Churning and the Death of Low Risk Larceny: Calculating Damages to Redress the Churning Client's Loss in Portfolio Value

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COMMENTS

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Value

INTRODUCTION

When a client procures the advice and guidance of a stock broker and the client permits the broker to make trades in his account at the broker’s discretion, both the client and the broker enter into a fiduciary and contractual relationship whereby the broker promises to trade the client’s securities pursuant to the client’s financial interests and the client promises to pay commissions to the broker. As a result of this relationship, the broker is frequently in a position to defraud the client. One such fraud, churning, is a deceptive practice which occurs when a stock broker trades securities in his client’s account with a frequency greater than is warranted by the client’s financial needs, resources, and account size.

To prove the requisite fraudulent intent of the broker, the client must show the broker intended to generate commissions for himself with little or no regard for his client’s investment interests. De-

2. In Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1206-07 n.1 (9th Cir. 1970) (citations omitted), the court stated the following:
   The SEC has provided a definition of churning in the regulation under 15 U.S.C. § 780(c) (1). The definition reads: “The term 'manipulative, deceptive, or other fraudulent device or contrivance', as used in section 15(c) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.”
3. See supra note 1 and accompanying text.
frauded clients seeking recovery have brought actions *inter alia*, pursuant to the Securities Exchange Act of 1934.\(^5\)

The courts and commentators have had difficulty in calculating damages in churning cases. This Comment seeks to alleviate the problem.\(^6\) First, this Comment will discuss the churning cause of action and the remedial and deterrent purposes underlying the Securities Exchange Act of 1934.\(^7\) Second, this Comment will discuss how and why the courts have limited a churning client's recovery to the commissions the client paid the broker despite the Act's purposes and the fact that clients usually suffer more damage as a result of churning activity.\(^8\) Further, it will discuss how the courts have also based their decisions to limit recovery on the concept of speculation and the doctrine of suitability.\(^9\) Finally, this Comment will discuss alternative methods of calculating damages in churning cases which permit clients to recover the loss in their portfolio's value, and it will propose one method for calculating damages in all churning cases.\(^10\)

I. CHURNING

To recover in a churning case, the client must prove the broker (1) controlled his account; in effect, the account must be a discretionary one;\(^11\) (2) traded excessively in the account;\(^12\) and (3) acted

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\(^5\) The Supreme Court held there is a scienter element which must be proved in every Rule 10b-5 case, there has been added the third element in a churning action. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981); *Kaufman v. Magid*, 539 F. Supp. 1088 (S.D.N.Y. 1982); and *Carroll v. Bear Stearns & Co.*, 416 F. Supp. 998 (S.D.N.Y. 1976).


\(^7\) See *infra* note 105 and accompanying text.

\(^8\) See *infra* notes 18-20 and accompanying text.

\(^9\) See *infra* notes 30, 45 and 67 and accompanying text.

\(^10\) Portfolio value is the dollar value of all the securities the client holds. *Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978).

\(^11\) A discretionary account is one in which the customer allows the broker to select, time and price securities whether they are being bought or sold. *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 839 (E.D. Va. 1968). Moreover, New York Stock Exchange Rule 408 requires that before discretion can be exercised by the broker, the brokerage firm must receive an authorization in writing from the customer and initialed by a partner. *Id.* at 841.

\(^12\) To determine whether trading was excessive, courts consider the turnover rate in the account. This is computed by dividing the cost of all transactions made in the account during the period under consideration by the average investment. In turn, the average investment is determined by dividing the cumulative total of the net investment
with the intent to defraud his client or customer, or he must have acted with willful disregard for his client's or customer's interests. 13

Whenever a broker churns his client's account, the client should recover, at least in theory, all the damages proximately caused by the broker's fraudulent conduct. 14 However, courts have struggled with the issue of calculating a client's actual damages in churning cases. 15 They have clearly held that punitive damages cannot be recovered in any action brought pursuant to the Act. 16 Also, the Act provides that a client can recover no more than his actual damages. Yet the courts have frequently limited clients recovery to quasi-contract. 17

Quasi-contract is based on unjust enrichment principles. 18 Here

at the end of each month by the number of months involved. Landry v. Hemphill, Noyes & Co., 473 F.2d 365, 374 (1st Cir. 1974) (citing Note, Churning by Securities Dealers, 80 Harv. L. Rev. 869 (1967)).

Where respondeat superior principles are applied, the special good faith defense afforded by the last clause of Section 20(a) is unavailable. Quite apart from the fact that that conclusion was clearly adumbrated in SEC v. Management Dynamics, supra, 515 F.2d at 812-13, and has become settled law in other circuits, there is no warrant for believing that Section 20(a) was intended to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles. On the contrary Section 28(a), 15 U.S.C. § 78bb, specifically enacts that the rights and remedies provided by the '33 Act shall be in addition to any and all rights and remedies that may exist at law or in equity, and Section 16 of the '33 Act, 15 U.S.C. § 77p, similarly provides that the rights and remedies of the '33 Act additional to pre-existing remedies.
15. See infra note 1.

Damages should also be limited to the amount of commissions because this is the only element of damages which was proximately caused by defendants. Plaintiff argues defendant improperly bought speculative stocks instead of class A stocks. But his was admittedly a trading account which means the purpose was to buy and sell stocks whose value fluctuated hoping to buy at
the court considers the broker's gains resulting from his deceptive practice. The client's recovery is limited to the commissions he paid to the broker and the taxes and interest that accrued thereupon during the churning period. The problem with limiting churning client's recovery to quasi-contract damages is that, usually, the churning activity proximately results in damage to the client far in excess of the commissions he paid to the broker.\textsuperscript{19} Generally, a churning case client suffers a loss in his portfolio value as a result of the churning activity. Moreover, limiting the churning client's recovery to quasi-contract damages fails to deter brokers from churning other clients' accounts.\textsuperscript{20} Nevertheless, courts continue to limit the client's recovery to quasi-contract damages by avoiding the issue of what damages proximately resulted from the broker's fraudulent conduct.\textsuperscript{21}

Actions brought pursuant to the Act arise under Section 10b and Rule 10b-5.\textsuperscript{22} These sections stem from the "shingle theory" which provides that when the broker-dealer hangs out his shingle he impliedly represents he will act in the best investment interests of his client.\textsuperscript{23} The Supreme Court has held that the Act's provisions are

\begin{itemize}
\item low prices and sell at high prices, or vice versa on short transactions. Class A stocks fluctuate very little and would not be the best for a trading account.
\item Therefore, while defendant's choice of stock was unfortunate, his choice was not so wrong as to give rise to additional damages.
\item \textsuperscript{19} The concept of causation is critical to the damages issue in churning cases and will be discussed throughout this Comment.
\item \textsuperscript{20} Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981); Brodsky, supra note 1, and Note, Churning, supra note 16, at 875.
\item \textsuperscript{21} The Securities Exchange Act of 1934 provides that plaintiffs should recover no more than their actual damages. The issue addressed in this Comment is how we determine what are actual damages in the typical churning case. See infra note 26.
\item \textsuperscript{22} The relevant sections of the Securities Exchange Act of 1934, hereinafter referred to as the "Act," are discussed in the context of a churning action in Hecht v. Harris, Upham & Co. The court stated:
\item Securities Exchange Act Section 10(b) (15 U.S.C. § 78j(b)) makes it unlawful for any person, directly or indirectly, by the use of interstate commerce or of the mails or of any facility of any national securities exchange to use or employ, in connection with the purchase or sale of any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.
\item Pursuant to this Act, the Securities Exchange Commission promulgated Rule 10b-5, (17 C.F.R. 240.10b-5) providing that it shall be unlawful for any person, directly or indirectly, by the use of interstate commerce, or of the mails or any facility of any national securities exchange, (a) to employ any device, scheme or artifice to defraud, (b) to make any untrue statement of a material fact, or to omit to state a material fact necessary in order to make the statements made, not misleading, or (c) to engage in any act, practice or course of business which operates as or would operate as a fraud upon any person, in connection with the purchase or sale of any security.
\end{itemize}


\textsuperscript{23} See Note, Churning, supra note 16, at 870.
designed to redress clients injured as a result of a broker’s fraudulent and deceptive practices and deter brokers from engaging in such fraudulent practices in the future. Moreover, courts have held that legislative intent requires that the remedial purposes of the Act are to be liberally construed against the broker and to protect the financial interests of the client-investor. However, the Act explicitly provides that clients may not recover “a total amount in excess of actual damages on account of the act complained of.” Although the Act makes clear its intent concerning the need to redress clients and deter fraudulent brokers, the Act does not suggest a method by which to calculate damages in securities fraud cases. Calculating damages in churning cases has been particularly troublesome. Traditionally, a churning case client’s recovery has been limited to the commissions he paid the broker despite the fact that usually more damage is caused. Courts have so limited damages based on the following concepts: 1) the client’s conduct was such that it overshadowed the broker’s wrong; 2) an award in excess of quasi-contract would be too speculative; and 3) the broker overtraded securities which were suitable for the client’s investment interests and therefore he should recover no more than his

24. See Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953), in which the court stated:

Congress intended to make the control of securities transactions “reasonably complete and effective” as that phrase is used in the preamble of the Act. We can think of nothing that would tend more toward discouraging trading off the established business markets and out of governmental regulation or that would more certainly tend to deter fraudulent practices in security transactions and thus make the Act more “reasonably complete and effective” than the right of defrauded sellers or buyers of securities to seek redress in damages in federal courts.”

Id. (footnote omitted)

Moreover, the Supreme Court has stated that the purpose of the Act is to “achieve a high standard of business ethics in the securities industry.” S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 186 (1963).

Finally, in Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1202 n.8 (9th Cir. 1970), the court noted that one of the principal Congressional purposes of the Act is to protect the investor in a highly sophisticated field.


The Securities Exchange Act of 1934, Section 28, 15 U.S.C. § 78bb provides: “but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.”

27. See supra note 24.

28. See supra note 1.

commissions paid. Thus, the remedial and deterrent purposes of the Act have been largely ignored in churning cases.

A. Client's Conduct

The courts have limited the client's recovery even in cases in which the client has shown the broker controlled and overtraded the account and intended to defraud the client. The courts have limited a client's recovery by balancing against the broker's wrong, the client's education and background, trading experience, acceptance of confirmation slips detailing his broker's trading record, and subscriptions to sophisticated securities or business publications. The courts have held that if the broker can show the client was knowledgeable in securities by proving the existence of one of these factors, then the client's recovery can be limited to the commissions he paid to the broker; namely, the quasi-contract method of recovery. The client is not permitted to recover any loss suffered in his portfolio value during the churning period. Courts have called such an affirmative defense either estoppel, waiver, or laches.

The problem with recognizing this affirmative defense in churning cases is that the client is denied full recovery despite the broker's churning activity. To deny the client full recovery because his knowledge of the market suggested he should have known he was being defrauded is too harsh a result. Churning is a deceptive

30. A classic example is Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 428 (N.D. Cal. 1968), in which the court stated:

Defendants contend, in effect, that plaintiff had acquired a familiarity with security trading long before her dealings with either defendant Wilder or defendant Harris, Upham, through her dealings in securities since as early as 1928; especially through her accounts maintained with Johnson Company in the early thirties and with Walston Company between 1936 and 1955; also through her regular, frequent discussions with Ernest Fairey, her broker for about 23 years (1931-1955); also through her presence in the Hecht household where Hecht's dealings, not only in securities but in commodity futures as well, were a topic of conversation, and, also through her regular reading of the financial pages of the newspapers.

Id. See also Petrites v. J.C. Bradford & Co., 646 F.2d 1033 (5th Cir. 1981).

31. Hecht, 283 F. Supp. at 428; see also Mihara v. Dean Whitter & Co., Inc., 619 F.2d 814 (9th Cir. 1980) and Petrites, 646 F.2d 1033.

32. The theories proposed by the Ninth Circuit are 1) estoppel, requiring one party to reasonably rely on his detriment on the conduct of another; 2) laches, requiring a lack of due diligence in recognizing the wrong on the plaintiff's part and prejudice to the defendant; and 3) waiver, requiring the intentional relinquishment of a known right. See Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1208-09 (9th Cir. 1970); Fey v. Walston & Co., 493 F.2d 1036, 1050 (7th Cir. 1974); see also Mihara v. Dean Witter & Co., 619 F.2d 318 (9th Cir. 1980) where the court held that since plaintiff should have known his broker was trading his account excessively, his failure to stop his broker from continuing to do so constituted breach of the duty to mitigate his damages. The court limited plaintiff's recovery to quasi-contract.

33. The Hecht court's analysis appears to focus on contributory negligence. Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970). Other cases are in accord:
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practice whereby the broker intends to defraud his client; hence, it is an intentional tort. It is a well settled principle of tort law that contributory negligence is not a defense to an intentional tort. This principle should be applied in a churning case. So long as the client can show the broker controlled and overtraded his account and intended to defraud him, the broker should not escape full liability unless he can show the client’s conduct was so flagrant as to negate one of the elements of the churning cause of action.

For example, some courts in churning cases have examined the client’s conduct to see if he authorized the trades made by the broker. These courts have reasoned that if the broker can show the client authorized the trades, he can simultaneously show he neither controlled, nor excessively traded the client’s account. Rather, it was the client’s decision to churn the account.

Landry v. Hemphill Noyes & Co., 473 F.2d 365 (1st Cir. 1973) (Customer who was experienced in the stock market was held to have realized the broker’s fraudulent trading practice and was estopped from arguing he was an investor), and Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 168 (10th Cir. 1974).

Nevertheless, churning also consists of contract principles in that the broker and client enter into a contractual agreement. See supra note 1 and accompanying text.

“When there is an intent to mislead, it is clearly inconsistent with the general rule that mere negligence of plaintiff is a defense to an intentional tort.” W. PROSSER, HANDBOOK ON THE LAW OF TORTS § 108, at 716 (4th ed. 1971).

Id.

If the plaintiff has given the broker discretion over his account sufficient to satisfy the control element of the churning cause of action, it should be clear that the client is at the mercy of the broker's judgment. On the other hand, perhaps the control element should be interpreted strictly against the broker so that only where it can be said that the broker had no discretion over the account will he be held to have no control over the account. This would clarify the state of the law today.

Powers v. Francis I. du Pont & Co., 344 F. Supp. 429 (E.D. Pa. 1972). Plaintiffs exercised such involvement in the account that the court held the broker did not control the account and did not trade it excessively. This result appears to be better reasoned.

In Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 957 (E.D. Mich. 1978), the court stated: “The law is clear that if a customer controls his own securities account he cannot prevail against his broker under a theory of churning, even where he can prove that the account suffered an excessive number of trades.” See also Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 n.8 (7th Cir. 1983) where the court stated:

A few courts have suggested, as a third element that the customer must also have been relatively unsophisticated about the market. See Marshak v. Blyth Eastman, Dillon & Co., Inc., 413 F. Supp. 377, 379 (N.D. Ok. 1975). But while it is true that most successful churning plaintiffs have fit within this category, see Horne v. Francis I. du Pont & Co., 428 F. Supp. 1271, 1274 (D.C. 1977), imposing lack of sophistication as an absolute requirement would appear to go too far. Even a savvy investor may choose, for various reasons, to entrust the handling of his account to a broker and there is no reason to immunize that broker if he exercises control and intentionally trades the account excessively. The better view would seem to be that business sophistication is simply another consideration bearing upon the issue of control.

In sum, determining whether the client authorized the broker to trade stocks in his portfolio focuses more clearly on whether the client has a churning cause of action. The courts' inquiry should not be focused on whether the client, based on his securities knowledge, should have known his account was being churned at all. The law should deny recovery to clients who have simply been victimized by the market's normal fluctuations or by their own demand that the broker overtrade their account. However, the law should not reward fraudulent brokers who were fortunate enough to deal with clients believing themselves to be well versed in securities trading. To do so would be contrary to the deterrent purposes underlying the Act. Moreover, it would fail to redress the client in light of the broker's wrong since he would not recover any loss he may have suffered in the value of his portfolio. Nevertheless, courts have largely limited client's recovery in churning cases based on the client's knowledge of the market. The courts have also proffered two additional rationales for limiting a client's recovery: speculation and suitability.

B. Speculation

Courts have frequently limited a churning case client's recovery to quasi-contract damages when any greater award would be too speculative. Clearly, the uncertainty associated with market investments and market fluctuations will always make calculating damages in securities fraud cases inaccurate. The problem is that one can never say with certainty what his investment would have yielded had the broker not churned his account.

40. See infra note 41 and accompanying text.
41. Courts must not become the last recourse for disappointed market investors, thus clients whose accounts have not been churned should not recover at all in a churning case.
42. See supra note 24.
43. See supra notes 18, 19 and 20 and accompanying text.
44. See infra notes 45 and 67 and accompanying text.
45. When are damages too speculative? According to Dobbs, when the plaintiff can establish the fact of damages with reasonable certainty; but cannot establish the amount of damage with reasonable certainty. “To some extent this rule is merely an insistence that the trier of fact may not speculate or conjecture but must instead have some factual basis for fixing damages.” DOBBS, REMEDIES § 3.3 (1st ed. 1973).
47. Courts have recognized this problem yet they have handled the calculation of damages differently. For example, in Newkirk v. Hayden, Stone & Co., [current] Fed. Sec. L. Rep. (CCH) ¶ 91,621 (S.D. Cal. 1965), the court noted it was impossible to say with certainty what damages were proximately caused by a defendant's churning activity and that as a result “the damages should be limited to the amount of commissions wrongfully obtained.” In contrast, while recognizing the danger of excessive specula-
In calculating the client's quasi-contract recovery, the courts will forego the problem of discerning what damages were proximately caused by the churning. Rather, the courts will presume the broker acted wrongly with respect to every transaction made in the client's account since the broker's wrongdoing has caused the calculation of damages to be speculative. Hence, the courts will return to the client all the commissions he paid to the broker without fear of speculating as to whether each of the trades the broker made was fraudulent. Some courts are unwilling to make a similar presumption for purposes of calculating the client's loss in portfolio value. The arguments vary. One provides that an award to the client of his commissions paid to the broker is precisely what the client lost. Another stresses the impossibility of predicting with certainty what losses proximately resulted from the churning activity. This argument provides that any attempt to apportion loss in portfolio value between what was due to the ordinary hazards of a declining market and what resulted from the churning would be too speculative.

The arguments against awarding loss of portfolio value in a churning action due to the speculative nature of the act focus on churning as a series of individual trades rather than one unified offense; or one continuing wrong. No one can point to any particular transaction and declare it to be the wrong done or the compensable injury. Rather, it is the nature of the churning activity to overtrade, to escalate the offense's complexity, and to result in a lack of proof of causation. The best remedy may be to analyze the offense with respect to the entire past history of the broker's
trading pattern as compared to the pattern desired and contracted
for by the investor-client.57

Moreover, the arguments against awarding the client his loss in
portfolio value fail to focus on all the damage done to the client.58
If the courts limit the client’s recovery to the quasi-contract mea-
sure of recovery and the client’s portfolio is returned valueless fol-
lowing the churning and not as a result of a decline in the market,
an award of commissions paid the broker cannot fully compensate
the client.59 One court has determined the problem to be one of
competing windfalls.60 On the one hand, the client may receive
more than he originally bargained for and thereby attain a position
better than he might have been in had the churning not occurred.61
On the other hand, refusing to award the client his loss in portfolio
value suggests a windfall for the wrongdoer broker.62 If the courts
must decide which party is to receive a windfall, it would be more
equitable to fully compensate the innocent client than to aid the
wrongdoing broker.63 Finally, the arguments against awarding loss
in portfolio value fail to focus on the dual legislative purpose of the
Act which is to redress a client’s losses and to deter brokers from
dealing fraudulently in the future.64 To illustrate this latter pur-
pose, that of deterrence, a New York state court astutely pointed
out that to limit the client’s recovery to quasi-contract damages
would effectively encourage brokers to engage in “low risk lar-
ceny.”65 Thus, future courts should more liberally interpret the

57. Id.
58. Id.
59. Id. The trend today indicates that the trial courts’ discretion will be relied
upon in fashioning remedies in churning cases. Note, Churning, supra note 16, at 885;
Fey v. Walston & Co., Inc., 493 F.2d 1036, 1055 n.26 (9th Cir. 1974).
60. See Justice Goldberg’s enlightening if not comical opinion in Miley v. Oppen-
61. Id.
62. Id.
63. The Miley court appears to have based its decision on such equitable grounds.
637 F.2d at 328. See also Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir.
and Brodsky, supra note 1.
64. One commentator has noted that “deterrence” smacks of punitive damages
which are not recoverable under the Act. This is a pertinent comment since punitive
damages may not be awarded in an action brought under the Act. Nevertheless, an
award of commissions paid may only encourage brokers to churn accounts since (1) the
client may be so unfamiliar with the market he may not complain, and (2) the most for
which he would be liable to the plaintiff is the commissions he wrongfully received.
Thus, the strong policy in encouraging the public to invest in the market could poten-
tially be stymied by broker’s fraud. Based on these considerations, and so long as the
court awards damages based on a competent evidentiary showing of client’s loss, bro-
kers can be deterred from churning activity without being penalized.
concept of what is speculative to fully redress the client for the wrong done him and to deter brokers from continuing fraudulent practices.66

C. Suitability

Courts and commentators generally concur that a churning case client should recover no more than the commissions he paid the broker during the churning period if the securities purchased were suitable for his investment interests.67 Suitability focuses on the securities which the broker recommends his client purchase while churning focuses on the broker’s overtrading of his client’s account.68 The connection between the two actions is that both derive from the “shingle theory” which basically provides that a broker will act in the best interests of his client.69 The SEC regulations provide that a broker can be reprimanded for buying and/or selling unsuitable securities,70 without any allegation of churning activity.71 The client must show that the broker reasonably believed he traded securities which were unsuitable with regard to the client’s financial needs and interests and that despite this belief the broker traded the securities.72 Courts have also held that if the stocks

66. Id.
67. The concept is best addressed in Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981), and Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980).
68. Brodsky, supra note 1, at 157.
69. See supra note 23 and accompanying text.
70. Jacobs, supra note 1, at 897.
71. Id.
72. Id. See also Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68 (S.D.N.Y. 1981) and New York Stock Exchange Rule 405 which provides:

Diligence as to Accounts Rule 405. Every member organization is required through a general partner or an officer who is a holder of voting stock 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. Supervision of Accounts

(2) Supervise diligently all accounts handled by registered representatives of the organization. Approval of Accounts

(3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer, provided, however, that in the case of branch offices, the opening of an account for a customer may be approved by the manager of such branch office but the action of such branch office manager shall within a reasonable time be approved by a general partner or an officer who is a holder of voting stock in the organization. The member, general partner or officer approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization.

CCH N.Y.S.E. § 2405 (emphasis added). Also, the SEC promulgated Rule 15(b) 10-3
purchased are unsuitable or not in conformity with the investor's investment goals, then the investor may only recover his commissions paid to the broker despite the fact that the broker churned his account. In effect, the courts have held that the only wrongdoing on the broker's part is in the excessiveness of the trading and not in the trading of unsuitable securities. Hence, the client may recover only that amount of damages which proximately resulted from the excessiveness of the trading, that is, the commissions the client paid to the broker during the churning period.

Despite the separate and distinct natures of these two concepts the courts insist on unifying them for purposes of awarding damages in excess of quasi-contract damages in churning cases. For example, in *Hecht v. Harris Upham & Co.*, the court stated:

> Certainly churning an account may conceivably cause damage to a customer over and beyond the commission and interest generated by excessive transactions—and undoubtedly did so in this case. . . . [W]e have found that plaintiff assumed the ordinary risks of an active trading account in securities and commodities (as distinguished from maintaining the account as a mere investment account) . . . .

In *Hecht*, the plaintiff client desired that her account be handled as an active trading account. She received confirmation slips detailing the trades made and she did not complain as to the suitability of the stocks traded. Therefore, the court reasoned that, although her portfolio was churned, she could not recover damages in excess of the commission she paid to the broker. Courts have followed the reasoning of the *Hecht* court and limited client's recovery to quasi-contract damages when either the stocks purchased are "suitable" with regard to the client's investment goals and interests or the client's conduct estops him to argue the purchases were unsuitable. The problem with this analysis is two-fold. First, it does not address the policies of the Act in that the dishonest broker is not deterred but is reprieved if he churns the investor's account by over-trading the client's stocks for stocks the client might have author-

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which imposes on brokers the duty to act reasonably and diligently in selecting stocks that are suitable for a client's purposes.

73. *Brodsky, supra* note 1, at 157.
74. *Id.*
76. *Brodsky, supra* note 1, at 157-58.
78. *Id.* at 440.
79. *Id.* at 422-23.
80. *Id.* at 425.
81. *Id.* at 425-26.
82. *Id.* at 426-30.
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ized him to purchase. It assumes the churning activity causes no more damage to the client's account than the loss of the commissions he paid to his broker for each transaction the broker made. Rather than make such an assumption, the courts should allow the client to proffer evidence of damage to portfolio value which proximately resulted from the churning activity. This approach to the problem would be feasible if courts would consider churning to be an unsuitable practice per se. Whether the broker invested in suitable securities may be relevant in determining if the broker controlled the client's account or intended to defraud the client; but it does not alter the fact that the client may suffer damage to his portfolio value as a result of the churning activity. The reason being that the act of churning or overtrading an account itself may cause damage to a client's portfolio value.

In sum, the churning case client should be compensated for all the losses which proximately resulted from the churning activity. Churning is clearly a fraudulent practice requiring wrongful intent by the broker. When a client can show his broker churned his account, limiting his recovery to quasi-contract or damages due to (1) his own knowledge of the market; (2) the speculativeness of an award in excess of commissions paid by the client to the broker; or (3) the suitability of the transactions made by the broker, fails to redress the client for the damages resulting from the broker's wrong. A broker may gladly run the risk of churning his client's account if he knows he need only return to the client his commissions paid upon being sued for conducting a churning scheme. Moreover, it does not serve as a deterrent to fraudulent brokers. However, there are alternative methods of calculating damages which should make courts more willing to award churning case cli-

83. Id. at 428-30. The Hecht court addressed the issues of plaintiff's conduct and suitability. The court held that plaintiff's conduct estopped him to argue the trades made by the broker were unsuitable in light of his investment goals and desires.

84. See supra notes 19, 20 and 21 and accompanying text.


86. See infra note 125 and accompanying text.

87. Brodsky, supra note 1, at 159; but cf.: "If the securities are churned but they are suitable for the customer's account, the commissions and interest should be returned. . . ."

88. Id.

89. Id.

90. See supra note 14 and accompanying text.


92. To escape liability and to effect these policies, the broker must be able to show he did not churn.
ent's damages for loss in portfolio value. They are the out-of-pocket-loss and loss of bargain methods of calculating damages.

II. METHODS OF CALCULATING CLIENT'S LOSS IN PORTFOLIO VALUE

There are primarily two methods of calculating client's loss in portfolio value in churning cases. They are the out-of-pocket-loss and loss of bargain method.

A. Out-of-Pocket-Loss

The out-of-pocket-loss method of calculating damages returns to the client the difference between the client's portfolio value before and after the churning activity. For example, a churning client may give his broker discretion to trade the securities in his portfolio. It is valued at $1,000 on January 1. On January 30, the client discovers his broker churned his account. On January 30, the portfolio value is $100. If the trial judge were to apply the out-of-pocket-loss method of calculating damages, the client's loss would be $1,000 minus $100, or $900. Thus, the focus shifts from the quasi-contract method's notion of broker's gain to that of client's loss. This method is an effective remedial measure because it would likely deter brokers from churning. If the broker knew he was responsible for the client's portfolio loss, the increased financial

93. See infra note 95 and accompanying text.
94. Id.
95. These are the most readily used alternative methods of calculating damages in churning cases.
97. Twomey v. Mitchum, Jones and Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1st Dist. 1968), is a case in which plaintiffs failed to proffer evidence supportive of the loss of bargain method of calculating damages, the court determined that damages for churning are limited to the commissions earned but that in the present case plaintiff had been left with unsuitable securities and a huge loss. In such a case, the court decided that "[defendants . . . are in no position to object to the out-of-pocket rule adopted by the court." Id. at 732, 69 Cal. Rptr. at 251. The Twomey formula was outlined as follows:

<table>
<thead>
<tr>
<th>Initial portfolio value</th>
<th>$52,668.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount which would have been earned</td>
<td>$10,206.00</td>
</tr>
<tr>
<td>Total loss</td>
<td>$62,874.00</td>
</tr>
</tbody>
</table>

Subtract from this sum the following:
- Value of the Returned Portfolio: $14,843.25
- Profits from Sales and Dividends: $15,674.04

Plaintiff's award: $62,874.00 - $30,517.29 = $32,356.71. Id. at 730, 69 Cal. Rptr. at 249.
98. Id. This shift is probably more appropriate; however, it also threatens to provide clients much more than they would have recovered under normal market conditions. As will be discussed later in this paper, such a result is unnecessary.
risk of churning his client's account may outweigh his desire to fraudulently accrue commissions. Nevertheless, it is also an ineffective remedial measure because it does not redress the client's loss so much as it penalizes the broker for churning the client's account. Hence, the out-of-pocket-loss method of calculating damages may potentially overcompensate the client just as limiting a client's recovery based on the client's knowledge of the market, by the concept of speculation or the doctrine of suitability, may serve to undercompensate the churning client. Again the central problem is one of causation. A client's out-of-pocket losses do not take into account the damages caused by the normal fluctuations of the stock market. If, during normal market fluctuations, the client's portfolio would have suffered a loss in its value, the out-of-pocket-loss method would put the client in a position better than he would have been in if the churning had not occurred. Thus, while the out-of-pocket-loss method more correctly approaches the damages issue in churning cases, it is not the best solution to the problem. Moreover, the fact that the out-of-pocket-loss method arguably serves to penalize brokers rather than redress a client for his actual damages, suggest that this method is prohibited by the Act.

B. Loss of Bargain

A better method is based on a loss of bargain recovery which provides that the client recovers all he would have gained had the broker not churned his account. The Second Circuit has most recently applied a formula based on the loss of bargain method in Rolf v. Blyth, Eastman Dillon & Co., a securities fraud case. The formula is the product of a litany of opinions and has received positive critical reinforcement by cases and commentators. For example, the Miley court stated:

In order to approximate the trading losses caused by the broker's
misconduct, it is necessary to estimate how the investor's portfolio would have fared in the absence of the such misconduct. [sic]

The trial judge must be afforded significant discretion to choose the indicia by which such estimation is to be made, based primarily on the types of securities comprising the portfolio. However, in the absence of either a specialized portfolio or a showing by either party that a different method is more accurate, it seems that the technique discussed by Judge Oakes in *Rolf v. Blyth, Eastman Dillon & Co.*, and employed by Judge Mahon in this case is preferable. . . . This mode of estimation utilizes the average percentage performance in the value of the Dow Jones Industrials or the Standard and Poor's Index during the relevant period as the indicia of how a given portfolio would have performed in the absence of the broker's misconduct. 106

The following five steps are part of the *Rolf* formula and would be the most appropriate for calculating damages in any churning action. 107

**Step One.**—The first step in determining the calculation of damages in a churning action is to determine the market value of the client's portfolio on the date the fraudulent conduct began. 108 To determine the date the fraudulent conduct began, the court must decide, based on the facts before it, when the broker first controlled and overtraded the client's account and intended to defraud the client. 109 Next, to determine when the broker first had control of the account and when he began to overtrade the client's securities, the court can usually inspect monthly reports from the broker or his firm which are sent to the client concerning each transaction made. 110 However, to determine when the broker first manifested the intent to defraud the client, the court will have to make a factual determination of the broker's intent to defraud the client by considering the extent of the overtrading in the client's account. 111 Finally, to calculate the market value of client's portfolio on the date

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108. See supra note 106 and accompanying text.

109. Id.

110. Id. See also Hecht v. Harris, Upham & Co., 430 F.2d 1202 (9th Cir. 1970).

111. Clearly, a "showing of reckless disregard" would be sufficient to prove intent. Court's have also considered turnover rate, "in and out trading" and prolonged holding periods as evidence of intent to defraud. The first of these considerations, the turnover rate, is calculated by dividing the cost of all purchases made in the account during the churning period by the average investment. In Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980), the court held that an annualized turnover rate of four would be
the fraudulent conduct began, the court should multiply the number of shares of each security in the portfolio by the price of the security on the date the fraudulent conduct began.\footnote{112} Next, the court should aggregate the resulting totals of the number of each security multiplied by the price of each security.\footnote{113} The resulting figure is the market value on the date the fraud began.\footnote{114}

\textit{Step Two}.—The second step in assessing damages is to choose an appropriate index by which to adjust the client's portfolio value.\footnote{115} This step allows the client to adjust his portfolio value by an appropriate index to determine what he would have had if the broker had not churned the account. However, the client may recover no more than this amount.\footnote{116} The court must choose an index which would show market movement closely related to the movement the client's stocks would have undergone but for the churning.\footnote{117} Selecting an appropriate index is the most important step in the formula. If the chosen index measures the movement of stocks closely related to the client's own, then the danger of awarding speculative damages is presumptive of churning while a turnover rate of greater than six might be conclusive of churning activity. \textit{See also In re Matter of J. Logan \& Co., 41 S.E.C. 88 (1962).}

The second consideration, “in and out” trading, occurs when the broker engages in a pattern of trading consisting of all or part of his client's portfolio with the money immediately reinvested in other securities. Following a short period of time, these newly acquired securities are sold.

Finally, courts consider the length of time the broker held the client's securities before selling them. Evidence of short holding periods has been deemed persuasive evidence of the requisite churning intent. Mihara v. Dean Witter \& Co., Inc., 619 F.2d 814 (9th Cir. 1980).

\textit{112}. In \textit{Rolf v. Blyth, Eastman Dillon \& Co., [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) \# 98,201 (S.D.N.Y. 1981)}, the plaintiff contended that since his account was handled on a cash basis and certain shares were not paid for until after the initial date of plaintiff's portfolio market value, those shares should not be included as part of plaintiff's initial market value. Plaintiff's contention was based on the fact that he paid $144,000 for the shares while their market value was only $118,500, thus, adding the shares to plaintiff's portfolio would result in a loss of $25,500 in plaintiff's account. The court held that the shares should be included in the initial market value of plaintiff's portfolio. The court provided no rationale for its conclusion, however, the better rule is that if plaintiff requests his broker to purchase certain stocks, those stocks are considered purchased for purposes of calculating the initial market value of plaintiff's portfolio.

\textit{113}. \textit{See infra} note 114.

\textit{114}. Hence, if plaintiff had ten shares of $X$ security valued at $5 per share, and ten shares of $Y$ security valued at $10 per share on the date which the fraudulent conduct began, the resulting products would be $50 of security $X$ and $100 of security $Y$. Adding these figures plaintiff's market value is $150.


\textit{117}. \textit{See infra} note 141.
Moreover, it is unnecessary to inquire whether the stocks purchased were suitable for the client's investment goals and interests because, if the purchases were suitable, the index's movement would likely parallel the market movement which would have resulted in the client's loss of portfolio value under normal market conditions. Thus, the client would not recover damages for the loss of portfolio value which the churning did not cause.

To choose an index, there are essentially two issues with which the court must deal. First, the court must choose an appropriate index. Second, the court must adjust the client's portfolio value by the percentage of market movement in the index during the churning period.

Regarding the first issue, choosing an appropriate index, the trial court may, at its discretion, use any index it deems appropriate. For example, if a churning case client had twenty securities in his portfolio, most of which were issued by industrial companies, then the court could use an index indicative of the overall market movement of industrial stocks such as Standard & Poor's Industrial Stock Index. In contrast, if most of the client's twenty securities were issued at a price of less than ten dollars per share, the court could adjust the client's portfolio's market value by an index indicative of the market movement of low prices stocks such as Standard & Poor's Low Priced Index. Both these indices are well recognized ones; however, the court is not limited to selecting a well recognized index. The court may select any appropriate index.

In searching for the appropriate index, the Rolf court expressly declined to use an actual share index or a composite index to adjust...
the client's portfolio's market value. An actual share index provides that the actual shares in the client's portfolio be adjusted by their market activity during the period of fraudulent conduct. The use of this index rests on the presumption that the broker would have made no trades during the period of fraudulent conduct. Since the churning case client confides in the broker to engage in some trading activity, this index is inadequate to measure the client's losses in portfolio value and should not be used. The Rolf court also rejected a composite index proffered by the broker. The composite index was a weighted average index calculated as follows: First, the broker determined all the industries in which the client held stock. Second, the broker determined the dollar value of the stock the client held in each industry. Third, the broker chose six industry indices which contained stocks of roughly the same dollar value as client's stocks. Finally, the broker adjusted the client's portfolio's market value by the average increase or decline of the six industry indices during the period of fraudulent conduct.

The court rejected the use of the composite index because it incorrectly equated the quality of a stock with the dollar value of similar stocks in the same industry. The quality of a stock is determined by factors other than mere dollar value. Despite the court's criticism of the broker's composite index it did not hold that it should always be discarded in favor of a well recognized index. When a party can show that the composite index's stocks and the stocks in the client's portfolio are in the same industry; of the same dollar value; and of the same quality, the composite index may be adopted by the court. It can be a more reliable and accurate in-

127. In Rolf v. Blyth, Eastman Dillon & Co., [current] Fed. Sec. L. Rep (CCH) ¶ 98,201 at 91,414 (S.D.N.Y. 1981), the court rejected the use of an actual share index because its use "rests on the faulty premise that Rolf's investment advisor would have made no sales or purchases during the aiding and abetting period . . . ." Thus, the court indicated that using an actual share index is always inherently suspect.

128. Id.

129. Id.

130. Id. However, the court's holding is unclear. It appears the court held that a composite index can be used in other cases but in light of plaintiff Rolf's account and investment interests, the composite index was not the most appropriate one available in the Rolf case.

131. Although it is nowhere explicitly set out in the opinion, this analysis is implicit in the court's discussion. The court implied that if defendants could have shown that Rolf had requested defendants trade in certain industries with indices identical to those indices proffered by defendants, the composite index would have been acceptable. Id.

132. Id.


134. See supra note 105.

135. This was first recommended in Note, Churning, supra note 16, at 882, 883.
dex than a well recognized one because it is based on the market movement of many indices closely related to the stocks in the client's portfolio, while a well recognized index reflects the market movement of one broadly based index. The well recognized index does not bear as close a relation to the client's own stocks as the composite index.

Further, the composite index can be made even more accurate in its application. If the court is willing to look at the comparative market movement in several indices during the churning period to adjust the client's portfolio's market value, it should be willing to look at comparative stocks of similar dollar value and quality and in the same industry. By applying this latter composite index, the court may actually consider the market movement of stocks almost equal to the client's own during the churning period.

The court has wide discretion in determining whether to use a well recognized index or a composite index. However, in exercising this discretion, the court should be guided by the policy against speculating as to damages. The parties will always proffer to the court the index most favorable to their client's interests. To select the most appropriate index, the courts should consider whether there is a close relation between the value, quality, and type of stocks in the client's portfolio and the index proffered. However, while courts are free to choose either type of index, they should always opt for the index which is the most accurate in determining the client's actual damages; and thereby avoid speculation.

Regarding the second issue, adjusting the client's portfolio value, the Rolf court held that the client's portfolio value should have been multiplied by the percentage decrease in the appropriate index. Because the client's index showed a percentage increase during the churning period, his portfolio value remained unchanged for purposes of calculating his damages. In effect, the court declined to adjust the client's portfolio value unless he would have suffered a

136. See supra note 105.
137. See infra note 141.
138. The composite index suggested for use in this Comment is also discussed in Brodsky, supra note 1, at 160.
140. Id. at 94,413.
141. The suggested "close relation" test would properly place the court's focus on the kind of account plaintiff had prior to the churning. If the court chooses an index closely related to plaintiff's account and his investment interests, the chance of awarding plaintiff's excessive damages is decreased substantially.
142. See supra note 105.
144. Id.
loss during the period of fraudulent activity.\textsuperscript{145} The court probably reasoned that a court cannot restore a plaintiff to a better position than he would have been in if the fraud had not occurred.\textsuperscript{146} The court's analysis was clearly guided by the Act's decree that a plaintiff can recover no more than his "actual damages."\textsuperscript{147} However, the court could have taken its analysis further by permitting client Rolf to adjust his portfolio's value by the percentage increase in the appropriate index. Had the court done so, it would not have restored plaintiff to a better position than he would have been in if the fraud had not occurred. Rather, it would have restored plaintiff to a position similar to the one he would have been in had the fraud not occurred. If the market index showed an overall percentage increase during the period of fraudulent activity, then it could be fairly said that the client's portfolio value would have increased during the same period. Thus, an adjustment by a percentage increase in the market would be justified. Once the appropriate index is chosen, the court can proceed to the next step.

\textit{Step Three.—} The third step used by the \textit{Rolf} court is to determine the client's portfolio value at the closing date of the fraudulent activity.\textsuperscript{148} This figure is then subtracted from the sum total determined from Steps One and Two. The court must determine, based on the facts of the case, when the broker either lost control of the account, stopped trading excessively, or relinquished the intent to defraud his client.\textsuperscript{149} The closing market value is that dollar value of all the stocks in the client's portfolio at the time the broker terminated the churning activity.\textsuperscript{150} The court should subtract the market value of the client's portfolio on the date the broker stopped churning his account from the adjusted market value of the client's portfolio on the date the churning began.\textsuperscript{151}

\textit{Step Four.—} The fourth step in calculating client's recovery is to return to the client all the commissions he paid to the broker during the period of fraudulent conduct; the quasi-contract measure of recovery. Thus, under this formula, quasi-contract recovery becomes

\textsuperscript{145} Id.
\textsuperscript{146} Id. at 94,414.
\textsuperscript{147} See supra note 26.
\textsuperscript{149} In effect, the court must determine when the broker first stopped churning the client's account.
\textsuperscript{150} Id.
\textsuperscript{151} A hypothetical is helpful. When plaintiff's portfolio is valued at $100,000 at the beginning of the churning period and $20,000 at the end of the churning period, and the most appropriate index increased by three percent during the churning period, plaintiff's recovery is $83,000. The calculation is as follows:

\begin{align*}
\text{($100,000 \times 3\% \ [i.e., \$3,000] \ plus \$100,000 = 103,000] - \$20,000 = \$83,000}
\end{align*}
one element of full recovery.\textsuperscript{152}

\textit{Step Five.---}The fifth step is to calculate prejudgment interest on the sum total of the client's recovery under Steps One through Four.\textsuperscript{153}

The following chart demonstrates how the above formula would be applied in a typical churning case. Assume the following facts: X, a client, went to Y, a stock broker, with a portfolio containing A, B, C, & D securities on July 1, 1983. X owned 100 shares of each security and each security had a value of $9.00 per share. Y churned X's account until January 1, 1984. Upon X's calling a halt to Y's deceptive practice, X's portfolio contained securities E, F, G, & H. X owned seventy-five (75) shares of each security and each security had a value of $7.00 per share. Moreover, during the churning period, X paid Y $1,000 in commissions. At trial on January 22, 1984, Y offered to settle for $769,555.34.

\begin{center}
\begin{tabular}{|l|c|}
\hline
\textbf{Market value of plaintiff's portfolio as of July 31, 1969} & \textbf{$808,976.52$} \\
\textbf{(beginning of the aiding and abetting period)} & \\
\textbf{Adjustment for market factors during the aiding and abetting period.} & \\
\textbf{Less: Market value of plaintiff's portfolio as of January 21,} & \textbf{$211,129.98$} \\
\textbf{1971 (closing date of aiding and abetting period)} & \\
\textbf{Plus: Brokerage commissions paid by plaintiff during the} & \textbf{$19,894.42$} \\
\textbf{aiding and abetting period} & \\
\textbf{Plus: Interest earned on plaintiff's margin account during} & \textbf{$2,369.26$} \\
\textbf{the aiding and abetting period} & \\
\textbf{Less: Credits for withdrawals of cash and securities during} & \textbf{$66,671.78$} \\
\textbf{the aiding and abetting period} & \\
\hline
\textbf{CARRIED FORWARD} & \textbf{$553,438.44$} \\
\textbf{BROUGHT FORWARD} & \textbf{$553,438.44$} \\
\hline
\textbf{Plus: 7\% annual interest, calculated from January 21,} & \\
\textbf{1971 to March 22, 1973 (date of Delanair settlement)} & \\
\textbf{($553,438.44 \times 7\% \times 2.1667 \text{ years}$)} & \textbf{$83,939.45$} \\
\textbf{Less: Value to plaintiff of the Delanair settlement} & \textbf{$153,411.25$} \\
\textbf{$483,966.64$} & \\
\hline
\textbf{Plus: 7\% annual interest, calculated from March 22, 1973} & \\
\textbf{present (August 26, 1981) ($483,966.64 \times 7\% \times 8.43 \text{ years}$)} & \textbf{$285,588.70$} \\
\textbf{TOTAL DAMAGES} & \textbf{$769,555.34$} \\
\hline
\end{tabular}
\end{center}

Thus, plaintiff is entitled to damages of $769,555.34.

\textsuperscript{152} Rolf v. Blyth, Eastman Dillon & Co., [current] Fed. Sec. L. Rep. (CCH) \textsuperscript{153} Rolf v. Blyth, Eastman Dillon & Co., [current] Fed. Sec. L. Rep. (CCH) ¶ 98,201 (S.D.N.Y. 1981). The \textit{Rolf} formula makes quasi-contract recovery a foundational element on which to build plaintiff's recovery. However, \textit{Rolf} is not purely a churning case. See \textit{Rolf} v. Blyth, Eastman Dillon & Co., 424 F. Supp. 1021 (S.D.N.Y. 1977). Moreover, in \textit{Rolf} v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir. 1978), the court stated: "We are not capable of precisely measuring Rolf's damages on this appeal, although we do not think that they were so speculative as to compel resort solely to damages as in a churning case, for commissions paid the broker (and interest thereon)." \textit{Id.} at 48. It was not until Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981), that a court applied the \textit{Rolf} formula in a garden variety churning case.

January 1, 1985, the judge determined that Standard & Poor’s Low Priced Index was the appropriate one by which to adjust X’s portfolio value. The index showed a four percent (4%) increase during the churning period. Also, the trial judge determined that prejudgment interest would be calculated at ten percent (10%) annually. The calculation of damages would be as follows:154

**STEP ONE:** PORTFOLIO VALUE ON THE DATE THE CHURNING BEGAN:
(Number of securities (4) multiplied by the number of shares (100) multiplied by the prices per share ($9.00)...

.................................................. $3,600.00

**STEP TWO:** ADJUST PORTFOLIO VALUE ON THE DATE THE CHURNING BEGAN BY THE PERCENTAGE MOVEMENT OF AN APPROPRIATE INDEX. (4% of $3,600 plus $3,600) .......... $3,744.00

**STEP THREE:** SUBTRACT THE PORTFOLIO VALUE ON THE DATE THE CHURNING ENDED. ($3,744 minus the total number of securities (4) multiplied by the number of shares (75) multiplied by the price per share ($7.00))........................................... $1644.00

**STEP FOUR:** ADD ALL COMMISSIONS CLIENT PAID BROKER TO TOTAL OF STEPS ONE THROUGH THREE .................. $2644.00

**STEP FIVE:** ADD 10% ANNUAL PREJUDGMENT INTEREST CALCULATED FROM DATE THE CHURNING BEGAN TO PRESENT. ($2644.00 multiplied by 10% multiplied by six months (0.5 year)=$132.20........................................... $2,776.20

TOTAL DAMAGES ........................................... $2,776.20

In sum, the Rolf formula will allow courts to come nearer to compensating the client’s actual loss as a result of churning.155 The formula would redress client’s loss because it recognizes the normal

154. This hypothetical is designed to demonstrate the simplicity and accuracy in calculating churning damages pursuant to a Rolf-type formula.

155. The Rolf formula recognizes the fact that there will be complications in the trading process which do not lend themselves to easy calculation. The case sets out three rules for making calculations where plaintiff has (1) a margin account; (2) made withdrawals of cash from his account; and (3) settled with other defendants.

First, when plaintiff has a margin account, one in which the customer advances only a portion of a securities purchase price and the broker puts up the rest, plaintiff is entitled to recover all the interest accrued thereon during the period of fraudulent conduct.

Second, when the plaintiff has made withdrawals; taking money from his account to make other securities purchases, “the court must determine whether the withdrawal was used to purchase securities fraudulently recommended by (defendant).” If so, defendants’ may subtract the withdrawal from plaintiff’s portfolio’s losses. For purposes of churning actions, if the withdrawal was made by plaintiff and used by defendant in
fluctuations of the market and thereby serves as an accurate estimate of how much the client would have gained but for the churning. Moreover, the potential for large awards assures the formula's deterrent effect.

CONCLUSION

To terminate low risk larceny in churning cases, the courts must not limit the client's recovery to the commission the client paid to the broker—quasi-contract recovery. The courts must recognize the remedial and deterrent purposes underlying the Act. Moreover in assessing the client's damages, the courts must bear in mind the fact that churning activity causes more damage to the client than the loss of the commissions he paid to the broker. Churning may cause damage to the client's portfolio value. To redress the client's loss, courts must be more liberal when examining client's conduct, such that the court does not fail to focus on the elements of the churning cause of action. Brokers who act fraudulently must not receive a reprieve if they deal with clients who are knowledgeable in securities. Also, the courts should not limit the client's recovery based on the concept of speculation or the doctrine of suitability. Courts should relax the inquiry into speculation to favor the innocent client. Courts should not inquire into suitability because churning an account makes any transaction unsuitable per se.

The courts should be prepared to invoke one method for calculating damages in all churning cases. The best formula is one akin to that proferred by the Second Circuit. That method allows the client to recover for the bargain he lost by multiplying his opening portfolio value by the percentage market movement in an appropriate index and by subtracting from the resulting amount the client's portfolio's closing value. This method is logical and easy to apply. Moreover, its use will bring courts closer to compensating the client's actual damages resulting from the broker's churning activity. Finally, it will force brokers to weigh the high risks of churning an

furtherance of the churning objective: defrauding plaintiff, the defendant is not entitled to subtract the withdrawal from plaintiff's portfolio's losses.

Finally, the Rolf court allowed defendant to subtract the value of plaintiff's settlement with another defendant from plaintiff's portfolio's losses. This factor is the most germaine to Rolf. There, defendant Delanair was a low-grade corporation in which Rolf's broker invested plaintiff's money. The Delanair's stocks value plummeted. The stocks had a closing market value of $21,588.75. Plaintiff settled with Delanair for $175,000. Therefore, defendants were "entitled to a credit of $153,411.25 for the settlement." See supra note 105.
account. In this way the courts will be able to enforce the purposes underlying the Act, and end low risk larceny.

Michael F.J. Romano*

* The author was honored with the Scriba Regis Award by the 1983-84 Board of Editors of the CALIFORNIA WESTERN LAW REVIEW. This comment was considered the best written student article of the year.