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**CUSTOMER SOPHISTICATION AND A PLAINTIFF'S DUTY
OF DUE DILIGENCE: A PROPOSED FRAMEWORK FOR
CHURNING ACTIONS IN NONDISCRETIONARY
ACCOUNTS UNDER SEC RULE 10b-5**

INTRODUCTION

Fraudulent broker practices often arise from the conflicting interests of a broker, who earns commissions based on the dollar amount and number of transactions, and a customer, who risks his capital and its profitability on the quality of the investment decisions.¹ Churning occurs when the broker causes the customer's account to be traded excessively for the purpose of generating commissions.²

To succeed in an action for churning under section 10(b) of the Securities Exchange Act of 1934 (1934 Act)³ and Rule 10b-5,⁴ the plaintiff must prove that there was excessive trading, that the broker acted with scienter and that the broker controlled the account.⁵

Courts and commentators recognize that there is no single formula for showing that an account has been traded excessively.⁶ The standard of measurement depends on the nature of the account.⁷ This, in turn, is a

1. See *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977), *aff'd in relevant part*, 570 F.2d 38, 42 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); 1 S. Goldberg, *Fraudulent Broker-Dealer Practices* XXV (1978); Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 Bus. Law. 571, 573 (1984).

2. See, e.g., *Bowley v. Stotler & Co.*, 751 F.2d 641, 644 (3d Cir. 1985); *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 773 (9th Cir. 1984); *Costello v. Oppenheimer & Co.* 711 F.2d 1361, 1367 (7th Cir. 1983).

3. Ch. 404, § 10(b), 48 Stat. 881, 891 (1934) (codified as amended at 15 U.S.C. § 78j(b) (1982)). Section 10(b) reads in relevant part, "[i]t shall be unlawful for any person . . . (b) To use or employ, . . . 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).

4. 17 C.F.R. 240.10b-5 (1985), which reads in relevant part, "[i]t shall be unlawful for any person . . . (a) To employ any device, scheme, or artifice to defraud, . . . (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person"

5. *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 2 (1st Cir. 1983); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

6. *Karlen v. Ray E. Friedman & Co., Commodities*, 688 F.2d 1193, 1203 (8th Cir. 1982); *Booth v. Peavy Co. Commodity Servs.*, 430 F.2d 132, 134 (8th Cir. 1970); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); 2 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 5.7(322), at 5:82.103 (1985); 1 S. Goldberg, *supra* note 1, § 2.9, at 2-41; Lowenfels, *A Report on Churning Actions Under Federal Securities Laws*, N.Y.L.J., Mar. 26, 1986, at 18, col. 3.

7. *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975) ("structure and investment objectives of an account" relevant to determination of excessive trading). A higher volume of trading is necessary to support a claim of churning in a trading account, where the customer's purpose is to realize short term gain on the purchase and sale of securities,

function of the customer's stated goals, purposes and financial resources.⁸ Once the nature of the account is determined, the trier of fact examines the entire course of trading for evidence of excessive volume.⁹

than in an investment account, where the customer hopes to derive dividend income and conserve principal. *See* Landry v. Hemphill, Noyes & Co., 473 F.2d 365, 373 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973).

8. *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983) (customer investment goals are standards against which excessiveness may be measured); Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. 1981) (broker's management of account analyzed in comparison to needs and desires of investor); Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980) (volume of trades must be examined in light of customer's trading objectives); Lang v. Paine, Webber, Jackson & Curtis, Inc., 582 F. Supp. 1421, 1428 (S.D.N.Y. 1984) (detection of fraud requires awareness that trading is excessive in light of dollar value of account and customer's objectives).

9. Single transactions or limited groups of trades do not constitute churning. Miley v. Oppenheimer & Co., 637 F.2d 318, 327 (5th Cir. 1981). Churning, as a unified offense, requires hindsight analysis of the broker's management of the account. *Id.*

One of the factors tending to show excessive trading is the turnover rate. Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983). The turnover rate is the ratio of the total cost of purchases made over a period of time to the amount invested. This rate reflects how many times in a given period the securities in a customer's account have been replaced by new securities. Whether a particular turnover rate is excessive depends on the customer's objectives. *Id.* at 1369 n.11. It has been suggested that "an annual turnover rate of six reflects excessive trading." Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980).

Another factor is the frequency of in and out trading. Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983). In and out trading occurs when all or part of a customer's portfolio is sold, and the money is reinvested in other securities that are in turn sold to finance the purchase of another set of securities. It is difficult for the broker to justify such a practice. *Id.* at 1369 n.9. It has been suggested that if in and out trading involves 75% of the portfolio during a six-month period, 50% during a three-month period, or 25% during a one-month period, it may indicate excessive trading when there are a sufficient number of transactions to be statistically relevant. *See* 1 S. Goldberg, *supra* note 1, § 2.9[b][2], at 2-52.

Another factor is the commission ratio. Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983). This is the ratio between the broker's commission and the size of the account. *Id.* An annual commission ratio approximately 25% of the size of the investor's equity may indicate excessive trading. *See* 2 A. Bromberg, *supra* note 6, § 5.7(322)(2), at 5:82.108.

Multiple trading is another relevant factor. *See* R.H. Johnson & Co., 36 S.E.C. 467, 471, 474 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956). Multiple trading is a variant of in and out trading in which the broker induces the customer to buy stock A, to sell it shortly thereafter to obtain the capital to buy stock B, and then after holding it briefly, to sell stock B and reinvest in stock A. 1 S. Goldberg, *supra* note 1, § 2.9[c][1], at 2-62-2-63.

Cross trading is another relevant factor. *See* Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983). "'Cross trading' occurs where a broker arranges for transfers between customers. It is a . . . suspect practice unless the dealer can demonstrate that the accounts had different purposes and that the particular securities were suitable for one account but not another." *Id.* at 1369 n.10.

The frequent purchase of poor quality investments may also indicate excessive trading. *See* Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 842 (E.D. Va. 1968); 2 A. Bromberg, *supra* note 6, § 5.7(322)(4), at 5:82.116 to -17. Poor quality securities include those rated less than investment grade by Standard and Poor. *Id.* at 5:82.117 (quoting Stevens, 288 F. Supp. at 842).

The frequent purchase of unsuitable investments is also relevant. *See* Twomey v.

The Supreme Court did not formally impose a scienter requirement¹⁰ on all Rule 10b-5 actions until *Ernst & Ernst v. Hochfelder*,¹¹ although prior lower court rulings recognized that proof of the broker's purpose was a necessary element in a churning action.¹² Some courts, in addition to imposing the general scienter requirement, have considered evidence of the broker's motivation in determining whether there has been excessive trading.¹³ One court has even indicated that scienter need not al-

Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 718, 69 Cal. Rptr. 222, 241 (1968) (purchase of unsuitable securities taints dealings and supports finding of churning); Note, *Churning by Securities Dealers*, 80 Harv. L. Rev. 869, 871 (1967) (National Association of Securities Dealers (NASD) action against broker for churning based on repeated purchase of unsuitable investments upheld by Securities and Exchange Commission (SEC)) [hereinafter cited as *Churning*]. Unsuitable investments are distinguishable from poor quality investments because unsuitability is determined by reference to the particular customer. See *Twomey*, 262 Cal. App. 2d at 718, 69 Cal. Rptr. at 241.

Another factor considered relevant is the percentage of the broker's total income derived from commissions on the account. See *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 436 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *R.H. Johnson & Co.*, 36 S.E.C. 467, 474 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956). However, this measure is more relevant to the issue of broker's motivation than to excessive trading, see 1 S. Goldberg, *supra* note 1, § 2.9[b][3], at 2-55 to -56; cf. *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976) (same measure used as evidence of scienter), *aff'd*, 560 F.2d 547 (2d Cir. 1977), because it does not measure the volume of trading in the account itself. For a discussion of the recklessness standard as a basis for Rule 10b-5 liability, see *Milich Securities Fraud under § 10(b) and Rule 10b-5: Scienter, Recklessness and the Good Faith Defense*, 2 J. Corp. L. 179 (1986).

10. Scienter "refers to a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976). Although the Supreme Court did not address the question whether reckless behavior is sufficient to create civil liability under § 10(b) and Rule 10b-5, *see id.*, some lower courts have recognized that willful or reckless conduct can create liability in a churning action. See, e.g., *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980); *M & B Contracting Corp. v. Dale*, 601 F. Supp. 1106, 1112 (E.D. Mich. 1984); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1039 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 400 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

11. 425 U.S. 185 (1976).

12. See, e.g., *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 134 (8th Cir. 1970) (pattern of trading used to indicate that broker's purpose was to generate commissions); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 380 (N.D. Okla. 1975) (dealer's profits compared with size of customer's account to determine whether broker's purpose was to generate commissions); *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 845 (E.D. Va. 1968) (churning involves improper purpose on the part of the broker); *see also E.H. Rollins & Sons Inc.*, 18 S.E.C. 347, 380 (1945) (it must be determined whether broker induced excessive trading for purpose of obtaining profits for themselves).

13. Compare *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976) (high percentage of broker total income earned in commissions from account at issue considered evidence of scienter), *aff'd*, 560 F.2d 547 (2d Cir. 1977) with *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 436 (N.D. Cal. 1968) (high percentage of broker's total commissions earned from account at issue is evidence of excessive trading), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *see also Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 380 (N.D. Okla. 1975) (comparison of size of broker's commission to size of customer's account used to demonstrate excessive trading with purpose to generate commissions).

ways be proved separately because it may be implicit in the broker's conduct.¹⁴ Other circuits have imposed the burden of proving scienter as a separate element of the claim.¹⁵ Commentators have suggested that this apparent disagreement is based more on form than on substance because it is difficult for scienter to be absent given the requisite demonstration of broker control and broker purpose.¹⁶ Thus, although some courts consider the broker's requisite mental state as indicative of excessive trading,¹⁷ these issues generally are more appropriately kept distinct.¹⁸

It has been suggested that broker liability is premised on his control of the account.¹⁹ This control provides the causal connection between the defendant broker's conduct and the plaintiff's loss.²⁰ Proof of broker control is necessary for discretionary²¹ as well as nondiscretionary accounts.²² When the customer has granted the broker the power to trade without prior authorization, actual control may be proved by reference

14. See *Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983) (scienter may be implicit in nature of broker's conduct).

15. See, e.g., *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 2 (1st Cir. 1983); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

16. See 2 A. Bromberg, *supra* note 6, § 5.7(323), at 5:82.119; N. Poser, *supra* note 1, at 585 (1984).

17. See *supra* notes 9, 12-13 and accompanying text.

18. A finding of excessive trading depends on a hindsight analysis of the history of the account. Thus, no single trade or identifiable series of trades constitutes a "but for" cause of the offense. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981). Factors that indicate scienter tend to involve single trades (for example, cross trading, see *supra* note 9) small groups of trades (for example, multiple trading, see *supra* note 9) or do not refer to the volume of trading in the account (for example, the percentage of the broker's total income derived from the account at issue, see *supra* note 9). When factors that go to determining volume are commingled with those determining purpose, there is a danger that a broker will be found liable for churning solely on the basis of transactions that, while indicative of improper motivation, do not prove excessive trading. Only the commission ratio, see *supra* note 9, which considers both the total volume of transactions and the benefit derived by the broker, is appropriate evidence for both issues.

19. See *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (dictum) (dealer's culpability for trading may be found when there is a discretionary grant of authority or when he occupies such a position with respect to customer that he may be held responsible for excessive trading); *Churning*, *supra* note 9, at 870 ("fact that a customer has given the dealer control over his account justifies the presumption that he relied on the dealer to act primarily as an investment counselor, even though he may have been aware to some degree of the dealer's adverse interest.").

20. See *Thomson & McKinnon*, 35 S.E.C. 451, 454 (1953) (broker not guilty of overtrading in accounts when customer controls trading); *Churning*, *supra* note 9, at 870 (when customer has given dealer control over account, broker has no justification for using his control to maximize his profits); see also *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 (3d Cir. 1981) (in misrepresentation action under Rule 10b-5 reliance is "one aspect of the ubiquitous requirement that losses be causally related to the defendant's wrongful acts"), *cert. denied*, 455 U.S. 938 (1982).

21. See *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 & n.8 (7th Cir. 1983) (proof of control required for discretionary account).

22. See *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676-77 (9th Cir. 1982) (proof of control required for nondiscretionary accounts).

to the brokerage contract.²³ Even when the customer retains the authority to approve each transaction—a nondiscretionary account—the broker will be found liable when he has assumed de facto control of the account.²⁴ De facto control requires a finding that the broker abused the customer's trust and confidence by causing excessive trading.²⁵ It is based on a determination of whether the customer relied on the broker's trading recommendations or reached an independent trading decision.²⁶ When the customer initiates the transactions in the account the broker generally may not be held liable for churning because he cannot be said to control the account.²⁷ A customer able to make independent trading decisions may be termed "sophisticated"²⁸ and may be deemed to retain control of the account,²⁹ even if he may have routinely relied on the bro-

23. See *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368-69 (7th Cir. 1983) (broker control established when customer has granted broker power of attorney).

24. *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980); 1 S. Goldberg, *supra* note 1, § 2.8[a], at 2-24; see also *Churning*, *supra* note 9, at 871 (findings that churning existed were once restricted to discretionary accounts, but this is no longer true).

25. See *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1069 (2d Cir. 1977) (broker may have control when he abuses customer confidence), *cert. denied*, 434 U.S. 1035 (1978); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 432 (N.D. Cal. 1968) (broker abused trust and confidence and caused excessive trading), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *R.H. Johnson & Co.*, 36 S.E.C. 467, 485 (1955) (when plaintiff trusted and had confidence in the defendant, the defendant was obligated to act in his customer's best interests), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); see also *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982) (dictum) (discussing factors relevant to finding de facto control).

26. See *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982) (account may be in broker's control if customer unable to exercise independent trading judgment); *Carras v. Burns*, 516 F.2d 251, 258-59 (4th Cir. 1975) (issue is whether customer can independently evaluate broker's suggestions); *Moran v. Kidder Peabody & Co.*, 609 F. Supp. 661, 666 (S.D.N.Y. 1985) (when a customer has the independent capacity to accept or reject broker's recommendations, he cannot accuse broker of control); *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 956-57 (E.D. Mich. 1978) (customer who independently decides to accept broker's recommendations retains control of his account); see also *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (customer's routine reliance on broker's recommendations, sophistication as to securities matters and independent evaluations are equal considerations); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1069-70, (2d Cir. 1977) (if customer has capacity to evaluate his broker's advice and agrees with it, customer controls the account), *cert. denied*, 434 U.S. 1035 (1978).

27. See *Karlen v. Ray E. Friedman & Co., Commodities*, 688 F.2d 1193, 1203 (8th Cir. 1982) (churning cannot occur as to any trade directed by customer); *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 345, 350 (1945) (dealer not responsible for overtrading when transactions are initiated by investor). But see *Fey v. Walston & Co.*, 493 F.2d 1036, 1050 (7th Cir. 1974) (even trades initiated by the customer may indicate churning where a relationship of trust and confidence vests control in the broker).

28. See *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983); *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 n.8 (7th Cir. 1983); *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676-77 (9th Cir. 1982).

29. See *Yopp v. Siegel Trading Co.*, 770 F.2d 1461 (9th Cir. 1985) (sophisticated investor retains control of his account), *withdrawn from publication on other grounds* (available Apr. 28, 1986, on LEXIS, Genfed library, USAPP file); *Carras v. Burns*, 516

ker's recommendations.³⁰ A customer unable to reach an independent, informed decision may be termed "naive" and de facto control may be found.³¹

The courts' characterization of customers holding nondiscretionary accounts as sophisticated or naive has been inconsistent³² and confusing. One explanation for this inconsistency is that the distinction between the naive and sophisticated customer is a means for justifying a decision rather than a functional rule of law.³³ Although the inquiry into the customer's actual reliance on the broker focuses on whether the customer was actually influenced in his investment decisions by the broker's actions,³⁴ the focus of the inquiry into customer sophistication is whether the customer *should* have been influenced by them.³⁵ Thus, the inquiry

F.2d 251, 258 (4th Cir. 1975) (dictum) (finding that customer has competence to manage account ordinarily disposes of churning claim).

30. See *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982).

31. *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975) ("[l]ack of competence itself may give rise to an inference of [broker] control"); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 433 (N.D. Cal. 1968) (reliance on broker's recommendations may prove control, especially when customer is relatively naive and unsophisticated), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970).

32. Compare *Shorrock v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,251, at 92,676 (D. Or. 1977) (customer who routinely relied on broker's recommendations and who possessed intelligence and good judgment, but lacked business experience, found in control of account) with *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 817, 821 (9th Cir. 1980) (customer who routinely relied on broker's recommendations and who had master's degree in engineering and ten years investment experience found not to be in control of account). Although the Ninth Circuit in *Mihara* based its holding on the principle that routine reliance suffices to prove broker control, *see id.* at 821, the court later explained this holding as a shorthand form of the concept that routine reliance suffices to prove control when the customer is relatively naive and unsophisticated, *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982).

33. See *Churning*, *supra* note 9, at 872.

34. See *Grubbs*, 28 S.E.C. 323, 328 n.10 (1948) (churning can be found in nondiscretionary accounts when, "by reason of the trust and reliance of the customer," broker can "dictate or influence the timing and frequency of the transactions"); *Wheeler, Plaintiff's Duty of Due Care Under Rule 10b-5: An Implied Defense to an Implied Remedy*, 70 Nw. U.L. Rev. 561, 592-93 (1975) (distinguishing actual reliance requirement from duty of due care for 10b-5 actions alleging omission or misrepresentation).

35. The touchstone of the sophistication inquiry "is whether or not the customer has sufficient intelligence and understanding to evaluate the broker's recommendations" and to reject them when he finds them inappropriate. *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982); *see Bowley v. Stotler & Co.*, 751 F.2d 641, 648-49 (3d Cir. 1985) (citing *Follansbee*, 681 F.2d at 677). However, as a result of the broker's greater access to financial information and research and support facilities, even the sophisticated customer who seeks advice from the broker is expected to rely on those recommendations or disassociate himself from the broker. *See Follansbee*, 681 F.2d at 677.

If the sophisticated customer is actively monitoring his account, he probably will be found to be in control of it. *See Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (sophisticated customer who monitors account and doesn't disagree with broker retains control). Because the pattern of trading must indicate a purpose to benefit the broker by generating excessive commissions, *see Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 (7th Cir. 1983), *see supra* notes 6-19 and accompanying text, it is unlikely that the sophisticated investor would intend to trade in a manner that is not merely

into customer sophistication is really an equivalent of the Rule 10b-5 requirement that the customer exercise good judgment and due care in order to recover damages.³⁶ This requirement is termed due diligence.³⁷

Due diligence requires a plaintiff to take reasonable steps to safeguard his interests and to exercise good judgment in making investment decisions. A plaintiff who has not exercised due diligence will not be eligible to recover money damages.³⁸ Courts disagree both on the standard of

unprofitable, but also against his interest. See *supra* note 1 and accompanying text. It can be inferred then, that the inquiry into customer sophistication is premised on denying recovery to plaintiffs who have the capacity to manage their affairs but do not show good judgment and due care in doing so.

At least one court has recognized that recovery for churning should be denied if the customer is insufficiently careful in the supervision of his account. See *Petrites v. J.C. Bradford & Co.*, 646 F.2d 1033, 1035 (5th Cir. 1981) (dictum) (reckless plaintiff not allowed to recover under Rule 10b-5).

36. The equivalence of the rule denying recovery to sophisticated plaintiffs in a churning action and the rule denying recovery to a plaintiff who fails to exercise due diligence is underscored by the standards used by courts when applying these rules. In *M & B Contracting Corp. v. Dale*, 601 F. Supp. 1106 (E.D. Mich. 1984), the court indicated that indicia of control for purposes of a churning action include:

- 1) the identity, age, education, intelligence, and investment and business experience of the customer; 2) the relationship between the customer and the account executive, that is, whether it is an arms-length one or a particularly close relationship; 3) knowledge of the market and the account; 4) the regularity of discussions between the account executive and the customer; 5) whether the customer actually authorized each trade; and 6) who made the recommendations for trades.

Id. at 1111. Similarly, in *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10th Cir. 1983), the court indicated that the relevant factors to determine whether plaintiff's reliance was reasonable include:

- (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations.

Id. at 1516.

37. See Comment, *A Reevaluation of the Due Diligence Requirement for Plaintiffs in Private Actions Under SEC Rule 10b-5*, 1978 Wis. L. Rev. 904, 904 (due diligence requires plaintiff to show good judgment and due care in his affairs) [hereinafter cited as *Diligence*].

Due diligence is synonymous with both the duty of care and the question of reasonable reliance. See Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs be Denied Recovery?*, 71 Cornell L. Rev. 96, 101 & n.22 (1985). The duty of care is an element in determining whether a particular plaintiff should be allowed to recover. See Wheeler, *supra* note 34, at 592. The plaintiff will be denied recovery for lack of due diligence if he disregards a risk known to him or if the risk is so obvious that he should have been aware of it. The risk must be so great as to make it highly probable that harm would result. See *Gower v. Cohn*, 643 F.2d 1146, 1156 (5th Cir. 1981) (citing *Dupuy v. Dupuy*, 551 F.2d 1005, 1120 (5th Cir. 1977) (citing W. Prosser, *Torts* § 34, at 185 (4th ed. 1971)), *cert. denied*, 434 U.S. 911 (1977)). Due diligence has been applied as a standard for evaluating a plaintiff's right to recover in a churning action. See *Petrites v. J.C. Bradford & Co.*, 646 F.2d 1033, 1035 (5th Cir. 1981).

38. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir. 1977) (only those who have

conduct that will fulfill the plaintiff's duty of due diligence³⁹ and on whether such an inquiry is properly an element of the *prima facie* case⁴⁰ or an affirmative defense.⁴¹ These disagreements should be evaluated under the two prong standard set forth by the Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*.⁴² Under the first prong, the court must determine that the plaintiff's culpability at least equals the defendant's before it may serve to preclude recovery under Rule 10b-5.⁴³ The second prong requires a finding that precluding the suit will not significantly interfere with the protection of the investing public and the enforcement of the securities laws.⁴⁴

This Note proposes a new framework for analyzing Rule 10b-5 churning actions in nondiscretionary accounts that will reduce the confusion currently faced by brokers and investors. Part I discusses the proper elements of the plaintiff's *prima facie* case, distinguishing between factors that determine excessive trading and those that determine scienter. It then argues that both the legislative history of the 1934 Act and Securities and Exchange Commission (SEC) policy indicate that actual reliance should be sufficient to prove broker control. Part II argues that the customer's conduct in supervising his account should be evaluated by a comparative culpability standard, and will suggest factors that indicate such culpability. It argues that under *Bateman*, both the structure of the statute and policy considerations suggest that an inquiry into the customer's capacity to evaluate broker's recommendations is only appropriate as an affirmative defense.

I. THE PROPER CHURNING INQUIRY

Churning is considered a manipulative or deceptive device; it therefore

pursued their interests with care and good faith should recover under 10b-5), *cert. denied*, 434 U.S. 911 (1977). See *supra* note 37 and accompanying text.

39. The Fifth, Seventh, Tenth and Eleventh Circuits measure the duty of care by a recklessness standard. See *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983); *Gower v. Cohn*, 643 F.2d 1146, 1156 (5th Cir. 1981); *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 79 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1048 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); *Friedlander v. Nims*, 571 F. Supp. 1188, 1197 (N.D. Ga. 1983), *aff'd*, 755 F.2d 810 (11th Cir. 1985).

The Third Circuit applies a reasonableness standard. See *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 194 (3d Cir. 1981) (plaintiff fails to meet duty of due diligence when he acts unreasonably), *cert. denied*, 455 U.S. 938 (1982); *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976) (plaintiff must act reasonably).

40. See *Gower v. Cohn*, 643 F.2d 1146, 1156 (5th Cir. 1981); *Holdsworth v. Strong*, 545 F.2d 687, 696 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977); see also *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 79 (2d Cir. 1980) (plaintiff only required to prove he was not reckless when defendant put it at issue), *cert. denied*, 449 U.S. 1123 (1981).

41. See *J.H. Cohn & Co. v. American Appraisal Assocs.*, 628 F.2d 994, 998-99 (7th Cir. 1980); *Straub v. Vaisman & Co.*, 540 F.2d 591, 598 (3d Cir. 1976).

42. 105 S. Ct. 2622 (1985).

43. See *id.* at 2629.

44. See *id.*

violates section 10(b), the anti-fraud provision of the 1934 Act, and Rule 10b-5.⁴⁵ In a churning action, the inquiry should focus on three issues: first, whether the account was excessively traded, thus causing an injury;⁴⁶ second, whether the broker acted with scienter, which establishes whether the trading was for the purpose of generating commissions;⁴⁷ third, whether the customer relied on the broker, which in a nondiscretionary account establishes whether the broker controlled the account.⁴⁸

A. *Excessive Trading*

Whether the customer's account was excessively traded establishes whether an injury has occurred⁴⁹ and should be determined by a three step inquiry. First the customer's goals and financial resources must be determined.⁵⁰ Once the customer's investment goals and resources are determined, objective measures should be used to quantify the volume of trading in the account.⁵¹ The trier of fact should then compare these measures with the customer's objectives and resources to determine whether the account has been traded excessively.⁵²

The inquiry into the customer's investment goals should not focus on the customer's intelligence, education or securities trading background⁵³ because the customer's ultimate investment goal,⁵⁴ and not his capacity

45. See *Leib v. Merrill, Lynch, Pierce Fenner & Smith, Inc.*, 461 F. Supp. 951, 952 (E.D. Mich. 1978).

46. See *infra* Part I.A.

47. See *infra* Part I.B.

48. See *infra* Part I.C.

49. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 326 (5th Cir. 1981) (investor harmed by excessive trading in two ways: decline in the value of his portfolio and amount of commissions generated); *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (excessive trading generates profits for brokers).

50. See *supra* notes 7-8 and accompanying text.

51. These measures include the turnover rate, the frequency of in and out trading and the commission ratio. See *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975) ("hallmarks [of churning] are disproportionate turnover, frequent in and out trading, and large brokerage commissions"). See *supra* note 9.

Churning is not localized to a single transaction or group of transactions. An excessive aggregation of transactions constitutes the offense. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 327 (5th Cir. 1981); *Fey v. Walston & Co.*, 493 F.2d 1036, 1050 (7th Cir. 1974). Therefore, a finding of churning can only be based on a hindsight analysis of the history of the account. See *Miley*, 637 F.2d at 327. Thus, the inquiry into whether the account was excessively traded should be restricted to those measures that relate to the overall pattern of trading and not to single transactions or limited groups of trades.

52. See *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 373 (1st Cir.) (volume of trading that might suffice to prove excessive trading in account where investment aims were solely to produce dividend income and conserve principle was insufficient to prove churning in trading account), *cert. denied*, 414 U.S. 1002 (1973); 1 S. Goldberg, *supra* note 1, § 3.2[a][1], at 3-7 to -9 (same).

53. But see *Fey v. Walston & Co.*, 493 F.2d 1036, 1045 (7th Cir. 1974); *Russo v. Bache Halsey Stuart Shields, Inc.*, 554 F. Supp. 613, 617 (N.D. Ill. 1982).

54. An investor's goals may be aggressive or speculative, which would necessitate active trading, or may be conservative or circumspect, which would require fewer trades. See *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 (7th Cir. 1983).

to plan investment strategies,⁵⁵ should be considered when determining the appropriate level of trading in the account. This is because churning frequently occurs when novice investors want to enter a profitable market.⁵⁶ By eliminating the inquiry into the customer's capacity to plan his investment strategies, disillusioned investors will properly be prevented from using their naivete as a sword against brokers who were merely pursuing their customer's investment goals.⁵⁷

B. *Scienter*

Scienter refers to a mental state embracing intent to deceive, manipulate or defraud.⁵⁸ In a churning action proof of scienter establishes that the broker caused the excessive trading for the purpose of generating commissions. Objective measures⁵⁹ are useful in determining the broker's motivation.⁶⁰ When the broker influences trading decisions these measures can support a finding of reckless disregard for the customer's interest.⁶¹

The trier of fact should then consider the specific trades and trading strategies recommended by the broker to determine whether the transactions involved could be justified for reasons other than to generate commissions.⁶² For example, if the broker has induced switching between securities,⁶³ an analysis of the number of switches and the overall profit

55. Strategies—the means of implementing an investment goal—may be characterized as sophisticated. See *Bowley v. Stotler & Co.*, 751 F.2d 641, 643 (3d Cir. 1985) (dictum) (customer's account reflected sophisticated market maneuvers such as spreads and straddles).

56. S. Jaffe, *Broker-Dealers and Securities Markets: A Guide to the Regulatory Process* § 15.04, at 314-15 (1977) (churning most often occurs in late stages of bull markets when there is a general increase in the volume of transactions and an influx of novice investors).

57. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 718-20, 69 Cal. Rptr. 222, 242-43 (1968) (dictum) ("sweet trusting widow" claiming conservative objectives may have asked for speculative recommendations); S. Jaffe, *supra* note 56, § 15.04, at 314 (courts are faced with factual problem of deciding if unsophisticated investor is simply greedy).

58. See *supra* note 10 and accompanying text.

59. These include the commission ratio and the percentage of the broker's total earnings derived from the account. See *supra* note 9.

60. See *supra* note 12 and accompanying text.

61. See *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976) (if high percentage of broker's total income was earned in commissions from account, court may infer scienter), *aff'd*, 560 F.2d 547 (2d Cir. 1977); *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 380 (N.D. Okla. 1975) (comparison of size of broker's commission with customer's equity demonstrates broker's purpose to generate commissions).

62. See *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977); see also *Arceneaux v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 767 F.2d 1498, 1502 (11th Cir. 1985) (plaintiff's expert testified that velocity of trading made no sense except to generate commissions).

63. Switching between securities is a form of in and out trading, see *supra* note 9 and accompanying text, in which, for example, the broker convinces the customer to sell security A, with a value of \$5000 and purchase security B, also valued at \$5000. The

can provide evidence of recklessness when the customer's profit has been substantially eroded by commissions.⁶⁴ Absent a reasonable explanation,⁶⁵ if the broker has recommended a purchase and shortly thereafter recommends a sale, or engages in multiple trading,⁶⁶ the transaction can provide evidence of a purpose to generate commissions. A few unjustified trades may merely indicate negligence, which is insufficient to support a claim of churning.⁶⁷ As the number increases, a higher degree of culpability may be inferred.⁶⁸ The percentage of poor quality recommendations will also serve as a guide in determining scienter. When the percentage is high, intent or reckless disregard may be inferred,⁶⁹ while a small percentage of such transactions may indicate only negligence.⁷⁰ Factors such as cross-trading,⁷¹ misrepresentation⁷² or unauthorized trading,⁷³ which either have no reasonable investment justification or are wrongful in themselves, should be considered strong evidence of scienter. Conversely, if the broker has widely published his recommendations, or engaged in many transactions that do not generate commissions, or has generally recommended investment in high caliber securities, these factors may negate a charge of recklessness.⁷⁴

C. Control

In determining whether the broker exercised sufficient control over a

broker earns commissions on both the sale and the purchase. The SEC considers this a single transaction. See Grubbs, 28 S.E.C. 323, 326 (1948); 1 S. Goldberg, *supra* note 1, § 2.9[c][3], at 2-66 to -67.

64. See *Karlen v. Ray E. Friedman & Co. Commodities*, 688 F.2d 1193, 1204 & n.12 (8th Cir. 1982) (churning found when, inter alia, customer's profits were exceeded by broker's profits); see also N. Poser, *supra* note 1, at 583 (same).

65. See *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976) (in typical churning case broker can offer no explanation or justification for his trading), *aff'd*, 560 F.2d 547 (2d Cir. 1977); S. Jaffe, *supra* note 56, at 311.

66. See *supra* note 9.

67. See *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976) (it is not "the purpose of the securities laws to guard against improvident or even negligent actions of [brokers]"), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

68. See *R.H. Johnson & Co.*, 36 S.E.C. 467, 474 (1955) (82% of purchases reversed in one year indicative of excessive trading with purpose to generate commissions), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956).

69. See *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 842 (E.D. Va. 1968) (investments constituting 22% of portfolio in poor quality stocks indicate indiscriminate trading).

70. See *supra* note 67 and accompanying text.

71. See *supra* note 9.

72. Broker misrepresentation is expressly prohibited by Rule 10b-5, which states: "It shall be unlawful for any person, directly or indirectly . . . [t]o make any untrue statement of a material fact or to omit to state a material fact" 17 C.F.R. § 240.10b-5 (1985).

73. Unauthorized trading occurs when a broker initiates transactions in a customer's nondiscretionary account without prior approval by the customer. See *Marshak v. Blyth Eastman Dillon & Co.*, 413 F. Supp. 377, 381 (N.D. Okla. 1975).

74. See *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 402 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

nondiscretionary account, the trier of fact should be limited to considering whether a substantial majority of trades were initiated on the broker's recommendation.⁷⁵ Proof of broker control over the account is necessary to establish the causal connection between the broker's actions and the plaintiff's losses.⁷⁶ Thus, actual reliance, and not the reasonableness of that reliance, is the key.⁷⁷ Analysis of the Securities Act of 1933⁷⁸ and the 1934 Act⁷⁹ indicates that actual reliance should be sufficient to demonstrate the causal connection between defendant's actions and plaintiff's injury.⁸⁰

75. When the customer initiates a majority or a substantial minority of the trades, his dependence on the broker is insufficient to justify the presumption that he relied on the broker to act as an investment counselor and not as an order-taker. *See Churning, supra* note 9, at 870 (dealer not in control of account when he is merely a conduit for customer's orders).

76. *Cf. Levinson v. Basic Inc.*, Nos. 84-3730, 84-3775, 84-3776, slip op. at 16 (6th Cir. Mar. 27, 1986) ("[r]eliance is the element of a Rule 10b-5 action that establishes the causal nexus between the defendant's wrongful conduct and the plaintiff's injuries."); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 (3d Cir. 1981) (in misrepresentation case under Rule 10b-5, court held that reliance is aspect of requirement that losses be causally connected to defendant's wrongful acts), *cert. denied*, 455 U.S. 938 (1982). Reliance is a determination whether the plaintiff was in fact influenced in his trading decisions by the defendant's statements. Reasonable reliance is a determination whether that plaintiff should have been influenced. *See, Wheeler, supra* note 34, at 592-93.

77. *See Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980) ("[T]he requisite degree of control is met when the client routinely follows the recommendations of the broker.").

78. Ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

79. Ch. 38, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

80. In enacting the federal securities acts, Congress intended to protect the investing public. *See H.R. Rep. No. 1383*, 73d Cong., 2d Sess. 7689, 78 Cong. Rec. 7702 (President's Message and Letter) (1934 Act is one step in broad purpose of protecting investors), *reprinted in* 4 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, 7689 at 7702 (J. Ellenberger & E. Mahar eds. 1973) [hereinafter cited as Legislative History]; 78 Cong. Rec. 7947 (1934) (statement of Rep. Fish) (purposes of bill include, inter alia, protection of investors and prevention of manipulation), *reprinted in* 4 Legislative History, *supra*, at 7947. Congress also intended to restore investor confidence, *see* 78 Cong. Rec. 7689 (1934) (remarks of Rep. Sabath), *reprinted in* 4 Legislative History, *supra*, at 7689, and provide for a fair and honest market place for the sale of securities. *See* 78 Cong. Rec. 7922 (1934) (remarks of Rep. Mapes), *reprinted in* 4 Legislative History, *supra*, at 7922. Although there is little mention of § 10(b) in either the floor debates or the house hearings, *see* 1 A. Bromberg, *supra* note 6, § 2.2(330), at 2:20-21; Sachs, *supra* note 37, at 120, the Supreme Court has used general legislative policy statements as a guide to the 1934 Act's interpretation. *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (1933 Act legislative history used to interpret § 10(b) and Rule 10b-5 action). This has been justified by the view that Congress intended the statute to be construed cumulatively. *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 383-87 & n.23 (1983). In the House Report on the 1934 Act, the legislature recognized that restoring investor confidence in a complex society required the investing public to trust others regarding their financial affairs and noted its intention to restore investor confidence by extending the legal concept of the fiduciary relationship. *See House Consideration, Amendment and Passage of H.R. 9323*, 73d Cong., 2d Sess., 78 Cong. Rec. 7703, *reprinted in* 4 Legislative History, *supra*, at 7703.

Legislative intent to expand the scope of this relationship is further evidenced by the emphasis on investor protection and the substitution of high business ethics for the rule of

Reliance on a broker's recommendations should be presumed in some circumstances as a consequence of the broker's responsibility to the client under normative rules.⁸¹ According to these rules the broker implicitly

caveat emptor. See *Message from the President—Regulation of Securities Issues*, 77 Cong. Rec. 937, reprinted in 1 Legislative History, *supra*, at 937 (proposal adds to the rule of caveat emptor, "let the seller also beware"). The Supreme Court has interpreted this message as indicating that a fundamental purpose of federal securities regulation is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor, and thus to achieve a high standard of business ethics in the securities industry." See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

It has been noted that the legislature was willing to accept an increased potential for strike suits as the price for removing common law barriers to proving fraud. See *Douglas & Bates, The Federal Securities Act of 1933*, 43 Yale L.J. 171, 174 (1933) (commentary on 1933 Act by William O. Douglas, one of bill's drafters).

The purpose of § 10(b), as expressed in the language of the statute, is "for the protection of investors" from "any manipulative or deceptive device." 15 U.S.C. § 78j(b) (1982). The persistent use of inclusive language, see *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-51 (1972) (acts proscribed by § 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive"), suggests that Congress intended the guarantees of fair dealing in securities to be applied equally to all investors, without regard for their capacity.

81. Section 10(b) grants the SEC the power to promulgate rules to prevent fraud. 15 U.S.C. § 78j(b) (1982). In defining the responsibility the broker has toward his client, the SEC has adopted the "shingle theory." See 2 A. Bromberg, *supra* note 6, § 5.7(214), at 5:48; *Churning*, *supra* note 9, at 870. Under this theory, brokers impliedly represent that their customer will be served fairly, according to the standards of the profession. See *E.H. Rollins & Sons*, 18 S.E.C. 347, 362 (1945); *Duker & Duker*, 6 S.E.C. 386, 388 (1939).

Section 15(b)(8) of the 1934 Act, 15 U.S.C. § 78o(b)(8) (Supp. 1982), requires all brokers to be members of a qualifying self-regulatory agency. These include the NASD, which is a self-regulatory organization registered under § 15a of the 1934 Act, 15 U.S.C. § 78o-3 (1982). See T. Hazen, *The Law of Securities Regulation* 259-60 (1985). Its members include all broker-dealers doing substantial retail business. See *id.* Another qualifying agency is the New York Stock Exchange (NYSE), which is a self-regulatory agency registered under § 6 of the 1934 Act, 15 U.S.C. § 78f (1982). See T. Hazen, *supra*, at 259-60. Its members may also be members of the NASD. *Id.* at 260.

Both the NASD and the NYSE have promulgated rules of conduct for their members. See NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2001 (Feb. 1986); NYSE Rules of Operation of Member Organizations, 2 NYSE Guide (CCH) ¶ 2325 (July 1983). Although violations of these rules do not create liability absent fraud, see *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 404 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977) (no liability under NYSE Rules absent proof of fraud); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 430 (N.D. Cal. 1968) (no liability under NASD art. III, § 2 absent proof of fraud), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970), they serve as standards of the profession. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. 1981); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 824 (9th Cir. 1980).

Two rules are particularly relevant to churning. One is the NYSE "know your customer" rule:

Every member organization is required through a general partner, a principal executive officer or a person or persons. . . 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.

NYSE Rule 405, 2 NYSE Guide (CCH) ¶ 2405, at 3697 (March 1982).

The other is the "suitability" rule, which reads:

represents that he has a reasonable basis for any recommendations made,⁸² that he is aware of how his past trades have affected the customer's account,⁸³ and that he has reasonable grounds for believing his recommendations are suitable for the customer based on facts such as the customer's other security holdings and his financial status and needs.⁸⁴ As a result, when the broker makes recommendations, the presumption should be that the customer relied on them.⁸⁵ Only when the broker acts merely as an order taker should the customer be presumed not to rely on the broker.⁸⁶

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

NASD—Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) ¶ 2152, at 2051 (Feb. 1986).

82. See *Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 288 (E.D. La. 1974), *aff'd*, 512 F.2d 484 (5th Cir. 1975).

83. The NYSE "know your customer" rule places an affirmative duty on the broker to make reasonable efforts to learn essential facts relative to every customer and every order. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 718, 69 Cal. Rptr. 222, 241 (1968) (when customer follows broker's recommendations there should be obligation on part of broker to determine customer's actual financial situation and needs); 1 S. Goldberg, *supra* note 1, § 3.3[b], at 3-33 (broker under affirmative duty to acquire facts about customer). The rule specifies that its scope includes "every customer, every order, every cash or margin account. . . ." NYSE Rule 405, 2 NYSE Guide (CCH) ¶ 2405, at 3697 (Mar. 1982). The use of the word "every" suggests that the broker must make a reasonable inquiry into the customer's financial situation at the commencement of the relationship.

As this duty extends to every order, the broker should be aware of how previous trades have affected the investor's situation. Because the broker will have copies of any confirmation slips and monthly statements supplied to the customer, his affirmative duty to learn essential facts about the customer suggests that the broker should be charged with constructive knowledge of changes in the investor's financial position.

84. NASD Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) ¶ 2152, at 2051 (Feb. 1986). Although the suitability doctrine is generally applied to evaluate the quality of single trades, see *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 4-5 (1st Cir. 1983) (churning requires the plaintiff to show quantity of trades was inappropriate; an unsuitability claim requires the plaintiff to show that quality of stocks was inappropriate), at least one court and one commentator have recognized that excessive trading must be gauged by the level of activity suitable to the customer's account. See *Miley v. Oppenheimer*, 637 F.2d 318, 333 (5th Cir. 1981); 1 S. Goldberg, *supra* note 1, ch. 1, at 1-7 (churning may be thought of as quantitative unsuitability). Excessive trading and the recommendation of the purchase or continuing purchase of securities that are beyond the customer's financial capacity violate the suitability rule. See Policy of the Board of Governors, Rules of Fair Practice, art. III, § 2, NASD Manual (CCH) ¶ 2152, at 2051-52 (Feb. 1986).

85. The suitability rule may shift responsibility for making inappropriate investment decisions from the customer to the broker. See Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445, 449-50.

86. See *id.* at 450. NYSE Rule 405 imposes constructive notice on the broker when trading in the account is approaching an excessive level. 2 NYSE Guide (CCH) ¶ 2405, at 3697 (Mar. 1982). At this point, if the broker continues to make recommendations that induce trading, such recommendations are inappropriate to the needs of the customer, and should constitute a violation of the suitability rule.

This presumption was acknowledged by the Ninth Circuit in *Follansbee v. Davis Skaggs & Co.*⁸⁷ In *Follansbee*, the court noted that the sophisticated investor can be expected to be influenced by the broker's greater access to financial information, and can further be expected either to accept the recommendation or disassociate himself from the broker.⁸⁸ The court concluded, however, that routine reliance by the sophisticated customer is not sufficient to satisfy the control element.⁸⁹ This conclusion was improper because the issue is reliance, not reasonableness. If the substantial majority of trades were made pursuant to the broker's recommendations, a causal connection sufficient to satisfy the customer's burden of proving actual reliance, and therefore control,⁹⁰ should be found.

II. THE INQUIRY INTO THE PLAINTIFF'S DUTY OF DILIGENCE AND THE *BATEMAN* STANDARD

Although not expressly recognized by the courts, the inquiry into the customer's capacity to make informed investment decisions should properly be considered an inquiry into whether the customer has met the general Rule 10b-5 requirement of due diligence.⁹¹ This requirement imposes on a plaintiff the duty to take reasonable steps to protect his interests and to exercise good judgment in making investment decisions.⁹² It arises from the belief that a person who is partially responsible for his own injury should not shift his loss to another.⁹³

Although courts properly require proof of broker control as part of the plaintiff's *prima facie* case,⁹⁴ courts often include as part of the control element an inquiry into the customer's sophistication.⁹⁵ The plaintiff's

87. 681 F.2d 673 (9th Cir. 1982).

88. See *id.* at 677; see also *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 956 (E.D. Mich. 1978) (a customer normally depends on his broker for information, advice and recommendations).

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

90. See *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980) (control exists when customer routinely follows broker's recommendations). Commentators have termed the customer's routine reliance on broker's recommendations as "direct" and "objective" evidence of broker control. See 1 S. Goldberg, *supra* note 1, § 2.8[b][1], at 2-30 ("objective" evidence); *Churning*, *supra* note 9, at 871 ("direct" evidence).

91. See *supra* notes 33-37 and accompanying text.

92. See *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir. 1977) (only those who have pursued their interests with care and good faith should recover under 10b-5), *cert. denied*, 434 U.S. 911 (1978). See *supra* notes 36-37 and accompanying text.

93. See *Diligence*, *supra* note 37, at 905.

94. See, e.g., *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980).

95. See, e.g., *Bowley v. Stotler & Co.*, 751 F.2d 641, 644-45, 648-49 (3rd Cir. 1985) (jury instruction mandating consideration of, inter alia, customer sophistication, trading experience and percentage of trades entered into on broker recommendation focuses jury attention on plaintiff's capacity); *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (customer's routine reliance on broker's recommendations, his sophistication on securities matters and his independent evaluation are equal considerations in de-

duty to exercise due diligence is thus made part of the prima facie case.⁹⁶ Courts disagree on the standard of conduct applicable to the general inquiry into the plaintiff's duty of due diligence,⁹⁷ and on whether such an inquiry is properly an element of the prima facie case⁹⁸ or an affirmative defense.⁹⁹ These disagreements must be evaluated under the standards set forth by the Supreme Court in *Bateman Eichler, Hill Richards, Inc. v. Berner*.¹⁰⁰

In *Bateman*, the Court considered the validity of the in pari delicto defense¹⁰¹ to a Rule 10b-5 action.¹⁰² The Court held that such a defense was not available under the Rule.¹⁰³ The Court established a two prong test to determine when a plaintiff's culpability may preclude recovery under Rule 10b-5.¹⁰⁴ The first prong requires that the plaintiff be at least as culpable as the defendant.¹⁰⁵ The second prong bars recovery only if to do so "would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."¹⁰⁶

A. *The Appropriate Standard for the Plaintiff's Duty of Due Diligence*

Under *Bateman*,¹⁰⁷ the plaintiff's recovery may be barred only if he

termining if customer retained control of account); *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1368 n.8 (7th Cir. 1983) (customer's business sophistication is consideration bearing on control); *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982) (if customer is fully able to evaluate his broker's advice and agrees with broker's recommendations, customer retains control of account); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977) (same), *cert. denied*, 434 U.S. 1035 (1978); *Carras v. Burnas*, 516 F.2d 251, 258 (4th Cir. 1975) (same).

96. The due diligence doctrine was initially incorporated into 10b-5 actions as an analog to the contributory negligence defense, *see Holdsworth v. Strong*, 545 F.2d 687, 692 (10th Cir. 1976) (discussing original reason for considering due diligence in 10b-5 action), *cert. denied*, 430 U.S. 955 (1977), on the theory that such a defense was appropriate when mere negligence could create broker liability. *See id.* at 692-93. Following *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), courts have reaffirmed the validity of the due diligence inquiry, but have held that a negligence standard is no longer appropriate. *See Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1043-44 (7th Cir. 1977) (negligence standard for due diligence no longer appropriate), *cert. denied*, 434 U.S. 875 (1977); *Dupuy v. Dupuy*, 551 F.2d 1005, 1017 (5th Cir. 1977) (when defendant's liability is premised on his intentional misconduct, evaluation of plaintiff's conduct against negligence standard is irrational), (citing *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976) (to offset intentional fraud, plaintiff's conduct must be somewhat comparable to that of the defendant's)), *cert. denied*, 430 U.S. 955 (1977)) *cert. denied*, 434 U.S. 911 (1978).

97. *See supra* note 39 and accompanying text.

98. *See supra* note 40 and accompanying text.

99. *See supra* note 41 and accompanying text.

100. 105 S. Ct. 2622 (1985).

101. The in pari delicto defense provides that in cases of equal or mutual fault, the defending party's position is the better one. *Id.* at 2626.

102. *See id.* at 2624, 2629-30.

103. *See id.* at 2628-29.

104. *See id.* at 2629.

105. *See id.*

106. *Id.*

107. 105 S. Ct. 2622 (1985).

bears substantially the same responsibility for the violation as the defendant.¹⁰⁸ A defendant in a churning action under Rule 10b-5 may be found liable only for intentional, willful or reckless conduct.¹⁰⁹ Because the fault of the plaintiff must involve gross conduct comparable to that of the defendant,¹¹⁰ the plaintiff must have behaved at least recklessly to preclude recovery. Negligence alone is not enough.¹¹¹

The equivalence of the control inquiry in a churning action to the general Rule 10b-5 due diligence requirement¹¹² suggests that the factors currently used to determine customer control of the account should be applied when evaluating customer culpability. Because churning is fact specific¹¹³ a universal standard for recklessness is inappropriate.¹¹⁴ An appropriate consideration¹¹⁵ is whether the plaintiff had the capacity to evaluate the broker's recommendations.¹¹⁶ This involves analysis of the plaintiff's education, intelligence, prior business and investing experience¹¹⁷ and the time that the plaintiff had to devote to the account.¹¹⁸ Absent such a capacity, there should be a presumption that the customer was not reckless.¹¹⁹ This presumption, however, should be rebuttable.¹²⁰

108. See *id.* at 2629.

109. See *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 821 (9th Cir. 1980); *M & B Contracting Corp. v. Dale*, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984); *Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 400 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

110. Cf. *Holdsworth v. Strong*, 545 F.2d 687, 693 (10th Cir. 1976) (in misrepresentation case under Rule 10b-5, court stated that "[i]f contributory fault of plaintiff is to cancel out wanton or intentional fraud, it ought to be gross conduct somewhat comparable to that of defendant").

111. Cf. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1122 (5th Cir. 1980) (action for manipulation of stock prices).

112. See *supra* notes 34-37 and accompanying text.

113. See *Lehman v. Madda Trading Co.*, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,417, at 29,866 (C.F.T.C. 1984) (churning determined by reference to the specific circumstances of the broker-customer relationship).

114. Cf. *Dupuy v. Dupuy*, 551 F.2d 1005, 1016 (5th Cir. 1977) (diligence in 10b-5 cases judged by subjective standard), *cert. denied*, 434 U.S. 911 (1978); *Friedlander v. Nims*, 571 F. Supp. 1188, 1197 (N.D. Ga. 1983) (due diligence standard is flexible and based on attributes of particular plaintiff), *aff'd*, 755 F.2d 810 (11th Cir. 1985); *Diligence*, *supra* note 37, at 920 (standard for plaintiff's conduct should be subjective).

115. Because a finding of investor recklessness rests on specific facts and circumstances surrounding the account, see *supra* note 113 and accompanying text, the following listing in the text is merely intended to suggest factors that might be examined and not to exhaust all possible factors.

116. Cf. *Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 677 (9th Cir. 1982) (touchstone of inquiry is plaintiff's intelligence and understanding).

117. Cf. *M & B Contracting Corp. v. Dale*, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984) (indicia of control include intelligence, education and investment and business experience of customer).

118. See *Petrites v. J.C. Bradford & Co.*, 646 F.2d 1033, 1035 (5th Cir. 1981) (plaintiff not reckless because nature of his occupation made it difficult for him to closely supervise business affairs).

119. Cf. *Carras v. Burns*, 516 F.2d 251, 259 (4th Cir. 1975) (customer's lack of capacity may itself give rise to an inference of broker control).

120. Cf. *Mundheim*, *supra* note 85, at 450 (under suitability doctrine, presumption of

Similarly, an ongoing or close personal relationship between the customer and the broker should raise the presumption that the customer was not reckless because the closeness of the relationship might tend to dissipate the customer's natural wariness.¹²¹ Conversely, a customer who has initiated a significant percentage of trades, rejected the broker's advice not to trade or misrepresented his financial condition to induce the broker to handle a transaction may be found to have been reckless.¹²² If a sophisticated investor actively monitored his account or sought information in addition to that provided by the broker, subsequent acquiescence in the broker's recommendations should be considered reckless.¹²³

B. *Plaintiff's Reckless Conduct as an Affirmative Defense to a Churning Action*

In *Bateman*¹²⁴ the Supreme Court held that a plaintiff's culpability may bar recovery in a Rule 10b-5 action only when the denial of recovery does not significantly interfere with the effective enforcement of the securities laws or the protection of the investing public.¹²⁵ Under this standard inquiry into a customer's responsibility for churning in his account should only be appropriate as part of an affirmative defense based on the customer's failure to exercise due diligence. To hold otherwise would significantly interfere with enforcement of the securities laws and the protection of the investing public.

When examining the customer's diligence in evaluating a broker's recommendations, two distinct questions are presented. First, did the defendant actually violate Rule 10b-5? Second, should this specific plaintiff be denied recovery in spite of the violation?¹²⁶ Restricting consideration of the customer's sophistication—and therefore his ability to exercise due

broker responsibility for inappropriate trading based on his recommendations is rebuttable).

121. *Cf. M & B Contracting Corp. v. Dale*, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984) (indicia of control include whether broker-customer relationship was "arms length" or "particularly close"); *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 354 (1945) (relationship between parties may cause normal customer wariness to be dissipated).

122. *Cf. Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 675 (9th Cir. 1982) (plaintiff who rejected broker's caution against purchasing limited partnership interest and falsified statement of marginal tax bracket to prevail on broker to handle transactions found in control of account); *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2d Cir. 1977) (defendant's contention that sophisticated plaintiff initiated as many trades as broker considered relevant in finding of customer control), *cert. denied*, 434 U.S. 1035 (1977).

123. *Cf. Tiernan v. Blyth, Eastman Dillon, & Co.*, 719 F.2d 1, 3 (1st Cir. 1983) (sophisticated customer who monitors account may retain control over it). A sophisticated investor having access to information other than the broker's recommendations and reasonable time in which to consider it, and who demonstrates willingness to reject or initiate trades, but nevertheless repeatedly acquiesces in broker's recommendations may be denied recovery on the grounds of recklessness. *Cf. Follansbee v. Davis, Skaggs & Co.*, 681 F.2d 673, 676-77 (9th Cir. 1982) (sophisticated customer who acquiesces in broker's recommendations despite independent investigation found to retain control of account).

124. 105 S. Ct. 2622 (1985).

125. *See id.* at 2629.

126. *See Diligence*, *supra* note 37, at 923.

diligence in detecting fraud¹²⁷—to the broker's affirmative defense clarifies this distinction. The guilty broker who is not liable merely because his customer's actions barred recovery is distinguished from the broker who did not violate the securities laws.¹²⁸ Because instances of broker fraud are exposed even though the plaintiff's lack of due care denied him money damages, the SEC is better able to take action against the guilty broker.¹²⁹ When the plaintiff's due diligence is treated as part of his prima facie case, this distinction is lost.

Furthermore, it is difficult to reconcile the inquiry into customer sophistication as part of a prima facie case with section 29(a)¹³⁰ of the 1934 Act. Section 29(a) voids any agreement binding a party to waive compliance with the 1934 Act,¹³¹ and apparently extends its protection even to the sophisticated investor.¹³² Thus, Congress has decided to protect even those investors who intentionally waive the protection of the 1934 Act.¹³³ It is unlikely Congress also believed it more important to penalize careless investors than to prosecute securities act violators. Treating customer sophistication as part of the prima facie case in a churning action hampers enforcement by shifting the focus of the inquiry from the defendant's fraud to the plaintiff's capacity to detect fraud. It is probable that Congress would have rejected such an inquiry as part of the plaintiff's prima facie case had it expressly considered statutory regulation of

127. See *supra* notes 35-37 and accompanying text.

128. Cf. *Dupuy v. Dupuy*, 551 F.2d 1005, 1015 (5th Cir. 1977) ("dispositive element in [10b-5 action] is that the defendant owes a duty of full and fair disclosure to the public, [and] not to any particular investor. Whether a private plaintiff might be precluded from recovery, then, need not alter the distinct consideration whether a defendant has violated duties imposed by the Act."), *cert. denied*, 434 U.S. 911 (1978); *Diligence*, *supra* note 37, at 923 (instances in which defendant found innocent distinguished from those in which plaintiff's conduct bars recovery).

129. Private actions under Rule 10b-5 are allowed as a supplement SEC enforcement of the 1934 Act. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975) (citing *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)).

Although there has been an increase in churning over the past three years, the SEC has taken a less active role in prosecuting these cases because it lacks manpower to scrutinize daily trading. See G. Morgenstern, *The Leaky Umbrella That is the SEC*, *Money*, Nov., 1985 226, 234. However, brokers are required to state whether or not they have ever been found liable for any securities law violation on their registration application. See Form BD, 3 Federal Securities Laws, Regulations and Forms (CCH) ¶ 33,401 at 33,281 (Mar. 1986). Thus, by clarifying when a broker has violated Rule 10b-5, this shift will increase the possibility of effective enforcement.

130. 15 U.S.C. § 78cc(a) (1982).

131. See *id.* This section reads:

(a) Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

Id.

132. The use of the term "any person" indicates that Congress did not intend to exempt sophisticated investors from this section's protection. See *Sachs*, *supra* note 37, at 126 & n.234.

133. See *id.* at 127. The section does so by specifically allowing even waived claims to be prosecuted. See *id.* at 127-28.

churning.¹³⁴

Several policy grounds have been used to justify the inquiry into a customer's due diligence in detecting fraud.¹³⁵ These include deterring investor carelessness,¹³⁶ promoting anti-fraud policies,¹³⁷ promoting fairness,¹³⁸ curbing excessive speculation,¹³⁹ ensuring a causal link between the defendant's fraud and the plaintiff's injury,¹⁴⁰ and protecting brokers from becoming insurers of their recommendations.¹⁴¹ The following examination of these policies indicates that the issue whether the plaintiff has met the duty of due diligence should be considered only as an affirmative defense to broker liability.

Nothing in the history of the 1934 Act suggests that Congress intended to penalize investor carelessness.¹⁴² The 1934 Act itself demonstrates legislative preference for penalizing perpetrators of fraud, not its victims.¹⁴³ This policy does not, therefore, justify impeding enforcement of the 1934 Act by including the due diligence inquiry in the *prima facie* case.

Although the suggestion that investor wariness will promote anti-fraud policies is plausible, it should not justify a rule of law that may mask the broker's violation of the Act. Moreover, when there has been customer carelessness and the account has been traded excessively, the duty of care is apparently ineffective in preventing the fraud. Because Congress viewed penalizing fraudulent broker practices as the most effective means of preventing fraud,¹⁴⁴ the goal of promoting customer vigi-

134. *Cf. id.* at 129 (§ 29 suggests that had Congress considered private actions under § 10(b) it would have rejected duty of care).

135. *See generally id.* at 130 (listing policy considerations supporting plaintiff's duty of due care).

136. *See Straub v. Vaisman & Co.*, 540 F.2d 591, 597 (3d Cir. 1976).

137. *See Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir.), *cert. denied*, 434 U.S. 911 (1977).

138. *See id.*

139. *See Powers v. Francis I. DuPont & Co.*, 344 F. Supp. 429, 433 (E.D. Pa. 1972) (broker not liable for failing to stop plaintiff's irresponsible trading as this would encourage customer to take even greater risks).

140. *See Sachs, supra* note 37, at 132.

141. *See Van Alen v. Dominick & Dominick, Inc.*, 441 F. Supp. 389, 400 (S.D.N.Y. 1976) (Rule 10b-5 not intended to remedy all losses resulting from brokers' recommendations), *aff'd*, 560 F.2d 547 (2d Cir. 1977).

142. The legislative history makes no mention of the goal of avoiding investor carelessness. *See Sachs, supra* note 37, at 131. Rather it refers to the goal of substituting a high level of business morality for the harsh rule of caveat emptor. *See supra* note 80. This suggests that Congress wished to reduce, rather than increase, the burden of watchfulness required of the investor. *See Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir.) ("rule of caveat emptor should not be relied on to reward fraud and deception") (quoting *FTC v. Standard Educ. Soc'y*, 302 U.S. 112, 116 (1937)), *cert. denied*, 321 U.S. 786 (1943).

143. Section 10(b) empowers the commission to prescribe rules that are "necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78j(b) (1982) (emphasis added).

144. *See House Consideration, Amendment & Passage of H.R. 9323*, 78 Cong. Rec. 7862, 73 Cong., 2d Sess. 7862 (remarks of Rep. Lea) (this bill proposes to punish persons

lance should not restrict enforcement of the Act.

"Fairness" is said to require a duty of care that limits access to Rule 10b-5 to "those who have pursued their own interests with care and good faith."¹⁴⁵ Because fairness requires penalizing the more blameworthy wrongdoer despite the negligence of his victim, it also requires an estimation of the relative blame accorded to the broker and the customer.¹⁴⁶ If the customer must prove his lack of fault as an element of his *prima facie* churning case, the trier of fact may never get to evaluate the fault attributable to the broker. Thus, fairness is better served if the customer's duty of care is treated as an affirmative defense in order to ensure that the blameworthiness of the broker will always be considered.

At least one court has suggested that the elimination of a due care requirement will lead to excessive speculation.¹⁴⁷ Although Congress was concerned with curbing such speculation, the legislative history of the 1934 Act indicates that this concern was subordinated to investor protection.¹⁴⁸ By defining the duty of due care as an affirmative defense, the plaintiff's conduct will still be considered, and therefore the curb on speculation is subordinated to investor protection, but is not eliminated.

Next, although proof of causation is necessary for recovery, such a connection does not require proof of due diligence.¹⁴⁹ Actual reliance can establish this causal connection.¹⁵⁰

Finally, one court has expressed concern that if no inquiry is made into customer sophistication, brokers will, in effect, become insurers of their recommendations.¹⁵¹ The analysis posited by this Note does not, however, call for eliminating this inquiry, but rather shifts the burden of proof. The broker will remain protected both by the scienter requirement and by the defense that the customer's culpability outweighs his own.

CONCLUSION

An inquiry into a customer's capacity to evaluate a broker's recommendation is an inappropriate element of the plaintiff's *prima facie* case in a churning action involving a nondiscretionary account. Because this

guilty of fraud), *reprinted in* 4 Legislative History, *supra* note 80, at 7862-63; Sachs, *supra* note 37, at 131.

145. *Dupuy v. Dupuy*, 551 F.2d 1005, 1014 (5th Cir. 1977) *cert. denied* 434 U.S. 911 (1978). See *supra* note 138 and accompanying text.

146. See *supra* notes 124-29 and accompanying text.

147. See *supra* note 139 and accompanying text.

148. In his letter to Congress requesting the legislation that became the 1934 Act, President Roosevelt asked for legislation "for the protection of investors, for the safeguarding of values, and, so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation." H.R. No. 1384, 78 Cong. Rec. 7702, 73 Cong., 2d Sess. (President's message and letter), *reprinted in* 4 Legislative History, *supra* note 80, at 7702.

149. See Sachs, *supra* note 37 at 132.

150. See *supra* notes 80-90 and accompanying text.

151. See *supra* note 141 and accompanying text.

capacity reflects only the customer's ability to be diligent in detecting churning, and is not relevant to the issues of broker control of the customer's account, excessive trading of that account or the broker's scienter in making trading decisions, the inquiry into the capacity question should be restricted to the broker's affirmative defense. Moreover, shifting the burden of proof from plaintiff to defendant will add an additional measure of protection to the customer because the SEC will be better able to penalize violators of the 1934 Act. Under the standards announced in *Bateman Eichler, Hill Richards, Inc. v. Berner*,¹⁵² in which a plaintiff's culpability in Rule 10b-5 actions may bar recovery only when it is substantially equivalent to the defendant's, the requisite weighing of culpability can best occur when the customer's sophistication and diligence in detecting fraud are viewed as elements of an affirmative defense.

Michael Slonim

152. 105 S. Ct. 2622 (1985).