

**DEFENSES TO CUSTOMER CLAIMS AGAINST
STOCKBROKERS**

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DEFENSES TO CUSTOMER CLAIMS AGAINST STOCKBROKERS

I. DEFENSES TO CHURNING, SUITABILITY AND UNAUTHORIZED TRADING CLAIMS

A. The Elements of Causes of Action for Churning, Unsuitable Recommendations and Unauthorized Trading

1. Churning of a brokerage account occurs when a broker who exercises control over the trading engages in an excessive number of transactions in order to generate commissions. *See, e.g., Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1368-69 (7th Cir. 1983). To prevail on a churning claim, the customer must prove three elements: (1) control of the account by the broker; (2) trading activity that is excessive in light of the customer's investment objectives; and (3) that the broker acted with scienter, *i.e.*, intent to defraud or reckless disregard of the customer's interests. *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 489 (6th Cir. 1990).
2. While a churning claim is a challenge to the quantity of transactions, a suitability claim challenges the quality of the investments recommended by the broker. To prevail on a suitability claim, the customer generally must prove: (1) that the broker recommended securities that are unsuitable in light of the customer's investment objectives; and (2) that the broker did so with intent to defraud or with reckless disregard for the client's interests. *E.g., Brown v. E.F. Hutton Group Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1991).
3. Unauthorized trading is the execution of transactions without the customer's prior consent. This is commonly pled as a breach of contract.

B. The Customer Cannot Prevail on a Churning Claim if the Customer Retained Control Over the Activity in the Account.

1. Control of the account by the broker can be express, as in the case of a discretionary account, or implied (*de facto* control).
 - a. Express control exists where the customer has a discretionary account established pursuant to a written agreement in which the customer has given the broker discretion to trade the

account without consulting the customer in advance regarding each transaction. The broker for a discretionary account is a fiduciary vis-a-vis the customer. The vast majority of retail brokerage accounts are nondiscretionary.

- b. Whether the broker has implied or *de facto* control over the account is determined by a number of factors related to the sophistication of the customer. “The touchstone is whether or not the customer has sufficient intelligence and understanding to evaluate the broker’s recommendations and to reject one when he thinks it unsuitable . . . As long as the customer has the capacity to exercise the final right to say ‘yes’ or ‘no,’ the customer controls the account.” *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982). “[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.” *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975).
- c. The factors relevant to the customer’s sophistication and control of the account may include:
 - (1) The customer’s age;
 - (2) The customer’s education;
 - (3) The customer’s business experience;
 - (4) The customer’s prior investment experience;
 - (5) The customer’s knowledge regarding investments;
 - (6) How frequently the customer spoke with the broker;
 - (7) The extent to which the customer initiated trades (*i.e.*, placed unsolicited orders) or rejected advice of the broker (*note*: the fact that the broker recommended all or nearly all the securities purchased does not in and of itself prove that the broker controlled the account; most customers of full-service brokerage firms follow their broker’s recommendations to a large extent. *See Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 956 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981));

- (8) The nature of the relationship between the broker and the customer--an arm's-length business relationship suggests customer control of trading; a family relationship or close personal friendship may be evidence that the broker controlled the account.
- d. The broker-dealer should request from the customer in discovery documents pertinent to "control" and customer sophistication, including:
- (1) The customer's tax returns for years during which the account was traded and for several years before the account was opened; tax returns will show not only income and sources of income, but also information regarding securities sold through other broker-dealers, how the customer describes his occupation to the IRS, whether the customer owns real estate, etc.;
 - (2) Account agreements, monthly statements, and confirmation slips for other brokerage accounts maintained by the customer either prior to or contemporaneously with the account at issue (these records may be obtained from the other brokerage firms using an arbitration subpoena or Notice to Produce in an industry arbitration if the customer no longer has the records);
 - (3) In some cases, the customer's bank statements;
 - (4) Pleadings and transcripts from any other securities-related litigation to which the customer has been a party;
 - (5) Investment-related periodicals or other literature that the customer reads;
 - (6) All documents the customer ever sent to or received from the broker-dealer;
 - (7) All notes, computer entries or other records made by the customer to track his investments;
 - (8) All documents (*e.g.*, prospectuses, news articles, quarterly reports) in the customer's possession regarding the securities, or issuers of the securities, at issue.

The NASD Discovery Guide provides lists of documents that customers (and broker-dealers) should consider presumptively discoverable without arbitrator intervention.

The Discovery Guide is as its name implies – a guide for the parties and the panel. A party may request from its opponent materials that are not listed, or convince the arbitrators that it should not be required to produce to its opponent certain of the items that are listed.

e. Representative cases dealing with “control” and customer sophistication:

- (1) *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384 (10th Cir. 1987) (no control by the broker where evidence showed customer owned several businesses and rental property, spoke with broker almost daily, knew how to use broker’s computer, and occasionally rejected broker’s recommendations);
- (2) *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (evidence that investor routinely followed broker’s recommendation is important consideration but not determinative of control; to hold otherwise would prevent imputing control to highly sophisticated investor who actively monitors account but typically does not disagree with broker);
- (3) *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677-78 (9th Cir. 1982) (no control by broker where customer had degree in economics, read and understood corporate financial reports, and regularly read investment literature);
- (4) *Newburger, Loeb & Co., Inc. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978) (no control by broker where customer had post-graduate degree, years of experience in the market, and subscribed to investment services);
- (5) *Cummings v. A.G. Edwards & Sons, Inc.*, 733 F. Supp. 1029, 1031-32 (M.D. La. 1990) (no control by broker where customer declined to follow broker’s recommendation, reviewed account statements, and was actively involved in decision-making);

(6) *Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391 (D.Md. 1986) (no control by broker where customer was experienced investor, had other brokerage accounts, and had sued a prior broker);

(7) *M&B Contracting Corp. v. Dale*, 601 F. Supp. 1106 (E.D. Mich. 1984), *aff'd*, 795 F.2d 531 (6th Cir. 1986) (no control by broker where relationship with customer was arm's length and customer had some education or experience).

C. A suitability claim should be denied if the broker did not recommend the securities.

1. Discount brokerage firms, which do not make investment recommendations, are not normally responsible for monitoring the suitability of investment decisions made by their clients or for preventing their clients from making inappropriate trades. *E.g.*, *Unity House, Inc. v. North Pacific Investment, Inc.*, 918 F.Supp. 1384 (D. Haw. 1996); *Chee v. Marine Midland Bank, N.A.* [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,806 (E.D.N.Y. 1991); *First Union Discount Brokerage Serv., Inc. v. Milos*, 744 F. Supp. 1145, 1157 (S.D. Fla. 1990), *aff'd*, 997 F.2d 835 (11th Cir. 1993).

D. New frontiers for suitability issues.

1. A recommendation for suitability purposes is a suggestion of a particular security made to a particular client in view of that client's objectives. General communications, such as sending newsletters or providing access to institutional research, traditionally have not been regarded as "recommendations."

The ability of on-line brokers automatically to transmit information about specific securities to parts of their client base that fit certain investor profiles raises new issues, for both regulators and private litigants, as to when the distribution of general information crosses the line and becomes a "recommendation" with corresponding suitability obligations.

2. In 2000, the NASD adopted Day-Trading Rules (NASD Conduct Rules 2360 and 2361) that apply to firms that "promote" (as opposed to "recommend") "day-trading strategies." The rules are

directed primarily at day-trading firms that offer on-site trading facilities to their customers, as opposed to on-line or more traditional brokerage firms.

Rules 2360 defines a “day-trading strategy” as “an overall strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.” The “promotion” of day-trading strategies might be done through advertising, seminars, or direct contact with customers.

These rules take a two-pronged approach – disclosure and account approval. Firms promoting day-trading strategies most deliver a risk disclosure document, fitting the requirements of Rule 2361, to each noninstitutional customer prior to opening a new account. In order to approve an account for day-trading, the firm must have a reasonable basis for determining that such a strategy is “appropriate” for the customer.

Although, as noted in section I(H) below, there is no private cause of action for violation of NASD rules, customers will likely seek to bring these regulatory requirements to bear in the civil litigation context.

E. The Defense of Lack of Scienter to Churning and Suitability Claims.

1. Churning and suitability claims are essentially fraud claims and may be pled under §10(b) of the Securities Exchange of 1934 and Rule 10b-5 or under common law fraud principles.
2. To prove a claim for churning or unsuitable recommendations, the customer must establish that the broker acted with scienter - an intent to defraud or, at a minimum, reckless disregard for the customer’s interests. No broker is an insurer or guarantor against losses. A broker’s poor judgment in giving advice, without more, is not actionable. *E.g., Trustman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984-1985] Fed. Sec. L. Rep. (CCH) ¶91,936 (C.D. Cal. 1985).

F. Defending the Trades on the Merits in Churning and Suitability Cases.

1. Whether the number of trades in an account is excessive and whether the recommendation of a particular security was unsuitable must be judged by reference to the customer’s

investment objectives. Transactions are necessarily more frequent and of a shorter duration in an account that is intended to be traded to generate short-term profits than in an account that is intended to hold income-producing securities over the long term. Likewise, accounts for which the investment objective is growth or speculation are likely to have different types of securities or a different mix of types of securities than accounts for which income is the sole investment objective. Evidence of the customer's investment objectives is found in conversations between the broker and the customer, and on opening account documents and agreements for the account where investment objectives generally are indicated in writing.

2. Prospectuses, financial reports of the issuer, and research coverage reports may be introduced by either side in a suitability case to prove the quality and the nature of the investment.
3. In churning cases, the customer may introduce any one of several mathematical calculations to try to show that the trading was excessive from an objective standpoint.
 - a. The more common formulas include:
 - (1) The turnover rate or turnover ratio - the ratio of the total cost of purchases made for the account during a given period of time to the amount invested. Whether a particular turnover rate is excessive depends on the investment objectives of the customer, but numerous courts have recognized that a turnover ratio of less than 2.0 is presumptive evidence that the account was not churned. *E.g.*, *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490-91 (6th Cir. 1990); *Hempel v. Blunt, Ellis & Loewi, Inc.*, 123 F.R.D. 313, 317 (E.D. Wis. 1988); *Siegel v. Tucker, Anthony & R.L. Day, Inc.*, 658 F. Supp. 550, 554 (S.D.N.Y. 1987);
 - (2) In-and-out trading - the sale of all or part of a customer's portfolio, with the proceeds reinvested in other securities, followed by the sale of the newly acquired securities. *E.g.*, *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 n.2 (6th Cir. 1990);
 - (3) Commissions as a percentage of the equity in the account, or as a percentage of the broker's total commission income.

- b. Turnover rates and other formulas proffered by the customer should be carefully scrutinized for mathematical and theoretical errors.

G. The Affirmative Defenses of Ratification, Waiver, and Estoppel in Churning and Unauthorized Trading Cases.

1. A customer cannot wait to see whether an investment proves to be profitable or unprofitable before he complains that the transaction was unauthorized, or that the trading was excessive. A customer who receives trade confirmation slips, monthly account statements, or other information reflecting that transactions have occurred and the nature and frequency of those transactions, and who fails to complain in a timely fashion, may have his claims barred under the doctrines of ratification, waiver, and estoppel - three variations on the same defense.
2. If the customer receives confirming documents and does not object, by his silence he has ratified the trades, or waived his claim. *E.g., Brophy v. Redivo*, 725 F.2d 1218 (9th Cir. 1984); *Jaksich v. Thompson McKinnon Securities Inc.*, 582 F. Supp. 485 (S.D.N.Y. 1984); *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591 (S.D.N.Y. 1981).
3. Likewise, a customer who was aware of the transactions in his account and failed to object timely is estopped to assert that the transactions were unauthorized or excessive. *E.g., Ocrant v. Dean Witter & Co.*, 502 F.2d 854, 858-59 (10th Cir. 1979); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373-74 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973).
 - a. Estoppel may also bar a customer who signs a subscription agreement affirming that he meets the suitability standards for the product from pursuing a claim that recommendation of the investment was unsuitable. *E.g., Porter v. Shearson Lehman Brothers, Inc.*, 802 F. Supp. 41, 63-64 (S.D. Tex. 1992).
4. A ratification or waiver defense may fail if the customer proves that he did not have all the material facts relating to the trade at issue. *E.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1213 (8th Cir. 1990); *Huppmann v. Tighe*, 100 Md. App. 655, 642 A.2d 309, 314-315 (1994).

H. No Private Right of Action.

1. Churning and suitability claims may be stated under §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, or as common law fraud. Although the SRO's (securities industry self-regulatory organizations such as the NASD and the New York Stock Exchange) have rules requiring brokers to "know your customer" and to recommend only suitable transactions, there is no private right of action for violation of SRO rules, or internal broker-dealer policies and procedures. *E.g.*, *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 681 (9th Cir. 1980) (no implied private right of action under NASD suitability rule); *Jaksich v. Thompson McKinnon Securities Inc.*, 582 F. Supp. 485, 499-501 (S.D.N.Y. 1984) (no private cause of action under NASD and NYSE rules); *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 596 (S.D.N.Y. 1981) (no private cause of action by customer against broker for violations of house margin requirements, which are established primarily to protect the broker).
2. Violations of SRO rules or company policy may be relevant, however, to prove a statutory or common law claim.

II. DEFENSES PERTINENT TO OTHER COMMON CAUSES OF ACTION

- A. A broker has no duty to accept an order from a customer unless a firm (unambiguous) order is placed and the broker may refuse to accept the order provided he makes clear at the time the order is given that he refuses to accept it so the customer can attempt to have the order executed through another broker-dealer. *E.g.*, *Courtland v. Walston & Co., Inc.*, 340 F. Supp. 1076, 1080 (S.D.N.Y. 1972) (stockbroker need not accept the orders of a customer so long as he makes clear at the time the orders are given that he refused to perform them); *Busch v. L.F. Rothschild & Co.*, 259 N.Y.S.2d 239, 240 (1965) (stockbroker is not obligated to accept order to sell bonds from margin account; "a stockbroker is an agent for the customer. Unless he accepts the agency he has no duty to execute any order and may refuse to do so.").
- B. Claims alleging improper liquidation of margin accounts are often limited by the fact that the courts generally hold that there is no private right of action for violation of the regulatory rules governing the conduct of margin accounts, and because the margin agreements between customers and broker-dealers generally have broad language

giving the broker-dealer discretion in the setting of house maintenance requirements and in liquidating securities.

- C. The customer has an obligation to mitigate his damages. The customer cannot recover losses incurred after he decided to hold a security after becoming aware of the alleged wrongdoing that caused him to buy the stock. *In re Olympia Brewing Co. Securities Litigation*, [1985-1986] Fed. Sec. L. Rep. (CCH) ¶ 92, 461 at 92, 821 (N.D. Ill. 1985).
- D. A claim that a broker made misrepresentations regarding a particular security must meet the requirements for pleading fraud at common law or under §10(b) and is subject to the traditional defenses to such claims, including lack of scienter, absence of reasonable reliance by the customer, truthfulness of all representations, and failure of causation.

III. STATUTE OF LIMITATIONS DEFENSES

- A. Claims brought under §10(b) of the Securities Exchange Act of 1934 and Rule 10(b)(5) must be brought within one year after discovery of the facts constituting the alleged fraud, or at most within three years after the transaction. *Lampf Pleva Lipkind Prupis & Petigrow v. Gilbertson*, 501 U.S. 1277 (1991).
- B. The Pennsylvania state statute of limitations on tort claims is two years. 42 Pa.C.S. §5524(7). This includes common law fraud claims, negligence claims, and breach of fiduciary duty claims. Breach of fiduciary duty is a tort subject to the two-year statute of limitations. *See Zimmer v. Gruntal & Co.*, 732 F. Supp. 1330, 1336 (W.D. Pa. 1989). Common law “discovery” and “fraudulent concealment” principles apply and may toll the two-year period in some cases.
- C. The statute of limitations in Pennsylvania for breaches of contract is four years. 42 Pa.C.S. §5525.

IV. JURISDICTIONAL SIX-YEAR BARS

- A. The Arbitration Rules of the NASD (Rule 10304) and the NYSE (Rule 603) have long provided that no claim is eligible for submission to arbitration unless it is filed within 6 years of the event or occurrence giving rise to the claim.

- B. These six-year bars are jurisdictional prerequisites to arbitration and do not extend the state and federal statutes of limitations that apply to the claims.

- C. In the Third Circuit, it is for the courts, not the arbitrators, to determine whether a claim is precluded from arbitration under one of the 6-year eligibility rules. *PaineWebber Inc. v. Hofmann*, 984 F.2d 1372 (3d Cir. 1993); *PaineWebber Inc. v. Hartmann*, 921 F.2d 507 (3d Cir. 1990).