

**Fernando S. G. Frota and Maria Carmen Frota, Plaintiffs, v. Prudential-Bache Securities, Inc., et al., Defendants**

**No. 85 Civ. 9698 (WCC)**

**UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK**

**1987 U.S. Dist. LEXIS 3916; Fed. Sec. L. Rep. (CCH) P93,253**

**May 14, 1987, Decided; May 15, 1987, Filed**

**CASE SUMMARY:**

**PROCEDURAL POSTURE:** Defendants, a brokerage and a broker, filed a motion for summary judgment in an action brought by plaintiff customers alleging violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78j(b), rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 (1985), the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C.S. §§ 1961-1968, and state law.

**OVERVIEW:** During a period of approximately 920 trading days, the broker made 1,224 purchases and sales of securities for the customers' account thereby generating \$ 1,900,000 in commissions and more than \$ 2,000,000 in margin charges. The broker also purchased \$ 7,204,506 worth of certificates of accrued Treasury securities. When the account was finally liquidated, only \$ 69,000 remained of the original \$ 2,424,635. The brokerage argued that any claim for fraud was barred by the doctrines of ratification, waiver, and estoppel because the customers had not made timely objections after receiving account statements and had authorized the broker's activities. The customers, who lived in Brazil, alleged that they did not regularly receive account statements, and that in opening the account they had signed blank papers presented by the broker. In denying defendants' summary judgment motion, the court held that material issues of fact existed concerning the customers' trading objectives and the particular representations made to them by their broker. While the Treasury securities were exempt from regulation, a question existed whether they were suitable investments for the customers' account.

**OUTCOME:** The court denied defendants' motion for summary judgment.

**CORE TERMS:** trading, customer, broker's, summary judgment, material facts, confirmation, unsuitable, estoppel, churning, matter of law, unsuitability, ratification, traded, cover letter, fails to state, cause of action, discretionary account, government securities, secondary market, misrepresentation, speculation, excessive, disputed, exempted, monthly, dealer, handled, opened, margin, fully disclosed

**LexisNexis(R) Headnotes**

***Civil Procedure > Summary Judgment > Standards > Genuine Disputes***

***Civil Procedure > Summary Judgment > Standards > Materiality***

[HN1] A court may grant a motion for summary judgment only if it determines that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. The court's responsibility is to assess whether there are any factual issues to be tried, while resolving ambiguities and drawing inferences against the moving party.

***Securities Law > Liability > Advisers, Brokers & Dealers > Churning***

***Securities Law > U.S. Securities & Exchange Commission > Penalties & Unlawful Representations***

[HN2] Churning occurs in a securities account when a broker or dealer, acting in his own interests and against those of his customer, engages in trading that is disproportionate to the size and character of the account traded.

***Evidence > Procedural Considerations > Burdens of Proof > General Overview***

*Securities Law > Liability > Advisers, Brokers & Dealers > Churning*

*Securities Law > U.S. Securities & Exchange Commission > Penalties & Unlawful Representations*

[HN3] To establish a cause of action for churning, plaintiffs must show that (1) the broker or dealer exercised control over the account, and (2) the broker or dealer traded the account excessively, considering the investment objectives of his customer and the size of the account.

*Securities Law > U.S. Securities & Exchange Commission > Penalties & Unlawful Representations*

[HN4] To establish churning, more must be shown than merely an abnormal number of trades. In a churning case the independent objectives of a customer are an important standard against which to measure claimed excessiveness.

*Civil Procedure > Pleading & Practice > Defenses, Demurrers, & Objections > Waiver & Preservation*

*Securities Law > U.S. Securities & Exchange Commission > Necessity for Regulation*

[HN5] The purpose of the Securities and Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act.

*Civil Procedure > Pleading & Practice > Defenses, Demurrers, & Objections > Waiver & Preservation*

*Securities Law > Liability > Securities Exchange Act of 1934 Actions > Implied Private Rights of Action > Deceptive & Manipulative Devices*

[HN6] Even express consent to churning does not raise a defense of waiver or estoppel if the consent is induced by undue influence over the customer, or results from the customer's trust and confidence in the broker.

*Securities Law > Blue Sky Laws > Exempted Issuers*

*Securities Law > Exemptions From Registration > Exempt Classes of Securities*

*Securities Law > Liability > Securities Exchange Act of 1934 Actions > Implied Private Rights of Action > Deceptive & Manipulative Devices*

[HN7] While government bonds may be exempt from certain section of the Securities Exchange Act of 1934, any manipulative or deceptive device used in connection with the sale of even exempted securities is clearly within the reach of § 10(b). 15 U.S.C.S. § 78j(b), 17 C.F.R. § 240.10b-5 (1985).

*Securities Law > Liability > Securities Exchange Act of 1934 Actions > Implied Private Rights of Action > Deceptive & Manipulative Devices*

[HN8] The knowing or intentional recommendation of an unsuitable security states a cause of action for fraud under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78j(b), and rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5 (1985).

**COUNSEL:** [\*1] EDUARDO F. LOPEZ, ESQ., P.C., Attorney for Plaintiffs.

CAHILL GORDON & REINDEL, ESQS., Attorneys for Defendants, THOMAS J. KAVALER, ESQ., LISA PEARSON, ESQ., Of Counsel.

**OPINION BY:** CONNER

**OPINION**

OPINION AND ORDER

CONNER, D. J.:

Plaintiffs Fernando S.G. Frota and Maria Carmen Frota ("the Frotas") brought this action against Prudential-Bache Securities, Incorporated ("Prudential-Bache") and Ahmed Hussein ("Hussein"), their broker at Prudential-Bache, alleging violations of section 10(b) of the Securities Exchange Act of 1934 ("the '34 Act"), 15 U.S.C. § 78j(b) (1982); Securities and Exchange Commission rule 10b-5, 17 C.F.R. § 240.10b-5 (1985); the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. §§ 1961-1968 (1982); and the laws of the state of New York. Subject matter jurisdiction is predicated upon section 27 of the '34 Act, 15 U.S.C. § 78aa (1982), section 1964 of RICO, 18 U.S.C. § 1964 (1982), the diversity of citizenship of the parties, and the doctrine of pendent jurisdiction.

This matter is now before the Court on defendants' motion for summary judgment pursuant to rule 56 of the Federal Rules of Civil Procedure on the grounds that (1) plaintiffs' complaint is barred [\*2] by the doctrines of ratification, waiver and estoppel; (2) plaintiffs' unsuitability claim fails to state a cause of action as a matter of law; and (3) any claims predicated on a misrepresentation theory must be dismissed because the material facts alleged withheld from

plaintiffs were fully disclosed by their account statements. Because defendants fail to establish that no genuine issue of material fact exists, their motion for summary judgment must be denied.

### **BACKGROUND**

In November 1981, the Frotas opened a "discretionary account" at Prudential-Bache, over which Hussein, their broker, exercised complete control. Between November 1981 and January 1982, the Frotas transferred a portfolio valued at \$ 2,771,635 from the Chase Manhattan Bank in Switzerland to the Prudential-Bache account. The Frotas withdrew \$ 347,000 for their own use; the remaining \$ 2,424,635 was managed and invested solely by Hussein. At the time of opening their account, the Frotas executed a Customer's Agreement, a Joint Account Agreement, an Option Agreement and a Power of Attorney (Bialow Affidavit Exhibits 1-3 and 5, respectively).

During the time the account was open, the confirmations and monthly statements [\*3] issued by Prudential-Bache on the account were not delivered to the Frotas either in Brazil or at their New York apartment. Up until June of 1982, they were delivered to Hussein, and thereafter to John F. Rasweiler, the supervisor of the Wall Street Branch where the account was located. At various times during the period in which the account was open, Frota met with Hussein and on each occasion he was given a few account statements.

Between November 1981 and June 1985, a period of approximately 920 trading days, Hussein made 1,224 purchases and sales of securities for the Frota's account. Hussein generated \$ 1,900,000 in commissions and more than \$ 2,000,000 in margin charges. when the account was finally liquidated in July 1985, only \$ 69,000 remained. Of the 1,224 transactions for the Frotas' account, 200 were purchases and sales of the same security in a single day; 700 were purchases and sales of the same security within a 30-day period; 165 were purchases and sales of securities for which Prudential-Bache was the sole market-maker.

Hussein also purchased, for the Frota's account, \$ 7,204,506 worth of Certificates of Accrued Treasury Securities ("CATS bonds"), a type of treasury [\*4] bond issued by the U.S. government which has all of its interest coupons previously removed by the original purchaser. Although there is a secondary market for the bonds, appreciation depends upon downward fluctuations in interest rates. Hussein purchased the bonds by margining the Frotas' account.

Defendants argue that plaintiffs' complaint is barred by the doctrines of ratification, waiver and estoppel because plaintiffs did not object upon receipt of confirmations and account statements and because they signed a Prudential-Bache letter approving the way their account was being handled. Defendants further claim that the Frotas have waived their right to complain about transactions in their account by failing to make timely objections thereto, as required by the Customer Agreement they signed when the account was opened. That agreement states in part:

"Reports of the executions of orders and statements of my account shall be deemed conclusive if not objected to in writing within five days or ten days respectively, after transmittal to me by mail or otherwise." (Bialow Affidavit Exhibit 1, para. 10)

Since the Frotas apparently made no such objections to any transactions, defendants [\*5] urge they are entitled to summary judgment.

### **DISCUSSION**

[HN1] A court may grant a motion for summary judgment only if it determines that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. The court's responsibility is to assess whether there are any factual issues to be tried, while resolving ambiguities and drawing inferences against the moving party. *Anderson v. Liberty Lobby, Inc.*, 106 S. Ct. 2505, 2509-11 (1986).

[HN2] Churning occurs in a securities account when a broker or dealer, acting in his own interests and against those of his customer, engages in trading that is disproportionate to the size and character of the account traded. *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 368 n.1 (1st Cir. 1973), cert. denied, 414 U.S. 1002 (1973). [HN3] To establish a cause of action for churning, plaintiffs must show that (1) the broker or dealer exercised control over the account, and (2) the broker or dealer traded the account excessively, considering the investment objectives of his customer and the size of the account. *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 211. (D. Mass. 1978).

[\*6] The Frotas' discretionary account named, Hussein as the trader and it is not disputed that Hussein exercised effective control over the account. Whether the account was traded excessively, however, is more difficult to determine. [HN4] To establish churning, more must be shown than merely an abnormal number of trades. "In a churning case the independent objectives of a customer are an important standard against which to measure claimed excessiveness." Fey

v. Walston & Co., Inc., 493 F.2d 1036, 1045 (7th Cir. 1974).

The parties dispute the facts regarding the stated investment objectives of the Frotas. An Option Form and Agreement, signed by the Frotas, contains information, filled in by hand, representing the Frotas as having two years investment experience actively trading options both in cash and on margin. The form lists their investment objectives as income and speculation (Defendants' Exhibit 3). The Frotas claim they signed the Option Agreement, along with the numerous other documents required to open the account, when it was blank (Frota Affidavit para. 6). They claim **Hussein** later filled in the information that appears, completely misrepresenting the Frotas' investment experience [\*7] (Frota Affidavit para. 7). The Frotas further claim that they told **Hussein** their investment objectives were conservative; they wanted "to apply the money in good investments, without speculations." (Frota Affidavit para. 6) Defendants claim the Frotas were wealthy speculators interested in high yields and argue that they are bound by the documents signed when the account was opened.

Since the question of whether trading is excessive must be examined in light of the trading objectives of the customer and since the Frotas' trading objectives cannot be established as a matter of law, a material question of fact remains unresolved. The nature of the plaintiffs' account and any possible misrepresentation by Hussein, therefore, remain open questions and must be resolved at trial. See *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968).

Defendants argue that the circumstances surrounding the signing of the agreements are not material since plaintiffs received monthly statements and did not object to the management of the account. They assert the equitable defenses of ratification, waiver and estoppel, well-recognized defenses to securities fraud claims. [HN5] "The purpose of the Securities [\*8] and Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act." *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962).

The establishment of the defense of ratification and waiver depends upon the trading experience of the plaintiffs and whether plaintiffs knowledgeably consented to the acts of defendants. In *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970), the Ninth Circuit affirmed a finding by the District Court barring, on the basis of estoppel, laches and waiver, the plaintiff's claim under section 10(b) that defendant traded in securities and commodities unsuitable for plaintiffs' needs and objectives and contrary to her instructions. In *Hecht*, the plaintiff spoke with her broker every day. She organized her confirmation slips in order to discuss them with her broker, in person, at least once a week. Her trading activities were also independently examined by her tax accountants and she was occasionally represented by an attorney. *Id.* at 1208; see also *Landry v. Hempill, Noyes & Co.*, 473 F.2d 365 (1st [\*9] Cir. 1973) (where Court found that plaintiff's "obvious experience" and failure to object to trades done over a twenty-two month period failed to support a claim for churning).

In addition to the added experience or knowledge necessary to ascertain a pattern of churning, [HN6] "[e]ven express consent to churning does not raise a defense of waiver or estoppel if the consent is induced by undue influence over the customer, or results from the customer's trust and confidence in the broker." *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. at 211 (citing *Fey v. Walston & Co., Inc.*, 493 F.2d at 1050).

The facts supporting the defense of estoppel and waiver are much less clear here than they were in *Hecht*. The Frotas live in Brazil and made visits to New York, during which Mr. Frota would meet with Hussein, only every three to four months. Whether the Frotas received all their confirmation slips is disputed. Also, the sporadic manner in which they received confirmation slips and statements raises question about whether plaintiffs were aware of specific purchases or understood the significance of the overall pattern of trading. Frota claims he found the statements incomprehensible [\*10] and that he was encouraged by Hussein not to attempt to understand the statements (Frota Affidavit para. 13). Ratification of Hussein's actions would require that the Frotas received the trading confirmations, had the stock market experience and knowledge to comprehend those actions and then failed, within a reasonable time, to object. See *Jaksich v. Thomson McKinnon Securities, Inc.*, 582 F. Supp. 485 (S.D.N.Y. 1984).

Defendants point to a form sent to the Frotas by the Prudential-Bache compliance department under a cover letter dated September 8, 1983. The cover letter states that the compliance department had noticed substantial trading in their account and asks that the Frotas reexamine their customer statements and sign the enclosed statement approving the way their account was being handled. The Frotas signed the form on October 10, 1983. Defendants claim that the fact the Frotas signed the form is further support for their argument that the Frotas ratified Hussein's actions. Plaintiffs dispute this and claim that Hussein brought the form to them without the cover letter, stating that it had to be signed "for his files" so he could "continue to supervise [the Frotas'] investments." [\*11] (Frota Affidavit para. 15). Plaintiffs claim that if they had seen the September 8, 1983 cover letter they would have been alerted to the alleged misconduct.

The text and the tone of the letter could have put the Frotas on notice of the importance of the otherwise routine

approval form. Whether the Frotas received all of the confirmations and statements and whether they received the September 8th letter are material facts, as they bear upon whether the Frotas knowingly consented to the way Hussein handled their investments. Additionally, the disputed facts as to the Frotas' investment objectives, their investment experience and consequent ability to understand either that the securities purchased were unsuitable that the level of trading was excessive are issues of material fact that must be resolved at trial.

Plaintiffs' unsuitability claim involves Hussein's purchase of the CATS Bonds. Plaintiffs allege that defendant Hussein failed to explain the nature of the CATS Bonds to Frota. Plaintiffs claim that Hussein knew that the Frotas were ignorant of the mark-up in the CATS bonds, the speculative nature of the securities and the risks of heavy trading on margin. Finally, plaintiffs [\*12] contend that defendants purchased the bonds for the Frotas with the sole purpose of generating for themselves an enormous and unreasonable profit in commissions or mark-ups.

Defendants argue that they are entitled to summary judgment on this issue because plaintiffs' unsuitability theory fails to state a claim as a matter of law. It is defendants' argument that a case for unsuitability under 10b-5 is "informed" by the NASD rules of fair practice. Plaintiffs fail to state a claim, defendants argue, because government securities are exempted under NASD rules and so, as a matter of law, a broker's recommendation cannot violate 10(b)5. Further, they argue that even if government securities do fall within the unsuitability rule, they are not liable because plaintiffs cannot show the CATS bonds were unsuitable or that defendants acted with the requisite scienter.

The fact that CATS bonds are "exempted securities" under the 34 Act is not relevant here. [HN7] While government bonds may be exempt from certain section of the 34 Act, any manipulative or deceptive device used in connection with the sale of even exempted securities is clearly within the reach of section 10(b). 15 U.S.C. § 78j(b) (1982), [\*13] 17 C.F.R. § 240.10b-5 (1985). The enormous volume of trading in CATS bonds for the Frotas' account clearly indicates that these obligations were not purchased for long-term investment, but for rapid turnover speculation in interest rate fluctuations, a type of trading which may be unsuitable for many customers even if the underlying securities represent the ultimate in safety. Further, the fact that the NASD Rules of Fair Trading do not apply to transactions in government securities is also irrelevant. Plaintiffs have not based their 10b-5 claim on the NASD rules as it is clear that no private right of action exists under the NASD rules. *Frota v. Prudential-Bache Securities, Inc.*, 639 F. Supp. 1186, 1190 (S.D.N.Y. 1986).

In this circuit, [HN8] the knowing or intentional recommendation of an unsuitable security states a cause of action for fraud under section 10(b) and rule 10b-5. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594, 600 (2d Cir. 1978); *Clark v. Kidder, Peabody & Co., Inc.*, 636 F. Supp. 195, 198 (S.D.N.Y. 1986); *Leone v. Advest, Inc.*, 624 F. Supp. 297, 304 (S.D.N.Y. 1985). In order to prevail upon their claim, plaintiffs only have to show that defendants, knowing [\*14] the CATS bond trading to be unsuitable in light of the Frota's stated investment objectives, purchased them for their discretionary account. See *Clark v. Kidder, Peabody & Co., Inc.*, supra. at 198 . . .

As I have indicated above, the Frota's investment objectives are unclear. It is also unclear what Hussein's purpose in purchasing the CATS Bonds might have been. It is undisputed that Prudential-Bache was a market maker for the bonds. Defendants claim, however, that the bonds had an active secondary market and that there may have been attractive tax advantages to nonresidents if the bonds were sold on the secondary market before maturity. Plaintiffs claim that the excessive mark-up taken by defendants made it unlikely that they would realize a profit on resale. The question of Hussein's intent regarding the purchase of the bonds is a question of fact and should be determined by the jury at trial where his credibility can be assessed. See *S. E. C. v. Research Automation Corp.*, 585 F.2d 31, 33 (2d Cir. 1978) (Summary judgment likely to be inappropriate when the issues concern intent).

Defendants' basis for summary judgment on the state law claims echoes their federal arguments. [\*15] They argue that plaintiffs' claims of misrepresentation and breach of fiduciary duty must be dismissed because the material facts allegedly withheld were fully disclosed in the monthly account statements. As discussed above, it is unclear how many account statements the Frotas received, how much they understood about what was being done for their account and what Hussein represented to them was being done.

## **CONCLUSION**

After a careful examination of the affidavits and exhibits submitted to the Court by both parties, I have concluded that there are material facts in dispute. Accordingly, for the reasons stated above, defendants' motion for summary judgment is denied.

SO ORDERED.