissal of the 10b-5(1) and (2) claims, holding that the investor was entitled to a presumption of reliance on the integrity of the market, and that the issuer's "fraud on the market" was sufficient to constitute a scheme or artifice to defraud.[73]

4. Causation

"Reliance and causation are related, yet distinct concepts."[74] Reliance is, in essence, cause in fact: "but for" the broker's misrepresentation or failure to disclose a material fact, the investor would have known the truth and would not have acted as he did.[75] A causation inquiry, however, asks whether the broker's fraud was a proximate cause of the investor's loss.[76] The investor, therefore, must also prove that the fraud "was in some reasonably direct, or proximate, way responsible for his loss."[77] Thus, even if the investor's decision is induced by material misrepresentations or omissions, his recovery may nonetheless be foreclosed if the broker's fraud is not the proximate cause of his loss.[78] This is the distinction between "transaction causa-

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73. *Id.* at 471-72. In order to establish "fraud on the market," an investor must prove: (1) the defendant knowingly placed securities totally without value on the market, with intent to defraud purchasers; (2) the plaintiff reasonably relied on the availability of the securities on the market as an indication of their genuineness; and (3) the plaintiff suffered a loss as a result of the defendant's scheme to defraud. *Id.* at 469-70. The "fraud on the market" theory, however, does not apply in a misrepresentation/material omission case brought under rule 10b-5(2). Finkel v. Docutel/Olivetti Corp., 817 F.2d 356, 362-63 (5th Cir. 1987). *Contra* Peil v. Speiser, 806 F.2d 1154, 1162-63 (3d Cir. 1986)(applying market fraud reasoning when occurring in "well-developed market").

While the issuer of a security is typically the principle defendant in a fraud on the market case, broker-dealers are also potential defendants. In Kirkpatrick v. J. C. Bradford & Co., 827 F.2d 718 (11th Cir.), *petition for cert. filed*, 56 U.S.L.W. 3416 (U.S. Dec. 15, 1987)(No. 87-836) *and* 56 U.S.L.W. 3437 (U.S. Jan. 5, 1988)(No. 87-932), for example, a putative class of investors asserted § 10(b) and other claims against three firms which sold and promoted limited partnership interests in various oil and gas programs, which had encountered severe financial difficulties following the decline in oil and gas prices in 1981 and 1982. *Id.* at 720. The investors claimed that the firms participated with the issuer in disseminating misleading prospectuses and engaging in standardized promotions. *Id.* at 721. They also alleged that the firms continued to sell and promote the programs, despite their knowledge of the issuer's difficulties. *Id.* The Eleventh Circuit reversed the district court's denial of class certification, holding that the securities "could not have been marketed but for the defendants' fraud." *Id.* at 722.

74. Herman & MacLean v. Huddleston, 640 F.2d 534, 549 (5th Cir. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983).

75. *See id.*

76. *See id.*

77. *Id.*

78. *See id.*

tion" and "loss causation."[79]

Transaction causation refers to the requirement that the defendant's fraud must precipitate the investment decision.[80] By contrast, loss causation asks whether the misrepresentation or omission was responsible for investor's "pecuniary injury."[81] Loss causation is established "only if the misrepresentation touches upon the reasons for the investment's decline in value."[82] As an example:

> [A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstance, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.[83]

In other words, "an independent intervening cause, such as a fluctuation in the stock market, will break the chain of causation."[84]

In cases involving misrepresentations and material omissions by broker-dealers, proof of loss is difficult at best. The decline in a security's value, for example, is often—if not always—attributable to external market forces rather than a broker's misrepresentation or failure to disclose the risks attendant to the investment at the time of the transaction.[85] Proof of loss causation, therefore, is not invariably nec-

79. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

80. *See id.* at 380. Reliance is thus a necessary element in a misrepresentation case: "to show transaction causation a plaintiff must demonstrate that he relied upon the misrepresentations in question when he entered into the transaction which caused him harm." *Id.* Similarly, "in an omission case, transaction causation, which is actually reliance, can be inferred from materiality." *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1415 (E.D. Pa. 1984).

81. *See In re Catanella*, 583 F. Supp. at 1414. Loss causation is similar to proximate causation, in that it requires "a direct causal link between the misstatement [or omission] and the claimant's economic loss." *Huddleston*, 640 F.2d at 549 n.24.

82. *Huddleston*, 640 F.2d at 549.

83. *Id.* at 549 n.25.

84. *In re Catanella*, 583 F. Supp. at 1416 (citing *Huddleston*). Loss causation is required in both misrepresentation and omission cases. *See* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975).

85. Kronfeld v. Advest, Inc., [Current Binder] Fed. Sec. L. Rep. ¶ 93,573, 97,561-62 (S.D.N.Y. Dec. 23, 1987).

essary to recover damages in cases involving broker-dealers and other securities professionals.[86] As one court recognized, the customer's harm is not the price paid for the security, but the broker-dealer's act of inducing the investor to enter into the transaction.[87]

5. Due Diligence

The investor's contributory fault, or lack of justifiable reliance, is not an affirmative defense. Rather, the investor must prove that he exercised due diligence as an element of his case.[88] The investor's failure to exercise due diligence, however, is judged subjectively.[89] In order for lack of due diligence to bar the customer's recovery, a broker-dealer must show that its customer "intentionally refused to investigate 'in disregard of a risk known to him or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow.' "[90] The customer's reliance, as well as the broker's ability to rebut the *Ute* presumption in omission cases, and the existence of a fiduciary of quasi-fiduciary relationship between the parties are both relevant to the due diligence issue.[91]

Generally, the issue of due diligence is a question of fact. Some courts have held, however, that when an investor is given a prospectus or private offering memorandum, his failure to read the information disclosed is reckless, and establishes a lack of due diligence as a matter of law.[92] Similarly, when an investor bases his claim on oral representations which conflict with written representations made in a prospectus or private placement memorandum, or when he is expressly warned in writing that inconsistent oral representations are unauthorized and not to be relied upon, his reliance is not reason-

86. *In re* Washington Pub. Power Supply Sys. Sec. Litig., 650 F. Supp. 1346, 1353 (W.D. Wash. 1986).

87. *Id.* at 1352.

88. G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 958-54(5th cir. 1981)(investor required to use due diligence in investigating representations).

89. Dupuy v. Dupuy, 551 F.2d 1005, 1016 (5th Cir. 1977).

90. *Id.* at 1020 (quoting W. PROSSER, THE LAW OF TORTS § 34, at 185 (4th ed. 1971)).

91. *See id.* at 1023 n.30.

92. Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983); *see also* Kennedy v. Josephthal & Co., 814 F.2d 798, 805 (1st Cir. 1987)(failure to investigate obvious contradictions between oral representations and memorandum; lack of diligence); Scarfotti v. Bache & Co., 438 F. Supp. 199, 203 (S.D.N.Y. 1977).

able.[93] Cases in which the investor's due diligence is decided as a matter of law usually involve sophisticated investors. In other cases, however, the courts typically refuse to impute such knowledge to investors who cannot reasonably be expected to understand or evaluate this type of information.[94]

6. Damages

Section 28(a) of the Securities Exchange Act of 1934 provides that a plaintiff may recover "his actual damages on account of the act complained of."[95] Section 28(a) establishes the proper measure of damages in a rule 10b-5 case.[96] Under Section 28(a), however, there are two possible measures of damages: the rescissional measure and the out-of-pocket measure.

The rescissional measure is usually applied in cases pitting customers against broker-dealers.[97] Under the rescissional measure of damages, the investor is entitled to recover "the fair value" of what he gave up, usually the purchase price of the security, minus the fair value of what the he received, usually the price at which he later sold the security.[98] Because the object of this measure is to place the parties in the position in which they would have otherwise been, the investor's recovery is reduced by the amount of any income he has received from the security in the form of distributions, dividends or the like.[99] The investor's recovery, however, may not be reduced by any tax benefits he may have received.[100] Conversely, the investor

93. Platsis v. E.F. Hutton & Co., 642 F. Supp. 1277, 1299 (W.D. Mich. 1986), *aff'd*, 829 F.2d 13 (6th Cir. 1987)(per curiam); *see also* Xaphes v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 632 F. Supp. 471, 482 (D. Me. 1986)(investor's unsuitability claim failed because margin agreements signed by him disclosed risks of margin trading).

94. *See, e.g.*, Kalfas v. E.F. Hutton & Co., Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,260, 96,258-59 (S.D.N.Y. April 28, 1987)(failure to disclose in language investor could understand may be actionable deception); Berger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 505 F. Supp. 192, 194 (E.D.N.Y. 1981)(with unsophisticated investor, broker may act intentionally or recklessly by omitting to disclose material facts).

95. 15 U.S.C. § 78bb(a)(1982).

96. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 155 (1972).

97. *See In re* Letterman Bros. Energy Sec. Litig., 799 F.2d 967, 972 (5th Cir. 1986)(rescissional damages not recoverable against bank unless acting as broker).

98. *See, e.g.*, Chasins v. Smith Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970)(defining recissional measure of damages).

99. *See* Randall v. Loftsgaarden, __ U.S. __, __, 106 S. Ct. 3143, 3152-53, 92 L. Ed. 2d 525, 543 (1986).

100. *Id.* at __, 106 S. Ct. at 3152-53, 92 L. Ed. 2d at 543. The court may decline to apply

may not recover the value of anticipated tax benefits he expected would flow from the investment.[101]

7. Defenses

Because the cause of action under rule 10b-5 is implied and is based, the common law defenses of estoppel, laches, waiver, and ratification are applicable in a 10b-5 case.[102] In order to establish estoppel, however, the defendant must show reliance and injury resulting from the plaintiff's conduct.[103] Similarly, laches will not bar recovery unless the defendant establishes that the plaintiff's delay resulted in some disadvantage to him.[104] Because broker-dealers can rarely, if ever, prove that they have been materially disadvantaged by a customer's conduct, these defenses are of questionable value.

Waiver and ratification, by contrast, focus on the investor's knowledge. In order to establish these defenses, the broker must show that the customer acted with full and actual knowledge of his rights.[105] Given the sheer volume of information that must be provided to investors under the federal securities law, an investor may be shown to have had constructive knowledge sufficient to establish waiver or ratification.

Waiver and ratification are often raised as defenses to claims based on unauthorized trading and churning. Typically, brokers assert that customers have rectified a particular transaction by failing to object to it following the customer's receipt of confirmation slips or monthly statements. The defenses have met with mixed results. The courts have consistently held, for example, that the mere receipt of confirmation slips or the failure to read such statements is not sufficient to establish recklessness, estoppel, waiver, or ratification.[106] Similarly, a customer's failure to timely object to a particular trade does not, by itself, establish ratification. Although a customer's failure to object

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a rescissional measure of damages in a case in which the investor has realized significant tax benefits early in the life of the investment. *See id.*

101. *See* Torres v. Borzelleca, 641 F. Supp. 542, 545 (E.D. Pa 1986).

102. *See* Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 213-14 (9th Cir. 1962)(common law defenses applicable to 10b-5 case).

103. Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 570 (9th Cir. 1964)(*Royal Air* II).

104. *Id.* at 570.

105. *Id.* at 571.

106. *See, e.g.*, Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1035 (5th Cir. 1981); Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168, 172 (10th Cir. 1974).

can result in ratification, his silence alone is not sufficient evidence of his intent to affirm an otherwise unauthorized transaction.[107]

Because the question of the customer's knowledge is crucial to the issue of ratification, the customer's relative sophistication bears heavily upon the defense. As the Eighth Circuit recognized in *Karlen v. Ray E. Fiedman & Co. Commodities:*[108]

> [C]onfirmation slips and monthly statements do not enable a customer to determine his or her overall position or the total amount of real profit or loss occurring, unless the customer is sufficiently skilled to elaborate upon them to make that determination. [citations omitted]. When a customer lacks the skill or experience to interpret confirmation slips, monthly statements or other such documents, courts have generally refused to find that they relieve a broker of liability for its misconduct.[109]

The converse, of course, is also true. For example, in *Ocrant v. Dean Witter & Co.,*[110] the investor entrusted the management of her account to her husband, himself a broker, and demonstrated a continuing reluctance to familiarize herself with the affairs of her account.[111] The court, therefore, imputed her husband's knowledge to her, and held that a nine month delay between the time her husband first had knowledge of certain unauthorized trades and plaintiff's objections constituted a ratification of the transaction.[112]

Irrespective of the customer's sophistication, the courts have generally found that the customer ratifies an unauthorized transaction when he learns of it, but waits an unreasonable period of time to object. Of course, what constitutes an "unreasonable" delay depends upon the facts and circumstances of the particular case. As the court recognized in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock:*[113]

> A customer who wishes to repudiate an act of his broker must do so with reasonable promptness. How much time may be taken for this purpose is not established by any fixed rule. It has been held in some cases that the disaffirmance must be made immediately. It is clear,

107. Shearson Hayden Stone, Inc. v. Leach, 583 F.2d 367, 369 (7th Cir. 1978)(silence not ratification as a matter of law).

108. 688 F.2d 1193 (8th Cir. 1982).

109. *Id.* at 1200.

110. 502 F.2d 854 (10th Cir. 1974).

111. *Id.* at 857.

112. *Id.* at 859.

113. 247 F. Supp. 373 (S.D. Tex. 1965).

> however, from the decisions that the customer may not delay very long after the wrongful act has been brought to his knowledge.[114]

The ratification defense serves an important purpose by preventing the customer from "riding the market;" that is, the customer may not withhold his objections and later seek to disaffirm the transaction only after it is apparent that he will lose money.[115] Broker-dealers, after all, are not insurers of their customers' investments.

B. *Breach of Fiduciary Duty*

As the foregoing discussion demonstrates, claims against broker-dealers under section 10(b) are, primarily, fraud claims. Not all instances of broker misconduct, however, involve fraud in the traditional sense of misrepresentation or nondisclosure of material facts.[116] Churning and unsuitability cases, for example, rarely if ever involve misrepresentation or failure to disclose a particular fact. Instead, they involve breach of the broker's fiduciary duty to his customer, or constructive fraud.[117]

Although some courts have stated, without any qualification, that the broker-dealer is a fiduciary to his customer,[118] such sweeping generalizations are not always accurate.[119] The relation between a customer and his broker is clearly that of principal and agent, and a

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114. *Id.* at 377.

115. *See, e.g.*, Jaksich v. Thomson McKinnon Sec., Inc., 582 F. Supp. 485, 497 (S.D.N.Y. 1984)("plaintiff's knowledge of the wrong combined with her failure to object when stock prices rose demonstrate her lack of innocence and her waiver of the rule 10b-5 claim"); Altschul v. Paine, Webber, Jackson & Curtis, Inc., 518 F. Supp. 591, 594 (S.D.N.Y. 1981)("by failing to object to the course of trading in the accounts for approximately two years despite ample opportunity to do so, the Altschuls must be held to have ratified the transactions conducted on their behalf"); Ferguson v. Francis I. DuPont & Co., 369 F. Supp. 1099, 1100-02 (N.D.Tex. 1974)(customer, who was an attorney, was in constant contact with his broker, received confirmation slips and statements, and had numerous opportunities to stop trading but did not do so, acquiesced in and effectively ratified broker's unauthorized trades); Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 247 F. Supp. at 377 (delay of eleven months in attempting to disaffirm or repudiate allegedly unsuitable transactions was ineffective).

116. Misrepresentation is the essence of the common law tort of deceit. *See generally* RESTATEMENT (SECOND) OF TORTS § 525 (1977).

117. *See* Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1281 (1983).

118. *See* Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc., 794 F.2d 198, 200 (5th Cir. 1986)(broker and investor stand in fiduciary relationship).

119. *See* Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523, 530 (5th Cir. 1987); Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F.2d 605, 607(9th Cir. 1983)(while agent actually controls account, fiduciary relationship exists).

broker, like any other agent, is clearly a fiduciary with respect to matters within the scope of his agency.[120] But this only begs the key question: what is the scope of the broker's agency?[121]

Because an agency relationship is based upon the mutual consent of the parties, the existence of a fiduciary relationship cannot be based solely on the customer's subjective trust in his broker.[122] Brokers, moreover, are not fiduciaries merely because they must register as such under federal law.[123] Instead, the broker's duty to his customer depends upon the nature of the customer's account.[124]

Brokers who exercise discretionary control over the investor's account, and who have authorization to trade without the customer's prior consent, are clearly fiduciaries in the broadest sense.[125] Their duties are essentially the same as those of a trustee.[126] Thus, a broker who had discretionary control over a client's securities must manage the account in a manner that directly comports with the needs and objectives of the client as disclosed to the broker.[127] This fiduciary responsibility requires the broker to keep abreast of market changes that affect the account, to act responsively to those changes, and to explain in exacting detail to the customer the consequences of the broker's trading activities.[128]

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120. Hill v. Bache Halsey Stuart Sheilds, Inc., 790 F.2d 817, 824 (10th Cir. 1986).

121. *Id.* As Justice Frankfurter has stated in a related context:

> [T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

SEC v. Chenery Corp. 318 U.S. 80, 85-86 (1943).

122. *Id.*; *see also* Lefkowitz v. Smith Barney, Harris Upham & Co., Inc., 804 F.2d 154, 155 (1st Cir. 1986)(per curiam)(blind reliance not sufficiant to invoke fiduciary relationship).

123. *See In re* Atlantic Fin. Management, Inc. Sec. Litig., 658 F. Supp. 380, 382 (D. Mass. 1986)(registration by stockbroker does not establish fiduciary duty).

124. *See* Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 954 (E.D. Mich. 1978)(fiduciary duties depend on whether account is discretionary or non-discretionary).

125. *Id.* at 953(discretionary account creates fiduciary duties); *see also* RESTATEMENT (SECOND) OF AGENCY § 425 (listing of duties of agent in making investments)(1958).

126. RESTATEMENT (SECOND) OF AGENCY § 425 (1958)(duties of agent as investor analogsus to trustee).

127. *Leib*, 461 F. Supp. at 953.

128. *Id.* at 953; RESTATEMENT (SECOND) OF AGENCY § 425 (1958). There are, however, occasions when a broker, although not formally vested with discretionary authority, usurps actual control over the customer's account. In these instances, which arise frequently in litigation, "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." *Leib*, 461 F. Supp. at 954.

By contrast, if the account is nondiscretionary, meaning that the broker must first secure the customer's authorization to effect a particular transaction, the scope of the broker's agency is far more limited.[129] In *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, for example, the court found only six duties incident to the handling of such an account:

> (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis, . . . (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interest, . . . (3) the duty to inform the customer of the risks involved in purchasing or selling particular security, . . . (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security, . . . (5) the duty not to misrepresent any fact material to the transaction, . . . and (6) the duty to transact business only after receiving prior authorization from the customer, ...[130]

Although the precise manner in which the broker will carry out these duties necessarily depends upon the particular transaction,[131] most courts have agreed that each transaction in a nondiscretionary account must be viewed separately,[132] and that the agency relationship only arises when an order is placed and ends upon the completion of the transaction.[133] As such, while he may wish to do so as a matter of

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129. *See* Hecox v. R.G. Dickinson & Co., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,237 (D. Kan. Jan. 12, 1987)(where account nondiscretionary, only duty not to execute unauthorized transactions); *see also* Leboce, S.A. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 709 F.2d 605, 607 (9th Cir. 1983)(no fiduciary duties found absent evidence of control of account by broker); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 517-18 (Colo. 1986)(functional control may establish general fiduciary relationship).

130. 461 F. Supp. at 953 (citations omitted).

131. *Id.*

> For example, where the customer is uneducated or generally unsophisticated with regard to financial matters, the broker will have to define the potential risks of a transaction carefully and cautiously. Conversely, where a customer fully understands the dynamics of the stock market or is personally familiar with a security, the broker's explanation of such risks may be merely perfunctory.

Id. Courts, however, "generally are reluctant to find that there have been misrepresentations when a prospective customer has received disclosure documents." Hill v. Bache Halsey Stuart Shields, Inc., 790 F.2d 817, 824 (10th Cir. 1986).

132. *Leib*, 461 F. Supp. at 952; *see also, e.g.*, *Hill*, 790 F.2d at 825 ("Each task that Bache and Wright agreed to undertake must be established clearly before it can be determined whether fiduciary duties existed and if they were breached.").

133. *See, e.g.*, Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1985); *Leib*, 461 F. Supp. at 953; Robinson v. Merrill Lynch, Pierce,

good business practice, the broker owes his clients no continuing duty to advise them of market changes, or to dissuade them from trading in securities that may be unsuitable for their needs, so long as he fulfills his transactional duties.[134]

A finding that a broker has breached his fiduciary duties to his customer has two significant consequences in securities litigation. First, the investor is not required to establish the technical requirements necessary to support liability under section 10(b) and rule 10b-5.[135] Second, and more importantly, punitive damages may be recovered when a broker willfully breaches his fiduciary duty, since the breach is constructive fraud.[136] In most cases, moreover, proof of scienter sufficient to establish a violation of rule 10b-5 for churning will also support an award of punitive damages under state law for willful breach of the broker's fiduciary duty.[137]

C. *Churning and Unsuitability Claims*

In *Santa Fe Industries, Inc. v. Green*,[138] the Supreme Court held that, in the absence of some form of deception, misrepresentation or nondisclosure, a breach of fiduciary duty, standing alone, is not actionable under section 10(b) or rule 10b-5.[139] Similarly, a breach of a promise not to breach one's fiduciary duty is not sufficient to trigger liability under section 10(b) or rule 10b-5.[140] Relying on *Santa Fe*, broker-dealers often defend customer claims on the grounds that churning is nothing more than a breach of fiduciary duty, and not actionable under section 10(b) or rule 10b-5. This argument, however, has been uniformly rejected.[141] As one court has recognized,

Fenner & Smith, Inc., 337 F. Supp. 107, 111 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972)(per curiam).

134. *See Leib*, 461 F. Supp. at 953 (no continuing legal obligation exists on broker).

135. *See* Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1049-50 (11th Cir. 1987)(failure to prove reliance precluded recovery under rule 10b-5, but not for breach of fiduciary duty).

136. *See* Miley v. Oppenheimer & Co., 637 F.2d 318, 330 (5th Cir. 1981). Because section 28(a) of the 1934 Act limits an investor's recovery to "actual damages," exemplary damages cannot be recovered under rule 10b-5. Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1036 (5th Cir. 1981).

137. *Miley*, 637 F.2d at 330.

138. 430 U.S. 462 (1977).

139. *See id.* at 476.

140. Pross v. Katz, 784 F.2d 455, 458 (2d Cir. 1986).

141. *In re* Catanella & E.F. Hutton & Co. Sec. Litig., 583 F. Supp. 1388, 1405-06 (E.D. Pa. 1984)(collecting cases).

although liability for churning can be traced to a broker's fiduciary duty a broker owes to its customer, churning is a violation of section 10(b) because "[t]he act of churning itself is a deception."[142] As such, an investor's claim under section 10(b) and rule 10b-5 is not dependent upon any specific misrepresentation or omission.[143] Like churning, unsuitability claims do not involve any specific representation or omission. Rather, "the unsuitable purchase itself is the proscribed act, not any representation connected with that purchase."[144] Furthermore, in order to prevail under either a churning or unsuitability theory, the investor must establish a fiduciary or quasi-fiduciary relationship.[145]

1. Churning

Churning occurs when a broker-dealer enters into transactions and manages its customer's "account for the purpose of generating commissions in disregard of the client's interests".[146] Although churning

142. *Id.* at 1406; *see also, e.g.*, Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983)("churning, as a matter of law, is considered a violation of section 10(b) and Rule 10b-5"); Armstrong v. McAlpin, 699 F.2d 79, 91 (2d Cir. 1983)(churning itself may be a deceptive device); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980)("churning of a client's account is, in itself, a scheme or artifice to defraud within the meaning of Rule 10b-5"). *See generally* Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1279-83 (1983)(discussing churning as 10b-5 violation). Churning is also considered a manipulative, deceptive, and fraudulent practice under rule 15cl-7, but only if the customer's account is discretionary. *See* 17 C.F.R. § 240.15cl-7(a) (1987).

143. Yancoski v. E.F. Hutton & Co., 581 F. Supp. 88, 91 (E.D. Pa. 1983).

144. Clark v. Kidder, Peabody & Co., 636 F. Supp. at 198. Unsuitability is closely related to churning; essentially, churning is "quantitative unsuitability." Note, *Customer Sophistication and a Plaintiff's Duty of Due Diligence: A Proposed Framework for Churning Actions in Non-Discretionary Accounts Under SEC Rule 10b-5*, 54 FORDHAM L. REV. 1101, 1110-11 n.63 (1986). Consequently, "the decision in many churning cases turns on whether the trading in the account was suitable for the investor." Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 584 (1984).

145. As explained immediately below, to establish churning a customer must prove that the broker controlled his account. The proof necessary to meet this burden is, essentially, the same evidence that establishes the fiduciary relationship. *See* Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523, 529-30 (5th Cir. 1987); Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384, 1387 (10th Cir. 1987). Similarly, at least one court has suggested that discretionary authority is a necessary predicate to a suitability claim. *See* Clark v. Kidder, Peabody & Co., 636 F. Supp. 195, 198 (S.D.N.Y. 1986)("an unsuitability claim has been held to lie where a broker . . . exercises discretionary authority").

146. Miley v. Oppenheimer & Co., 637 F.2d 318, 324 (5th Cir. 1981); *see also* 17 C.F.R. § 240.15cl-7(a) (1987)(prohibiting as any act by a broker-dealer "designed to effect with or for any customer's account . . . any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of [the customer's] account"); Note,

is inherently deceptive, it does not involve a specific representation or failure to disclose a specific fact. Instead, churning rests upon the broker's failure to act in his customer's best interest and the simultaneous failure to disclose that he is not doing so.[147] Churning, in other words, is a breach of the broker's fiduciary duty.[148]

A churning claim under section 10(b) and rule 10b-5 consists of three elements:

> (1) the trading in the customer's account was excessive in light of his investment objectives;
> (2) the broker exercised control over the trading in his account; and
> (3) the broker acted with the intent to defraud or with willful and reckless disregard for the investor's interest.[149]

a. Control

Because a customer's account cannot be churned unless the broker controls the account, the nature of the account illuminates the issue of control. For example, control is clearly established when the account is discretionary, and the broker has authority to trade without the customer's prior approval.[150] Control, however, may also be established when the broker assumes "de facto control" over a nondiscretionary account.[151] Unauthorized trades, for example, may permit an inference that the broker has converted the investor's nondiscretionary account to a discretionary one.[152]

Control may also be proven if the client routinely follows his broker's recommendations.[153] The customer's acquiescence in his bro-

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Churning by Securities Dealers, 80 HARV. L. REV. 869 (1967)("the 'churning' of a securities account occurs when a dealer, acting in his own interest and against those of his customer, induces transactions in the customer's account which are excessive in size and frequency in light of the character of the account").

147. *See* Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1281 (1983).

148. *Cf. Miley*, 637 F.2d at 324.

149. *Id.* at 324.

150. *Costello*, 711 F.2d at 1368.

151. In general, the same level of control sufficient to establish the existence of a fiduciary relationship is necessary to establish control in a churning case involving a nondiscretionary account. *Cf.* Romano v. Merrill Lynch, Pierce, Fenner & Smith, 834 F.2d 523, 529-30 (5th Cir. 1987); Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384, 1387 (10th Cir. 1987).

152. *See* Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 954-55 (E.D. Mich. 1978)("if many . . . transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker").

153. Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980).

ker's advice, in and of itself, however, is not sufficient.[154] Instead, a number of factors must be examined, especially the age, education, intelligence and investment experience of the customer.[155]

The broker's relationship with his customer is also relevant.[156] For example, evidence that the broker was socially or personally involved with his client may indicate that the customer relinquished control because of a relationship of trust and confidence.[157] By contrast, evidence of an arm's length business relationship between the broker and customer indicates that the customer retained control over his account.[158] Similarly, evidence of the customer's interest in his account may negate any inference of control by the broker, particularly when the customer frequently speaks with the broker concerning the status of his account or the wisdom of a particular transaction.[159]

A nonprofessional investor may nonetheless control his account even if he usually follows the advice of his broker. As the court explained in *Follansbee v. Davis, Skaggs & Co.*:[160]

> No one is likely to form a continuing relationship with a broker unless he trusts the broker and has faith in his financial judgment. Usually the broker will have much greater access to financial information than the customer and will have the support of investigative and research facilities. Such a customer will be expected usually to accept the recommendations of the broker or to disassociate himself from that broker and find someone else in whom he has more confidence.
>
> The touchstone is whether . . . 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.[161]

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154. Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 3 (1st Cir. 1983).

155. "Where the customer is particularly young . . . , old . . . , or naive with regard to financial matters, . . . , the courts are likely to find that the broker assumed control over the account." *Leib*, 461 F. Supp. at 954. Similarly, an investor's "[l]ack of competence itself may give rise to an inference of control." Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975).

156. *See Leib*, 461 F. Supp. at 954.

157. *Id.*

158. *Id.*

159. *Id.*; *see also* M & B Contracting Corp. v. Dale, 601 F. Supp. 1106, 1111 (E.D. Mich 1984)(quoting *Lieb*), *aff'd*, 795 F.2d 531 (6th Cir. 1987).

160. 681 F.2d 673, 677 (9th Cir. 1982).

161. *Id.* at 677; *see also* Newburger, Loeb & Co. v. Gross, 563 F.2d 1057, 1070 (2d Cir. 1977)("if a customer is fully able to evaluate his broker's advice and agrees with the broker's suggestions, the customer retains control of the account"), *cert. denied*, 434 U.S. 1035 (1978);

b. Excessive Trading

Once the broker's control over the customer's account is established, the inquiry shifts to whether the broker engaged in excessive trading. Whether trading is excessive turns on the investor's objectives and the nature of his account.[162] For example, an acceptable level of trading in an options account might not be appropriate in another context.[163] While numerical indices are helpful, the ultimate issue "is whether the volume of transactions, considered in light of the nature and objectives of the account, was so excessive as to indicate a purpose on the part of the broker to derive a profit for himself at the expense of his customer."[164]

Once the investor's objectives have been determined, the inquiry shifts to the level and nature of trading activity and the commissions generated by the trading activity.[165] In general, the courts will look for evidence of a high "turnover rate,"[166] and a pattern of "in and out," "cross," or "multiple" trading.[167] Finally, it is appropriate to

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Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975)("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").

162. *Carras*, 516 F.2d at 258.

163. Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983)("Where, for instance, the goals of an investor are aggressive or speculative, as opposed to conservative and circumspect, it is easier to conclude that a given course of trading has not been excessive.").

164. *Id.* In the context of a rule 10b-5 case, the customer's investment strategy is relevant to the issue of transactional causation; "if a salesman does only what the customer independently has in mind as an objective, has authority to do so, and fulfills any fiduciary duty to furnish fair advice, the additional motive of the salesman to earn commissions does not convert the transaction into a deceptive or manipulative device in violation of section 10(b)." Fey v. Walston & Co., 493 F.2d 1036, 1048 (7th Cir. 1974).

165. *Costello*, 711 F.2d at 1369.

166. The turnover rate of an account is "the ratio of the total cost of the purchases made for the account during a given period of time to the amount invested." Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 875 (1967). The turnover rate "is computed by dividing the total amount of purchases over a particular period by the average equity (total amount invested, less margin debt) in the account during that period." Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 582 (1984). "While there is no clear line of demarcation, courts and commentators have suggested that an annual turnover rate of six reflects excessive trading." Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980). A churned account, however, will often "reflect significant turnover in the early stages, that is, a very short holding period for the securities purchased, followed by longer holding period in the later stages of the account." *Id.* at 819.

167. *See generally* Note, *Churning by Securities Dealers*, 80 HARV. L. REV. at 875-77. In and out trading "consists of the sale of all or part of the customer's portfolio, with the money immediately reinvested in other securities, followed in a short period of time by the sale of the

examine the ratio of the commissions generated by trading activity to the size of the customer's investment.[168] Although the broker's commissions will generally correspond to the level of trading in the account since brokers are compensated on a commission basis,[169] "several aspects of a dealer's profits are not reflected in the turnover but may be relevant to an overall view of the trading in the account."[170] For example, trading on one account may supply a disproportionate share of the broker's profits.[171]

c. Damages

Unlike cases based upon the purchase of a specific security, churning claims involve numerous transactions. There are, therefore, two distinct harms which may be proximately caused by churning.[172] The first and most obvious harm is the customer's payment of excessive commissions—"the skimmed milk' of the churning violation."[173] The investor, however, is also damaged by his "portfolio's decline in the value—the 'spilt milk' of churning."[174] Determining the damage to the customer's portfolio is difficult and, in many cases, may be specu-

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newly-acquired securities." *Id.* at 876. In and out trading is persuasive evidence of churning and is extremely difficult to justify. *Id.*

> If sales are accompanied by purchases to an unusual extent, the dealer will not be able to assert such justifications as the customer's need for money or a falling market. Similarly, if a high proportion of the customer's purchases are reversed after only a short holding time, it may be difficult to justify the initial decision to invest. For these reasons, detailed figures are usually presented concerning the proportion of transactions reversed within a short period of time . . . .

Id. at 876-77.

"Switching" is a form of in and out trading. It occurs when the broker induces the investor to sell one security and purchase another of identical value. The broker in such a transaction earns commissions on both the purchase and the sale. Note, *Customer Sophistication and a Plaintiff's Duty of Due Diligence: A Proposed Framework for Churning Actions in Non-Discretionary Accounts Under SEC Rule 10b-5*, 54 FORDHAM L. REV. 1101, 1110 n.63 (1986).

168. Note, *Churning by Securities Dealers*, 80 HARV. L. REV. at 877-78.

169. Indeed, churning occurs because brokers "are salespersons who are dependent upon brokerage commissions in order to make a living." Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. at 573.

170. Note, *Churning by Securities Dealers*, 80 HARV. L. REV. at 877-78.

171. *Id.* at 878.

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

173. *Id.* at 326.

174. *Id.* at 326. The investor, however, may not recover damages for both commissions paid and his portfolio's decline in value. An award of damages for both of these elements amounts to a double recovery. Winer v. Patterson, 644 F. Supp. 898, 901 (D.N.H. 1986).

lative due to the inherent risks of investing.[175]

For this reason, a court cannot award full "out-of-pocket" damages, i.e., the difference between the original and final values of the plaintiff's portfolio.[176] Selecting an out-of-pocket measure of recovery would, in effect, assume that none of the transactions effected by the broker were legitimate, and would "disregard the ordinary hazards of the stock market."[177] However, the customer's failure to establish the damage to his portfolio with exact certainty effectively forecloses recovery.[178]

Instead, in order to establish trading losses caused by churning, "it is necessary to estimate how the investor's portfolio would have fared in the absence of the [broker's] misconduct."[179] Accordingly, trial courts have "significant discretion to choose the indicia by which such estimation is to be made, based primarily upon the types of securities comprising the portfolio."[180] For example, it is not appropriate to utilize the Dow Jones Industrial Index as a measure of performance for highly speculative investments, although such a standard may be appropriate for "blue chip" stocks. When the investor does not have a specialized portfolio in a particular group of securities, however, the court should utilize "the average percentage performance in the value of the Dow Jones Industrial's or the Standard and Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct."[181]

In many instances, however, even an approximation of how an in-

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175. *Miley*, 637 F.2d at 327. As the Fifth Circuit observed in *Miley*:

> Churning is a unified offense: there is no single transaction, or limited, identifiable group of trades, which can be said to constitute churning. Rather, a finding of churning, by the very nature of the offense, can only be based on a hindsight analysis of the entire history of a broker's management of an account and of his pattern of trading that portfolio, in comparison to the needs and desires of an investor. A corollary of the principle that churning is a unified offense—of the notion that no set group of transactions can be specifically identified as "but for" causes of churning—is that there are many "legitimate" ways of handling any given account. Each of the countless legitimate ways to manage every account would yield a different portfolio value. Thus, it is impossible to compute the exact amount of trading losses caused by the churning of an account.

Id.

176. *Id.* at 327.

177. *Id.*

178. *Id.*

179. *Id.* at 328.

180. *Id.*

181. *Id.* (citing Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 49 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978)).

vestor would have fared, notwithstanding the broker's misconduct, is impossible.[182] In *Carras v. Burns*,[183] for example, the plaintiffs' account was a highly leveraged margin account, and excessive trading occurred during a precipitous market decline which necessitated trades to meet margin calls.[184] According to the court, "[a]ny attempt to apportion loss of equity in this margin account between churning and the ordinary hazards of a declining market would be unduly speculative."[185] Thus, the court limited the plaintiff's damages "to the ascertainable losses to the account, including commissions, services charges, and taxes attributable to trading."[186]

2. Customer Suitability

"Unsuitability" refers to the broker's failure to recommend the purchase of securities suitable to his client's needs and financial situation. A broker who knowingly recommends that his customer purchase unsuitable securities violates section 10(b) and rule 10b-5.[187] To prevail, the investor must show that the broker "knowingly or

182. *See id.* at 328 n. 9.

183. 516 F.2d 251 (4th Cir. 1975).

184. *See id.* at 254-55, 259.

185. *Id.* at 259.

186. *Id.* There is also a question as to whether the plaintiff may recover for a "market loss," or "paper loss," as opposed to a "realized," or actual loss. As the Seventh Circuit explained in *Costello v. Oppenheimer & Co.*, "a loss is not 'realized' until a sale is made, because until that point it is possible that the security may regain or exceed its original value, thus wiping out the 'loss.'" Costello v. Oppenheimer & Co., 711 F.2d 1361, 1374 (7th Cir. 1983). The court, however, expressly avoided deciding whether market losses could be recovered in a churning case. *Id.* at 1374 n.29.

The requirement that damages be based upon a realized loss, as opposed to a market loss, is consistent with the requirement of "loss causation" in other 10b-5 cases. Until such time as the loss is actually realized, the defendant's churning cannot be said to have proximately caused the plaintiff to sustain any damages other than the payment of excessive commissions. In *Hatrock v. Jones & Co.*, however, the court held that a plaintiff in a churning case is not required to prove loss causation. 750 F.2d 767, 773 (9th Cir. 1984). The court reasoned that the investor "should not have to prove loss causation where the evil is not the price the investor paid for a security, but the broker's fraudulent inducement of the investor to purchase the security." *Id.*

In *Miley*, the leading Fifth Circuit case on churning, the court did not discuss the requirement of causation. *Miley* was decided before *Huddleston*, which held that loss causation was an essential element of a rule 10b-5 claim. In *Hatrock*, however, the Ninth Circuit distinguished *Huddleston* as a case that did not involve churning. *Id.* at 773 n.4; *see also In re* Washington Pub. Power Supply Sys. Sec. Litig., 650 F. Supp. 1346, 1353 (W.D. Wash. 1986)(holding loss causation not always required in broker-dealer cases).

187. Clark v. John Lamula Inv., Inc., 583 F.2d 594, 600 (2d Cir. 1978).

intentionally chose unsuitable investments . . . ."[188]

As a member of the National Association of Securities Dealers, every broker-dealer has the affirmative duty to have "reasonable grounds" to believe that his recommendation that a customer purchase a particular security is suitable for the customer.[189] The rules of the national securities exchanges impose similar obligations on their members.[190] Most broker-dealers also have their own internal suitability rules, particularly for those securities that involve a substantial risk of loss such as margin and options account.[191] Finally, many states securities authorities have adopted suitability standards developed by the North American Association of Securities Administrators

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188. Leone v. Advest, Inc., 624 F. Supp. 297, 304 (S.D.N.Y. 1985). The courts are divided over the issue of whether proof of recklessness is sufficient to establish the scienter element required under section 10(b) and rule 10b-5. *Compare* Clark v. Kidder, Peabody & Co., 636 F. Supp. 195, 198 (S.D.N.Y. 1986)(reckless conduct insufficient to formulate scienter) *with* Kalfas v. E.F. Hutton & Co., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,260, 96,259 (E.D.N.Y. April 28, 1987)(reckless conduct sufficient).

189. Article III, section 2 of the NASD's Rules of Fair Practice provides:

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

NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL (CCH) ¶ 2152 [hereinafter NASD MANUAL]. Prior to the 1983 amendments to the Securities Exchange Act, Pub. L. No. 98-386, 97 Stat. 205, not all broker-dealers were required to be members of the NASD. Instead, a broker-dealer could opt for SEC only (SECO) registration. The Commission's SECO rules, however, generally paralleled the NASD's Rules of Fair Practice. For example, former rule 15b10-2 provided:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer after reasonable inquiry concerning the customer's investments objectives, financial situation and needs, and any other information known to such broker or dealer or associated person.

Following the 1983 amendments, rule 15b10-2 and the other SECO rules were repealed. Rescission and Modification of Rules, Exchange Act Release No. 34-20409, [1983-84 Transfer Binder] ¶ 83,457 (Nov. 22, 1983).

190. For example, rule 405 of the New York Stock Exchange provides, in relevant part:

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

191. Article III, section 33, appendix E, § 19 of the NASD's Rules of Fair Practice provides express suitability standards for trading in options. *See* NASD MANUAL ¶ 2184, 2155.

and the NASD for investments in direct participation programs.[192] All of these suitability rules are consistent with the idea that "[a] securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents that he has a basis for the opinions he renders."[193]

In *Colonial Realty Corp. v. Bache & Co.*,[194] the Second Circuit concluded that general provisions under the NYSE constitution and NASD by-laws, requiring members to "observe high standards of commercial honor and just and equitable principles of trade," could not form the basis of an implied cause of action under sections 6 and 15A of the 1934 Act.[195] Three years later, in *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[196] the Seventh Circuit held that a violation of NYSE Rule 405 could, under certain circumstances, give rise to an implied cause of action under section 10(b) of the 1934 Act if the violation was "tantamount to fraud."[197] This theory was adopted by many courts.[198] Other courts rejected the implication of a private

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192. *See, e.g.*, 7 TEX. ADMIN. CODE §§ 117.3 (real estate programs), 121.4 (oil and gas programs)(1986); *see also* NASD MANUAL ¶ 2192, 2171 (direct participation programs in general).

193. Hanley v. SEC, 415 F.2d 589, 596 (2d Cir. 1969). As one court has recognized, however, "whatever reepresentations may be implicated in the broker-investor relationship, failure to live up to those representations does not automatically give rise to an action under the anti-fraud provisions of the securities laws." Forkin v. Rooney Pace, Inc., 804 F.2d 1047, 1050 (8th Cir. 1986).

194. 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

195. *Id.* at 182; *see also supra* note 21.

196. 410 F.2d 135 (7th Cir. 1969).

197. *Id.* at 142-43. The Seventh Circuit's reasoning in *Buttery* was followed by a district court which construed a violation "tantamount to fraud" to mean that "the violations operated as a fraud upon the plaintiff and that the defendants acted with *scienter*, that is, with intent to defraud or with willful and reckless disregard for the truth or falsity of their representations or whether their actions constituted a fraud." *See* Rolf v. Blyth, Eastman, Dillon & Co., 424 F.2d 1021, 1041 (S.D.N.Y. 1977), *aff'd in part and rev'd in part on other grounds*, 570 F. Supp. 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978)(*emphasis original*).

198. *E.g.*, Shull v. Dain, Kalman & Quail, Inc., 561 F.2d 152, 160 (8th Cir. 1977)(no "private right of action for violations of exchange rules in the absence of a finding of fraud"); Utah State Univ. v. Bear, Stearns & Co., 549 F.2d 164, 168 (10th Cir. 1977)(in "claims asserted under association and exchange rules, something more than mistake or negligence must be shown"); Parsons v. Hornblower & Weeks-Hemphill, Noyes, 447 F. Supp. 482, 494 (M.D.N.C. 1977)("there is no private right of action for alleged violations of NASD rules in the absence of facts which demonstrate fraud, independently cognizable under anti-fraud provisions of the securities laws"), *aff'd*, 571 F.2d 203 (4th Cir. 1978)(per curiam); Wolfson v. Baker, 444 F. Supp. 1124, 1134 (M.D. Fla. 1978)("a reckless disregard of the duty imposed by Rule 405 is sufficient to sustain a cause of action for breach of that rule . . . . [C]ircumstances can exist . . . under which a broker's obligations to know his customer may be so recklessly

cause of action for violation of exchange and the NASD suitability rules, but held that these rules could be used as evidence of the applicable standard of care required of brokers, as well as the fiduciary duties owed by a broker to an investor.[199]

In 1979, however, the United States Supreme Court decided two cases which have been interpreted as precluding the implication of a private cause of action for violation of exchange and NASD rules. In *Touche Ross & Co. v. Redington*,[200] the Court held that there was no private cause of action implied from section 17(a) of the 1934 Act. Six months later, in *Transamerica Mortgage Advisors, Inc. v. Lewis*,[201] the Court held that there was no implied cause of action for damages under section 206 of the Investment Advisers Act of 1940. In light of *Touche Ross* and *Transamerica*, most courts have held that violations of the NASD and exchange rules pertaining to investor suitability do not, by themselves, give rise to an implied private cause of action.[202]

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disregarded as to be tantamount to fraud"), *aff'd on other grounds*, 623 F.2d 1074, 1081-82 (5th Cir. 1980)(expressly avoiding the issue of whether breach of NYSE Rule 405 gives rise to federal cause of action).

199. *E.g.*, Lange v. H. Hentz & Co., 418 F. Supp. 1376, 1384 (N.D. Tex. 1976); Piper, Jaffray & Hopwood, Inc. v. Ladin, 399 F. Supp. 292, 297, 299 (S.D. Iowa 1975)(no federal cause of action for NASD violation; violation is evidence of negligence); Mercury Inv. Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160, 1162 (S.D. Tex. 1969).

200. 442 U.S. 560 (1979).

201. 444 U.S. 11 (1979).

202. Jablon v. Dean Witter & Co., 614 F.2d 677, 679-81 (9th Cir. 1980); Finne v. Dain Bosworth, Inc., 648 F. Supp. 337, 342 (D. Minn. 1986); Cummings v. A.G. Edwards & Co., 637 F. Supp. 132, 134 (M.D. La. 1986); Shahmirzadi v. Smith Barney, Harris Upham & Co., 636 F. Supp. 49, 52 (D.D.C. 1985); Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 605 F. Supp. 510, 512 (W.D. Pa. 1984); Klock v. Lehman Bros. Kuhn Loeb Inc., 584 F. Supp. 210, 216-17 (S.D.N.Y. 1984); Miller v. E.W. Smith Co., 581 F. Supp. 817, 820 (E.D. Pa. 1983); Gilman v. Shearson/American Express, Inc., 577 F. Supp. 492, 494-95 (D.N.H. 1983); Walck v. American Stock Exchange, Inc., 565 F. Supp. 1051, 1058-59 (E.D. Pa. 1981), *aff'd* 687 F.2d 778 (3d Cir. 1982), *cert. denied*, 461 U.S. 942 (1983); Kirkland v. E.F. Hutton & Co., 564 F. Supp. 427, 443 (E.D. Mich. 1983); Pierson v. Dean Witter, Reynolds, Inc., 551 F. Supp. 497, 501-02 (C.D. Ill. 1982); Thompson v. Smith Barney Harris Upham & Co., 539 F. Supp. 859, 865 (N.D. Ga. 1982), *aff'd*, 709 F.2d 1413 (11th Cir. 1983); Greene v. Loeb Partners, 532 F. Supp. 747, 748-49 (S.D. Fla. 1982); Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 532 F. Supp. 480, 483-84 (S.D. Ohio 1982); Holtzman v. Proctor, Cook & Co., 528 F. Supp. 9, 16 (D. Mass. 1981); Colman v. D.H. Blair & Co., 521 F. Supp. 646, 653-54 (S.D.N.Y 1981); Klitzman v. Bache, Halsey, Stuart, Shields, Inc., 499 F. Supp. 255, 259 (S.D.N.Y. 1980); Birotte v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 468 F. Supp. 1172, 1180 (D.N.J. 1979).

The Court's decisions in *Touche Ross* and *Lewis* have also been read by the lower courts as precluding an implied right of action under section 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1982), and rule 15cl-2, 17 C.F.R. § 240.15cl-2 (1987). Like rule 10b-5, rule 15cl-2 is a general anti-fraud provision. There are three distinctions between rule 10b-5 and rule 15cl-2.

Subsequent to the Supreme Court's decision in *Touche Ross* and *Transamerica*, the Fifth Circuit has expressly avoided addressing the issue of whether a private cause of action for violations of exchange and the NASD "suitability" rules can be implied under the 1934 Act.[203] In *Miley v. Oppenheimer & Co.*, however, the court held that a jury is entitled to consider the NYSE and NASD rules in determining whether a broker has churned a customer's account in violation of rule 10b-5.[204] Other courts have also held that violations of these rules are relevant evidence of an investor's claims under the anti-fraud

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First, rule 10b-5 applies to "any person," whereas rule 15cl-2 applies only to a "broker or dealer." A second distinction is that rule 15cl-2 applies only to securities traded on an over-the-counter market or securities traded on a national securities exchange of which the broker-dealer is not a member. Finally, unlike rule 10b-5, rule 15cl-2 prohibits misstatements or omissions that are made with "reasonable grounds to believe" that they are untrue or misleading. This is a negligence standard. *See* Clark v. John Lamula Inv., Inc., 583 F.2d 594, 604 (2d Cir. 1978)(Van Graafeiland, J., concurring). Nonetheless, the only court that ever considered the issue has held that "the same scienter standard applies to sections 10(b) and 15(c) and Rules 10b-5 and 15cl-2." Darvin v. Bache Halsey Stuart Shields, Inc., 479 F. Supp. 460, 464 (S.D.N.Y. 1979).

Prior to *Touche Ross*, one district court held that a private cause of action could be implied under section 15(c). Franklin Nat'l Bank v. L.B. Meadows & Co., 318 F. Supp. 1339 (E.D.N.Y. 1970); *see also* Opper v. Hancock Sec. Corp., 250 F. Supp. 668 (S.D.N.Y.)(applying cause of action under § 15(c)(1) and rule 15cl-2), *aff'd*, 367 F.2d 157 (2d Cir. 1966)(per curiam). In the aftermath of *Touche Ross*, however, the courts have uniformly held that no cause of action can be implied under section 15(c). Brannan v. Eisenstein, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); SEC v. Seaboard Corp., 677 F.2d 1301, 1313-14 (9th Cir. 1982)(no cause of action as matter of law); Roberts v. Smith Barney, Harris Upham & Co., 653 F. Supp. 406, 414 (D. Mass. 1986); Baum v. Phillips, Appel & Walden, Inc., 648 F. Supp. 1518, 1529 (S.D.N.Y. 1986)(no congressional attempt to create private cause of action); Rhoades v. Powell, 644 F. Supp. 645, 660-61 (E.D. Cal. 1986); Bull v. American Bank & Trust Co., 641 F. Supp. 62, 65 (E.D. Pa. 1986); Corbey v. Grace, 605 F. Supp. 247, 251 (D. Minn. 1985). As a practical matter, conduct in violation of section 15(c)(1) and rule 15cl-2 will be actionable under section 10(b) and rule 10b-5. *See Pierson*, 551 F. Supp. at 502-03.

203. Vigman v. Community Nat'l Bank & Trust Co., 635 F.2d 455, 458 n.7 (5th Cir. 1981); *see also* Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1034-35 n.1 (5th Cir. 1981); Miley v. Oppenheimer & Co., 637 F.2d 318, 333 (5th Cir. 1981).

204. 637 F.2d at 333 ("these NYSE and NASD rules are excellent tools against which to assess *in part* the reasonableness or excessiveness of a broker's handling of an investor's account"); *see also Petrites*, 646 F.2d at 1034-35 n.1. ("evidence of violations of NYSE and NASD rules is admissible . . . as evidence of industry standards and practices"); Smith v. Oppenheimer & Co., 635 F. Supp. 936, 940 (W.D. Mich. 1985)("Although exchange rules may not provide . . . a private cause of action, violations of those rules may be probative"); *Greene*, 532 F. Supp. at 748-49 ("*Miley* does allow a jury to consider the NYSE and NASD rules as *one* of, not the sole, factor in determining whether plaintiff's account has been excessively traded.").

provisions of the securities laws.[205] Similarly, a broker-dealer's violation of its own, "in-house" rules pertaining to investor suitability may also be admissible as evidence of the broker's conduct.[206]

III. ARBITRABILITY OF CUSTOMER DISPUTES

Under the Arbitration Act,[207] an arbitration clause in "a contract evidencing a transaction involving commerce" is "valid, irrevocable, and enforceable . . . ."[208] Although the Act does not provide an independent basis for federal court jurisdiction,[209] it nonetheless creates a body of federal substantive law.[210] Accordingly, the Act preempts state law to the extent it precludes enforcement of an agreement to arbitrate.[211]

Transactions involving the purchase and sale of securities are "transactions involving commerce," and are subject to the provisions of the Arbitration Act.[212] While many broker-dealers include arbitration clauses in a variety of agreements, not all firms require written agreements, and not all customer agreements contain arbitration clauses.[213] Furthermore, a defendant can waive the right to arbitration by failing to timely assert a motion to compel arbitration[214] or by undertaking pre-trial discovery in litigation.[215] Thus, a number of in-

205. *Kirkland*, 564 F. Supp. at 443 (citing *Miley*); *see also* Mihara v. Dean Witter & Co., 619 F.2d 814, 824 (9th Cir. 1980).

206. Rupert v. Clayton Brokerage Co., 737 P.2d 1106, 1112 (Colo. 1987).

207. 9 U.S.C. §§ 1-14 (1982).

208. *Id.* § 2.

209. *See generally* 13B C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 3569 (2d ed. 1984).

210. Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 25 n.32 (1983)(creates federal substantive law without creating federal jurisdictional question).

211. Southland Corp. v. Keating, 465 U.S. 1, 14-15 (1984)(Congress intended Act to apply to federal and state courts).

212. Macchiavelli v. Shearson, Hammill & Co., 384 F. Supp. 21, 30 (E.D. Cal. 1974).

213. *See supra* note 8.

214. Singer v. Dean Witter Reynolds, Inc., 614 F. Supp. 1141, 1143-44 (D. Mass. 1985)(outlining factors considered in determining whether waiver has occurred).

215. De Sapio v. Kohlmeyer, 321 N.E.2d 770 (N.Y. 1979). Courts are more likely to find a waiver by a broker-dealer rather than the investor. *Compare* National Foundation for Cancer Research v. A.G. Edwards & Sons, 821 F.2d 772, 775 (D.C. Cir. 1987)(broker waived right to arbitration by engaging in discovery and seeking summary judgment on issues subject to arbitration) *and* Price v. Drexel Burnham Lambert, Inc., 791 F.2d 1156, 1159-60 (5th Cir. 1986)(broker that initiated discovery, filed motions and requests for pre-trial deadlines waived right to demand arbitration) *with* Drexel Burnham Lambert, Inc. v. Warner, 665 F. Supp. 1549, 1552-54 (S.D. Fla. 1987)(investor's filing suit in state court and undertaking discovery not "substantial invocation of the judicial process" to waive arbitration).

vestor claims will continue to be litigated, rather than arbitrated.

The Arbitration Act, moreover, expressly provides that an arbitration clause may be avoided "upon such grounds as exist at law or in equity for the revocation of any contract."[216] Investors, for example, often claim that they are not bound by arbitration clauses because they were fraudulently induced by their broker to enter into the customer agreement. As Justice Blackmun pointed out, after *McMahon*, litigation over the validity of arbitration agreements is likely to increase.[217]

Under section 4 of the Arbitration Act,[218] a court must first be "satisfied that the making of the agreement for arbitration . . . is not in issue" before it may compel arbitration of a dispute. In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,[219] however, the Court held that the Act "does not permit the federal court to consider claims of fraud in the inducement of the contract generally."[220] Instead, such challenges to the entire contract are to be decided, in the first instance, by the arbitrators, not the court.[221] A court may only entertain challenges to the arbitration clause itself.[222] The Court's holding in *Prima Paint* "extends to all challenges to the making of the contract,"[223] including claims of duress and unconscionability.[224] Thus, even after *McMahon*, broad attacks on the validity of customer agreements in general, as opposed to arbitration clauses, are not likely

216. 9 U.S.C. § 2 (1982). *But see* Aronson v. Dean Witter Reynolds, Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,593, 97,648, 97,649 (S.D. Fla. Dec. 24, 1987)(arbitration agreement not inherently oppressive or unfair).

217. Shearson/American Express, Inc. v. McMahon, __ U.S. __, __, 107 S. Ct. 2332, 2359, 96 L.Ed.2d 185, 220 (1987)(Blackmun, J., dissenting); *see also* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985)("courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds" for revocation).

218. 9 U.S.C. § 4 (1982).

219. 388 U.S. 395 (1967).

220. *Id.* at 404.

221. *Id.*

222. *Id.* at 403-04. Even then, under § 4, the court must conduct a trial to determine the validity of the customer's claim. *See* Dougherty v. Mieczkowski, 661 F. Supp. 267, 275 & n.5 (D. Del. 1987).

223. Rhoades v. Powell, 644 F. Supp. 645, 653 (E.D. Cal. 1986).

224. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu, 637 F.2d 391, 398 & n.11 (5th Cir. 1981)(claims of "coercion, confusion, undue influence and duress" to be decided by arbitrator, not district court); *see also* Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 833 F.2d 545, 547 (5th Cir. 1987)(alleging overreaching in investment account agreement).

to succeed.[225]

An investor may not avoid arbitration by claiming he failed to read the agreement before signing it.[226] Similarly, even if the customer has not signed the broker-dealer's customer agreement, he may nonetheless be bound by its arbitration provisions—like any other contract, one containing an arbitration clause may bind the customer based on his conduct.[227] In *Blatt v. Shearson Lehman/American Express, Inc.*,[228] for example, the wife of an investor who had signed a joint account agreement was bound by its arbitration clause, even though she had not signed the agreement.[229] At trial, she conceded that she wanted to, and did in fact, participate with her husband in the joint agreement.[230] The court, therefore, held that she had "clothed her husband with actual authority to [bind her], or "ratified" [his] . . . action in entering into . . . [the customer agreement]."[231]

Prior to October 21, 1987, SEC rule 15c2-2 prohibited broker-dealers from requiring customers to enter into pre-dispute agreements purporting to require investors to arbitrate claims,[232] unless they were advised that they were "not required to arbitrate any dispute or controversy that arises under the Federal securities laws. . . ."[233] Before

225. *See Villa Garcia*, 833 F.2d at 547-48 (where agreement provided for all disputes arising under it to be resolved in arbitration, allegation that agreement entered into under overreaching did not remove issue from arbitration); *see also Aronson*, [Current Binder] FED. SEC. L. REP. at ¶ 93,593, 97,649 (nothing inherently unfair or oppressive about arbitration agreements). Claims of forgery, however, stand on a different footing. A contract induced by fraud is merely voidable at the option of the defrauded party; by contrast, forgery relates to fraud in the execution of the contract. *Dougherty*, 661 F. Supp. at 274. Such a contract, including its arbitration clause, is void. *Id.*

226. Smoky Greenhaw Cotton Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 720 F.2d 1446, 1450-51 (5th Cir. 1983)(customer bound by signed agreement containing conspicious notice of voluntary nature of contract).

227. First Citizens Mun. Corp. v. Pershing Div. of Donaldson, Lufkin & Jenrette Sec. Corp., 546 F. Supp. 884, 887 (N.D. Ga. 1982)(full performance under terms of contract containing arbitration clause).

228. [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,976 (S.D.N.Y. Oct. 30, 1986).

229. *Id.* at 94,798-799 (court applying agency and contract principles to find unsigned joint investor bound by the agreement).

230. *Id.* at 94,799.

231. *Id.*

232. *See* 17 C.F.R. § 240.15c2-2(a) (1987), *repealed*, 52 Fed. Reg. 39216 (1987).

233. *Id.* 15c2-2(b)(required notice). The Commodities Future Trading Commission's regulations require a futures contract merchant to obtain the customer's separate signature to an arbitration agreement. 17 C.F.R. § 180.3(b)(2) (1987). The agreement must contain cautionary language notifying the customer of his right, among other things, to a judicial forum. *Id.* § 3(b)(6)(specifying required language). The courts, however, have held that noncompli-

McMahon, one district court held that a broker-dealer's violation of rule 15c2-2, together with evidence of a "gross" disparity in bargaining power between the parties, was sufficient to negate the existence of "an enforceable, binding contractual agreement to arbitrate . . . ."[234] Rule 15c2-2, however, was rescinded after *McMahon* was decided,[235] and the Fifth Circuit has since held that the rescission applies retroactively.[236] Accordingly, future challenges to arbitration clauses based on noncompliance with rule 15c2-2 will also be unlikely.

In any event, a customer's unconscionability argument probably will not succeed, given the empirical data suggesting that arbitration agreements are not invariably required in industry.[237] Furthermore, apparently nothing would prevent a customer from refusing to arbitrate by simply deleting the arbitration clause from the customer agreement.[238] After all, broker-dealers are in business to earn money. It therefore seems unlikely that a firm would reject a customer simply because he refuses to agree to arbitrate future disputes.

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ance with these regulations will not invariably void the arbitration agreement. *See, e.g.*, Olson v. Paine, Webber, Jackson & Curtis, Inc., 806 F.2d 731, 743-44 (7th Cir. 1986)(failure to comply with regulations does not void agreement when the investor is in no way harmed); Ingbar v. Drexel Burnham Lambert, Inc., 683 F.2d 603, 606-08 (1st Cir. 1982)(failure to comply with regulation requiring notice of intent to arbitrate does not vitiate agreement with sophisticated investor); *see also* Gans v. Merrill Lynch Futures, Inc., 814 F.2d 493, 496-98 (8th Cir. 1987)(contract entered into prior to notice requirement not void for lack of notice provision where investor provided with actual notice outside of contract).

234. Woodyard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 640 F. Supp. 760, 766-67 (S.D. Tex. 1986). According to the court, the case

> present[ed] a classic example of an unsophisticated investor who has sought, received, and relied upon the superior knowledge of a securities advisor. Upon entering a relationship of trust, it is understandable that the customer's adversarial instincts would be lulled. Thus, equitable principles leave little space for the subsequent operation of the doctrine of *caveat emptor*. At the very least, pre-dispute arbitration agreements between brokers and their public customers should remain subject to meaningful judicial inquiry. There is a potential for conflicts of interest when an investor's marketplace intermediary, upon entering a fiduciary relationship, has one unilateral, adversarial eye cocked upon possible litigation between the parties to a standardized brokerage contract.

Id. at 766.

235. Exchange Act Release No. 34-2504, 52 Fed. Reg. 29316 (1987).

236. *See* Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 833 F.2d 545, 547-48 (5th Cir. 1987)(citing Noble v. Drexel, Burham, Lambert, Inc., 823 F.2d 849, 851 (5th Cir. 1987)(holding *McMahon* retroactive)).

237. Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 447 & nn.347-50 (1987)(revealing that only one of four largest national brokerage houses require arbitration clauses).

238. *See id.* at 447-48 & n. 351.

IV. Issues After *McMahon*

Once investors' claims are referred en masse to arbitration, a number of substantive and procedural issues will inevitably arise. Depending on how these issues are ultimately resolved, the securities industry, which has consistently sought to resolve customer disputes through arbitration rather than litigation,[239] may find that arbitration's preceived advantages are largely illusory. Conversely, investors whose claims have increasingly failed to withstand motions to dismiss[240] may receive a more extended hearing in arbitration than they currently do in litigation.[241]

The most significant issue is whether exemplary damages may be awarded in arbitration. Awards of punitive damages under pendent state law claims are a particular concern to the securities industry.[242] Some states, such as New York, however, do not permit arbitrators to award exemplary damages.[243] For this reason, many firms include a choice of law clause in their customer agreement, specifying that New York law will govern the resolution of any dispute arising out of the agreement. Such a contractual provision will normally be enforced by the courts, especially if the broker-dealer is a member of the New

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239. *See* Shearson/American Express v. McMahon, __ U.S. __, 107 S. Ct. 2332, 2355, 96 L. Ed. 2d 185, 216 (1987)(Blackmun, J., dissenting); *see also* Rothman, *Jury Ruling Lets Unhappy Client Fight Broker Through Trial, Not Arbitration*, WALL ST. J., Jan. 25, 1988, at 20, col. 2 (noting investors prefer litigation; brokers, arbitration).

240. *See generally* Note, *Pleading Securities Fraud Claims With Particularly Under Rule 9(b)*, 97 HARV. L. REV. 1432 (1984)(discussing courts' use of Federal Rule of Civil Procedure 9(b) to dismiss investors' claims).

241. This is especially true in light of the Court's decisions relaxing the standard of review applicable to summary judgments in general. *See generally* Anderson v. Liberty Lobby, Inc., __ U.S. __, 106 S. Ct. 2505, 91 L. Ed. 2d 202 (1986)(libel); Celotex Corp. v. Catrett, __ U.S. __, 106 S. Ct. 2548, 91 L. Ed. 2d 265 (1986)(product liability); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986)(antitrust).

242. *See, e.g.*, Aldrich v. Thomson McKinnon Sec. Inc., 756 F.2d 243, 246 n.3, (2d Cir. 1985)(punitive damages for $1.5 million for common law fraud and breach of fiduciary duty allowed); Malandris v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 703 F.2d 1152, 1156 (10th Cir. 1981)(affirmed by divided court en banc subject to remititture)($3 million for intentional infliction of emotional distress, remitted to $1 million), *cert. denied*, 464 U.S. 824 (1983); Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 512 (Colo. 1986)(en banc)(punitive damages of $1.2 million for breach of fiduciary duty).

243. Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 794 (N.Y. 1976); *see also* School City of East Chicago Ind. v. East Chicago Fed'n of Teachers, Local 511, 422 N.E.2d 656, 663 (Ind. Ct. App. 1981); Shaw v. Kuhnel & Assocs., 698 P.2d 880, 882 (N.M. 1985). *Contra* Rodgers Bldg., Inc. v. McQueen, 331 S.E.2d 726, 733-34 (N.C. Ct. App. 1985); Anderson v. Nichols, 359 S.E.2d 117, 121 & n.1 (W. Va. 1987).

York Stock Exchange or maintains its principal place of business in New York.[244]

Assuming that New York law is controlling, an investor's claim for exemplary damages may be resolved in one of three ways. The first, and most obvious, is a finding that the investor has contractually waived his right to recover punitive damages.[245] Such a result, however, ignores the primacy of the Arbitration Act, which determines the types of claims that can be referred to arbitration.[246] As one court has stated, "If an issue is arbitrable under federal law, it remains so despite contrary state law."[247] Thus, a second possible outcome is that the parties, by agreeing to arbitration of their disputes, have impliedly authorized the arbitrators to award punitive damages.[248]

Even in those jurisdictions that do not permit arbitrators to award punitive damages, there is nothing that prevents a *court* which is petitioned to confirm an arbitration award from entering judgment awarding the investor exemplary damages. In *Stewart v. State Farm Mutual Automobile Insurance Co.*,[249] for example, an arbitration panel noted that it did not have jurisdiction to award exemplary damages, but recommended that such damages should be awarded by a proper court. In a suit to confirm the award, the trial court adopted the arbitration panel's recommendation, and included punitive damages in its judgment. On appeal, the Supreme Court of New Mexico affirmed, holding that neither the panel nor the trial court had exceeded their authority.[250]

244. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Brooks, 404 F. Supp. 905, 906 (N.D. Tex. 1975)(choice of law provision enforceable if reasonably related to agreement), *aff'd*, 548 F.2d 615 (5th Cir.), *cert. denied*, 434 U.S. 855 (1977); *see also* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 187 (1971)(standards for enforcement for choice of law agreements).

245. *See* Shahmirzadi v. Smith Barney, Harris Upham & Co., 636 F. Supp. 49, 56 (D.D.C. 1985)(New York forbids arbitrators from awarding punitive damages; where agreement provides for application of New York law, no exemplary award may be given).

246. *See* Willis v. Shearson/American Express, Inc., 569 F. Supp. 821, 823-24 (M.D.N.C. 1983).

247. *Id.* at 824; *see also* Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353, 360 (N.D. Ala. 1984)(federal policy does not prohibit award of punitive damages despite contrary state law), *aff'd*, 776 F.2d 269 (11th Cir. 1985)(per curiam).

248. *Willis*, 569 F. Supp. at 824 (broad arbitration provision included claims for punitive damages). This view is consistent with the Supreme Court's holding in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), that the Arbitration Act preempts state law to the extent state law prevents arbitration of the parties' disputes. *Id.* at 14-15.

249. 726 P.2d 1374 (N.M. 1986).

250. *See id.* at 1377.

Of these three alternatives, the last is clearly preferable. Under the first, the investor's waiver may not be truly effective since most investors will claim, with substantial justification, that by agreeing to the application of New York law they did not intend to waive their right to recover exemplary damages. The second outcome, which permits arbitrators themselves to award such damages, is equally unattractive because it delegates the public's interest in punishment to a private body.[251] Indeed, permitting arbitrators to award punitive damages may well violate the eighth amendment's proscription of excessive fines.[252]

By contrast, so long as the court is the body that determines whether exemplary damages should be awarded, as well as their amount, there are adequate judicial safeguards to ensure that the public policies behind punitive damages are served. Similarly, permitting a court to award such damages in appropriate cases ensures that investors will not waive their rights unknowingly. In any event, as the foregoing demonstrates, it does not appear that industry members will be able to avoid exposure to exemplary damages simply because customer claims are arbitrated instead of litigated.

Investors may also find that arbitration has significant procedural advantages over litigation. For example, the pleading requirements of rule 9(b) of the Federal Rules of Civil Procedure apply to rule 10b-5 and other fraud claims.[253] Accordingly, the investor's complaint must set forth the time, place, and contents of false representations or material omissions, as well as the identity of the person making, or failing to make, them.[254] The investor's complaint, moreover, may

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251. *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 795 (N.Y. 1976). The New York view is that "enforcement of an award of punitive damages as a purely private remedy would violate public policy . . . ." *Id.*

252. *See* Bankers Life & Casualty Co., v. Crenshaw, 483 So. 2d 254 (Miss. 1985)(en banc)(upholding award of $20,000 actual and $1.6 million punitive damages), *prob. juris. noted*, 55 U.S.L.W. 3607 (U.S. Mar. 10, 1987)(No. 85-1765). One of the issues before the Court in *Crenshaw* is whether excessive awards of punitive damages violate the eighth amendment prohibition of excessive fines. *Arguments Before the Court*, 56 U.S.L.W. 3423 (Dec. 22, 1987).

253. Fed. R. Civ. P. 9(b) provides, in relevant part, "In all averments of fraud . . . , the circumstances constituting fraud . . . shall be stated with particularity."

254. *E.g.*, Zerman v. Ball, 735 F.2d 15, 22-23 (2d Cir. 1984)(complaint failed to identify with particularity with whom plaintiff dealt); Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 115-16 (2d Cir. 1982)(generalized allegations insufficient to state claim); Ross v. A.H. Robins Co., 607 F.2d 545, 557 (2d Cir. 1979)(must allege specific acts or omissions upon which claim rests), *cert. denied*, 446 U.S. 946 (1980). Factual allegations "which fail to specify the time,

"lump" multiple defendants together; instead, it must "inform each defendant of the nature of his alleged participation in the fraud."[255]

Similarly, because a churning claim under rule 10b-5 is a fraud claim, the pleading requirements of rule 9(b) must be satisfied.[256] In order to plead the circumstances consituting fraud with required particularity, the investor must allege, in detail, "the dialogue between the parties, and the nature of their relationship."[257] Furthermore, the complaint "must identify the securities involved, the nature, amount and dates of transactions in issue, as well as sufficient facts to allow for a determination of the turnover ratio in the account and/or the percentage of the account value paid in commissions."[258] Conclusory allegations that the defendant engaged in trading for the sole purpose of generating commissions are insufficient.[259] Similar pleading requirements apply in unsuitability cases.[260]

As one commentator has pointed out, defendants in securities cases

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place, speaker, and sometimes even with content of the alleged misrepresentations, lack the 'particulars' required by Rule 9(b)." Luce v. Edelstein, 802 F.2d 49, 54 (2d Cir. 1986).

255. DiVittorio v. Equidyne Extractive Indus., Inc. [1987 transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,300, 96,513 (2d Cir. June 26, 1987). References to misstatements and material omissions in a prospectus or other offering memorandum, however, are sufficient to connect the defendants to a fraudlent scheme if they "are insiders or affiliates participating in the offer of the securities in question." *Luce*, 802 F.2d at 55.

256. *See* Todd v. Oppenheimer & Co., 78 F.R.D. 415, 423-24 (S.D.N.Y. 1978).

257. Heller v. L.F. Rothschild, Unterberg, Towbin, 631 F. Supp. 1422, 1424 (S.D.N.Y. 1986). Thus,

> . . . a plaintiff alleging fraud by churning should allege specifically what instructions he gave to the broker or other representative of the corporate defendant; to whom those instructions were given; on what dates they were conveyed; and whether they were oral, in writing, or both. The plaintiff . . . should allege, with comparable particularity, what his own investment experience was, and what information he conveyed on that subject to the broker, with comparable detail.
>
> Secondly, the plaintiff should allege with comparable particularly the responses or assurances made by the broker or on behalf of the brokerage house which plaintiff alleges were fraudulent.

Id. at 1424-25.

258. Russo v. Bache Halsey Stuart & Shields, Inc., 554 F. Supp. 613, 618 (N.D. Ill. 1982).

259. Winkler v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,154, 95,705 (N.D. Ill. April 25, 1986).

260. The investor's complaint must "identify the transactions in question and the securities involved and at least give some indication why . . . such securities [were] unsuitable." Vetter v. Shearson Hayden Stone Inc., 481 F. Supp. 64, 66 (S.D.N.Y. 1979); *see also* Polera v. Altorfer, Podesta, Woolard & Co., 503 F. Supp. 116, 119 (N.D. Ill. 1980); Rotstein v. Reynolds & Co., 359 F. Supp. 109, 114 (N.D. Ill. 1973)(complaint dismissed as "vague, conclusory, and without factual support").

"have been winning motions to dismiss under rule 9(b) with increasing frequency."[261] Since one of the reasons parties agree to arbitration is a belief that less formal, streamlined proceedings will better serve their needs,[262] it is doubtful that the requirements of rule 9(b) can be transposed to apply with equal force in arbitration. Under section 25(a) of the NASD's Code of Arbitration Procedure, for example, a proceeding is initiated by filing a statement of claim, together with documents supporting the customer's contentions.[263] Although the statement "should specify the relevant facts and remedies sought,"[264] the Code does not contain an equivalent of rule 9(b).[265]

Similarly, while discovery may be employed to "flesh out" a vague complaint in litigation, no such tools expressly exist for unraveling a vague and conclusory statement of claim. Under section 32(b) of the NASD Code, for example, discovery is limited to the "voluntary exchange of such documents and information as will serve to expedite the arbitration."[266] Pre-trial discovery procedures such as depositions, however, are not usually permitted.[267] Thus, counsel for both

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261. Note, *Pleading Securities Fraud Claims With Particularity Under Rule 9(b)*, 97 HARV. L. REV. 1432, 1432 (1984); *see, e.g.*, Zola v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,159, 95,720-21 (S.D.N.Y. Feb. 24, 1987); Lowenbraun v. L.F. Rothschild, Unterberg, Towbin, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,066, 95,297-98 (S.D.N.Y. Jan. 15, 1987)(RICO, Rule 405, and § 10(b) claims dismissed); Bergen v. L.F. Rothschild, Unterberg, Towbin & Bennett Mostel, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,143, 95,645 (D.D.C. Aug. 8, 1986); Winkler v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,154, 95,705 (N.D. Ill. Apr. 25, 1986)(churning complaint dismissed).

262. *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 633 (1985).

263. NASD MANUAL ¶ 3725.

264. *Id.*

265. Of course, better practice would dictate that the grounds for relief be stated in as much detail as possible. Although the Code permits the arbitrators to dismiss the proceedings on their own or at the request of one of the parties, such a dismissal merely relagates the customer to those "remedies provided by applicable law." NASD MANUAL ¶ 3716. Presumably, such a dismissal would be without prejudice to refiling the claim in either a subsequent arbitration or in litigation. For a thorough discussion of industry procedures, see generally Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279 (1984).

266. NASD MANUAL ¶ 3732.

267. *See* Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 286-88 & nn.50-52 (1984). For a detailed discussion of the limited discovery opportunities available in arbitration proceedings, see generally, Willenken, *The Often Overlooked Use of Discovery in Aid of Arbitration and the Spread of the New York Rule to Federal Common Law*, 35 BUS. LAW. 173 (1979).

parties often lack the intangible advantage of having previously questioned their adversaries to determine the precise nature of their claims, as well as their credibility.[268]

The absence of discovery may actually work to the customer's benefit. In litigation, for example, the defense counsel is usually entitled to discover the investor's income tax returns, as well as documents reflecting his transactions with other broker-dealers.[269] Similarly, depositions of the investor and his financial advisers and accountants are usually fertile sources of defensive information in litigation. In many cases the broker-dealer may lack the ability to determine the viability of the customer's claims because its registered representative's interests may be adverse to those of the firm, thus precluding common counsel.[270] Under such circumstances, arbitration, for the broker-dealer, may be nothing more than trial by ambush.[271]

Finally, investors should benefit from the less formal nature of arbitration proceedings, as opposed to litigation. Under section 34 of the NASD Code, arbitrators are not bound by formal rules governing the admissibility of evidence.[272] Coupled with the lack of discovery, liberalized hearing procedures will often work to the benefit of investors, rather than broker-dealers. For example, it is conceivable that an investor, not bound by the hearsay rules, could introduce out-of-court

268. As one litigator has observed, "Depositions are the most important of the pre-trial discovery tools. In evaluating the strength of a case for settlement purposes, litigators accord great weight to the performance in depositions of both their own and their opponents witnesses." Suplee, *Depositions: Objectives, Strategies, Tactics, Mechanics and Problems*, 2 REV. LITIGATION 255, 257 (1982).

269. *See* Weiner v. Bache Halsey Stuart, Inc., 76 F.R.D. 624, 627 (S.D. Fla. 1977)(plaintiff's income tax returns "highly relevant" in suit against broker, thus discoverable); Lavin v. A.G. Becker & Co., 60 F.R.D. 684, 686 (N.D. Ill. 1973)(all documents concerning financial activities and tax liability relevant to "total quantum" of plaintiff's financial activities, reasonableness of customer-broker dealings, and extent and accuracy of customer's financial disclosure).

270. *See* E.F. Hutton & Co. v. Brown, 305 F. Supp. 371, 387-400 (S. D. Tex. 1969)(corporate counsel, having previously appeared on behalf of officer, disqualified from representing corporation in later suit against officer).

271. In *Drexel Burnham Lambert, Inc. v. Warner*, 665 F. Supp. 1549 (S.D. Fla. 1987), an investor commenced a civil action in state court and undertook extensive discovery. After the defendants noticed the plaintiff and her accountant for deposition, but before these depositions were taken, the investor demanded arbitration and dismissed her lawsuit. *Id.* at 1550. In the broker-dealer's suit to enjoin the arbitration, the court nonetheless denied the broker's motion for summary judgment on the issue of waiver of arbitration because the broker failed to prove that the investor's use of discovery was "substantial." *Id.* at 1554-55.

272. NASD MANUAL ¶ 3734.

statements by other securities investment professionals concerning the propriety of the defendant's conduct, in addition to unanticipated admissions by the firm's registered representative and other employees.[273] Of course, the weight the arbitration panel will accord such statements necessarily depends upon the strength of the investor's claim.

Investors may also find that the composition of arbitration panels will obviate the need for expert testimony in many cases. In litigation, for example, expert testimony is helpful, if not necessary, in order for a customer to prevail on a churning claim.[274] While the absence of such testimony does not automatically defeat a churning claim, investors who proceed without the assistance of an expert, do so at their own risk.[275] In arbitration, however, the panel will usually consist of persons knowledgeable in the securities laws, some of whom will be members of the industry.[276] Arbitrators will presumably be familiar with practices such as churning and, unlike most jurors, will not require the assistance of an expert in reaching their decision. Industry arbitrators can also be expected to know the pertinent provisions of the NASD's Rules of Fair Practice, as well as the rules of the various exchanges. Thus, investors with viable churning and unsuitability claims have nothing to fear in arbitration, so long as the procedures are fairly administered and arbitrators remain impartial.[277]

V. THE ROLE OF THE COURTS AFTER *MCMAHON*

Under the Arbitration Act, an award can be vacated on only limited grounds: procurement of the award by fraud, evident partiality on the part of or gross misconduct by the arbitrators, or failure to render an award.[278] An award, however, may also be set aside if the

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273. *See* Tanick, *Thou Shalt Not Ignore Arbitration*, 13 LITIGATION 34, 37 (1987)(discussing tactics concerning hearsay in arbitration).

274. Shad v. Dean Witter Reynolds, Inc., 799 F.2d 525, 529-30 (9th Cir. 1986)(exclusion of expert testimony offered to prove churning held abuse of discretion).

275. Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384, 1386 (10th Cir. 1987); *see also Shad*, 799 F.2d at 530 (failure to introduce expert testimony to prove churning may result in adverse judgment n.o.v.).

276. Brener v. Becker Paribas Inc., 628 F. Supp. 442, 448 (S.D.N.Y. 1985); *see also* NASD MANUAL ¶ 3719.

277. *See Brener*, 628 F. Supp. at 448-49 (securities dispute arbitration provides adequate procedural protections for investor's rights).

278. 9 U.S.C. § 10(a), (b), (d) (1982). Damage awards by arbitrators are likewise subject to considerable deference. *See* French v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 784

arbitrators acted in "manifest disregard" of the law.[279]

The "manifest disregard" standard, for example, requires more than an erroneous application or misunderstanding of the law.[280] Instead, the arbitrators' error "must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator."[281] In essence, to act in manifest disregard of the law, the arbitration panel must ignore a binding legal principle brought to their attention.[282]

This standard of review is far more limited than an appellate court's review of a trial court's findings of fact and conclusions of law. Under rule 52(a) of the Federal Rules of Civil Procedure, a district court's findings of fact may not be reversed on appeal unless they are "clearly erroneous."[283] The trial court's conclusions of law, however, are reviewed de novo; if the district court has erred in its application of the law to its findings of fact, the court of appeals is free to substitute its own view of the applicable law and reverse the district court's judgment.[284]

F.2d 902, 908-09 (9th Cir. 1986)(upholding award of lost interest income). A court may, however, correct an evident miscalculation by the arbitrators. 9 U.S.C. § 11(a) (1982).

279. *See* Wilko v. Swan, 346 U.S. 427, 436-37 (1953)(interpretation of law, as opposed to clearly shown "manifest disregard" of law, not subject to judicial review). While lack of evidence is not sufficient to vacate an award, some courts have also hinted that an "arbitral award may be set aside if it is 'completely irrational.'" Shearson Hayden Stone, Inc. v. Liang, 653 F.2d 310, 312 (7th Cir. 1981)(citing Storer Broadcasting Co. v. American Fed'n of of Television and Radio Artists, 600 F.2d 45 (6th Cir. 1979) and Swift Indusustries, Inc. v. Botany Industries, Inc., 466 F.2d 1125 (3d Cir. 1972)).

280. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 933 (2d Cir. 1986).

281. *Id.*

282. *See id.*

283. FED. R. CIV. P. 52(a).

284. *See* Pullman-Standard v. Swint, 456 U.S. 273, 287 (1982)(clearly erroneous standard of rule 52(a) not applicable to conclusions of law). *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930 (2d Cir. 1986), illustrates the distinction between the different standards of review. Bobker instructed Merrill Lynch to tender 4,000 shares of Phillips Petroleum stock in acceptance of a tender offer. Three days later, he instructed Merrill Lynch to effect a short sale of 2,000 shares of Phillips at the market price. *Id.* at 931 ("A 'short sale' is a sale of shares of stock not owned by the seller but borrowed by him from someone else for the purpose of effectuating the sale.") Merrill Lynch, at first, effected and confirmed the transaction, but later cancelled it because it violated firm policy. Bobker was unable to acquire 2,000 shares elsewhere, and demanded arbitration to recover his expected profits. Merrill Lynch denied liability on the grounds that Bobker's transaction was a "hedged sale" in violation of rule 10b-4, 17 C.F.R. § 240. 10b-4 (1987), a position the arbitration panel rejected. *Id.*

Merrill Lynch subsequently filed suit to vacate the panel's award on the same grounds the arbitration panel had rejected. *See id.* at 933. The district court accepted Merrill Lynch's

In certain aspects, however, the limited nature of a court's review of an arbitration award may benefit the customer who prevails in arbitration. Broker-dealers often defend customer disputes on purely legal grounds; for example, that a particular practice is not prohibited or a particular disclosure is not required. Under the "manifest disregard" standard of review, the success of such defenses will depend largely, if not entirely, on the arbitration panel's construction of the law. Apparently, so long as the arbitrators acknowledge the existence of a particular legal principle, they have not ignored it, and, a fortiori, they have not acted in manifest disregard of the law.[285] The message is clear: A party that loses in arbitration has little chance of vacating the award on narrow, legal grounds.

The limited nature of judicial review also illustrates the importance of maintaining the integrity of the industry's arbitration process. If the courts are content to entrust the legal rights of investors to the industry's protection, they must insist that arbitration remain a fair and impartial forum for resolving customer disputes. As Justice Blackmun pointed out in his dissent in *McMahon*, "Courts should take seriously their duty to review the results of arbitration to the extent possible under the Arbitration Act."[286]

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construction of rule 10b-4, and vacated the award. *See id.* Having sustained Merrill Lynch's argument, the court concluded that permitting the award to stand would penalize Merrill Lynch for complying with the law. *See* Bobker v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 636 F. Supp. 444, 447-48 (S.D.N.Y.), *rev'd*, 808 F.2d 930 (2d Cir. 1986). On appeal, however, the Second Circuit reversed the district court's order vacating the award. *See Bobker*, 808 F.2d at 937 (arbitral award upheld as not in manifest disregard of law).

Significantly, the Second Circuit made no attempt to determine whether the arbitration panel or the court had correctly applied rule 10b-4. Rather the court's decision turned on its determination that the award resulted from the arbitrators' "careful and conscientious analysis" of rule 10b-4. *See id.* at 936-37. That either the arbitration panel or the district court may have been wrong in construing rule 10b-4 was of no moment. *Id.* at 937-38 (Meskill, J., concurring). By contrast, had the question come to the Second Circuit on appeal from a motion for summary judgment or a trial to the court, the question of the correct application of rule 10b-4 would have controlled the court's decision. *Id.*

285. *See Bobker*, 808 F.2d at 937 (arbitrators did not "understand . . . and deliberately ignore" the meaning of regulation, therefore, no "manifest disregard"); *see also id.* at 937-38 (Meskill, J., concurring)(substantive judicial review of arbitral decision concerned only with intentional disregard of settled legal principles).

286. Shearson/American Express Inc. v. McMahon, __ U.S. __, __, 107 S. Ct. 2332, 2359, 96 L. Ed. 2d 185, 219 (1987)(Blackmun, J., concurring in part, dissenting in part). Whether the lower courts will respond to Justice Blackmun's appeal remains to be seen. Court decisions vacating arbitration awards on the grounds of partiality are rare. *See* Tamari v. Bache Halsey Stuart, Inc., 619 F.2d 1196, 1199-1202 (7th Cir. 1980)(bias must be direct and manifest to justify vacating award). The difficulty in demonstrating bias is compounded by the

VI. CONCLUSION

Since the Court's decision in *Byrd*, securities litigation has largely become litigation about arbitration. In light of *McMahon*, the focus should shift to the substantive law of arbitration. As more investor claims are resolved by arbitration, the sophisticated plaintiffs' bar that has emerged over the years will undoubtedly adjust to arbitration procedures and use them to their clients' advantage. Conversely, arbitration panels, which are comprised by and large of persons familiar with the business of the securities industry, can be expected to resolve customer claims in a manner sensitive to the economic realities and inherent risks of the market. So long as arbitrators, conduct themselves fairly and impartially, the resolution of customer claims in arbitration, as in litigation, will turn on the merits of the dispute, not the forum in which it is decided.

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fact that arbitrators are not required to provide reasons for their awards. *See* Shearson Hayden Stone, Inc. v. Liang, 653 F.2d 310, 312 (7th Cir. 1981). However, the lack of a recorded rationale for an arbitral decision may arouse a court's suspicion as to the objectivity of the arbitrators. In *Tinaway v. Merrill Lynch & Co.*, 658 F. Supp. 576 (S.D.N.Y. 1987), for example, the court held that an arbitration panel's award of five percent of an investor's documented loss, in the absence of some stated basis, could "only represent 'evident impartiality' on the part of the arbitrators . . . ." *Id.* at 579.