# CHURNING AND SUITABILITY OF INVESTMENTS: A FINANCIAL INDUSTRY REGULATORY AUTHORITY ARBITRATION CASE STUDY

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## CASE DESCRIPTION

*The identities of all parties in this matter have been changed to maintain confidentiality. An investor claimed that a broker at a well established securities firm was churning her account and had placed her funds in an account that was not suitable, given her investment objectives. She retained legal counsel. Her attorneys hired a consultant who wrote a report that discussed whether the investments were suitable, as well as whether there was excessive trading. The consultant's report and ultimately the author's testimony were expected to be introduced as evidence in Financial Industry Regulatory Authority (FINRA) arbitration. Ms. Laura Smith, a 72 year old retired widow, opened a brokerage account with Establishment Securities in March 1997, in response to a telephone solicitation from George Shady, an Establishment registered representative. Ms. Smith's primary investment account was with another securities firm. In March 2000, Ms. Smith transferred her primary investment account to Establishment Securities in response to another telephone solicitation from Mr. Shady. Based upon a review of documents that Ms. Smith signed when the Establishment account was created, Ms. Smith had specified that the account was nondiscretionary, meaning that Mr. Shady could not make trades or changes to her portfolio without her permission and that her investment objectives were income and growth.*

*Subsequently by 2003, Ms. Smith noticed that there was unusual activity in her account, which prompted the legal action discussed in this paper. In particular, Ms. Smith's legal counsel filed claims against Establishment Securities alleging that her account had been churned and that her investments were not suitable, relative to her investment objectives. Pursuant to the agreement originally signed in the brokerage agreement, the parties agreed to settle disputes according to FINRA Code of Arbitration.*

*This case study is appropriate for Senior Level and Graduate students of Accounting and Finance.*

**JEL:** M00, K1

**KEYWORDS:** Churning, Suitability.

## CASE INFORMATION

Regulatory suitability rules prohibit a securities broker-dealer from recommending a security to a customer unless he has a reasonable belief that the security is suitable for that customer. The National Association of Securities Dealers (NASD) through its Rule 2310 and the New York Stock Exchange (NYSE) through its Rule 405 articulate guidelines as to the suitability of an investment. The various rules, collectively and singularly, impose an affirmative duty on the broker-dealer to take the client's particular circumstances and situation into consideration. The conditions that need to be assessed when recommending a particular security include a customer's financial situation, risk threshold, investment sophistication, investment objectives, and other securities holdings. Before agreeing to serve a client, a broker is expected to obtain sufficient information regarding the client's

circumstances to be able to determine whether particular investments are suitable (National Association of Securities Dealers and New York Stock Exchange).

The difficulty with suitability arises because of the generality of the stated rules. For example, NASD Rule 2310 states:
*In recommending to customers 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, discussed by such customer as to his other security holdings and as to his financial situation and needs.*

NYSE Rule 405 is equally vague as it states:
*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 and account accepted or carried by such organization.*

This vagueness poses problems when trying to establish that a particular broker's behavior with a client account violates the suitability standard (Shapiro and Rodriguez, 2007).

Churning refers to excessive buying and selling of securities in a client's account for the purpose of creating greater broker commission income without regard to the client's interests. This type of behavior violates the antifraud provisions of Section 10 (b) of the Securities and Exchange Act of 1934, as well as various rules specified by the Securities and Exchange Commission, NASD and NYSE. It is common to use measures of turnover to access whether there was excess activity in a client's account. The most common measure used is the Looper Formula developed by the SEC in its enforcement actions (Looper & Co, 1958). The Looper Formula divides total security purchases by the average month-end account balance, and then the ratio is annualized.

$$Looper = \frac{Purchases}{AverageEquity} \div \frac{DaysInPeriod}{365}$$

In addition, the ratio of commissions charged for trades to average equity can be computed to yield a portfolio break-even rate of return, i.e., what the gross return on securities needed to be in order for the account commissions to be covered. The Commission-to-Equity ratio is computed as:

$$Commission-to-Equity = \frac{Commissions}{AverageEquity} \div \frac{DaysInPeriod}{365}$$

FINRA was created in 2007 as a regulatory body that would serve investors as a regulator of the practices and arbitration function of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). Under Section 12200 of the FINRA Rules, Arbitration Under an Arbitration Agreement or the Rules of FINRA, parties must arbitrate a dispute under the Code if: Arbitration under the Code is either: (1) Required by a written agreement, or (2) Requested by the customer; and The dispute is between a customer and a member or associated person of a member; and The dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

The panel consists of three arbitrators in most cases. Pursuant to FINRA Code of Arbitration Procedure Section 12401 subsection (b), claims between $25,000 and $50,000 may proceed with a single arbitrator. Under subsection (a) of Code of Arbitration Procedure Section 12401 claims under $25,000 are decided by a single arbitrator, generally on the pleadings.

Table1: Arbitration Process

| Step | Description |
|---|---|
| 1 | The arbitrators and the witnesses are sworn in. |
| 2 | Each party has an opportunity to make a brief opening statement. |
| 3 | The claimant presents facts to the arbitrators, including documents and live or written testimony. |
| 4 | The respondent presents his or her case in the same manner as the claimant. |
| 5 | Then, any counter claims are presented in the same way. |
| 6 | Parties may provide rebuttal evidence. |
| 7 | Parties may make closing statements or summations of the testimony. |

Parties demonstrate proof of the claims included in the complaint. Evidence rules are subject to the panels' discretion. Parties are given the opportunity to cross-examine witnesses. The panel then decides if an award is appropriate. Parties may reach settlement prior to conclusion of the arbitration.
In the discovery or information gathering process, in the pre arbitration process in an arbitration involving churning, the discovery requested includes documents that prove the 1) allegations of churning, 2) allegations of failure to supervise, 3) allegations of misrepresentations or omissions, 4) allegations of negligence, 5) allegations of unauthorized trading and 6) allegations of unsuitability.

Documents supporting the churning allegations include 1) All commission runs relating to the customer's account(s) at and 2) All documents reflecting compensation of any kind, including commissions, for the two months preceding through the two months following the transaction(s) at issue, or up to 12 months, whichever is longer, and 3) Documents sufficient to describe or set forth the basis upon which the Associated Person(s) was compensated during the years in which the transaction(s) or occurrence(s) in question occurred, including: a) any bonus or incentive program; and b) all compensation and commission schedules showing compensation received or to be received based upon volume, type of product sold, nature of trade (e.g., agency v. principal), etc.

In addition, testimony of witnesses can be introduced to explain the impact of the violation. Due to the fact specific nature of the proceeding, the expert will correlate the facts with the corresponding legal and ethical responsibilities of the finance professional.

When Ms. Smith had moved her primary account to Establishment Securities, nearly all of her portfolio was invested in shares of General Electric common stock. The defendants claimed that their investment strategy involved diversifying her portfolio so that she was not overly dependent on the performance of a single stock, especially given Ms. Smith's age. Although initial activity in Ms. Smith's account was devoted to diversifying her portfolio, there was the issue of whether this had been done with Ms. Smith's permission, since this was a nondiscretionary account.

The consultant's focus was on assessing whether churning had occurred. In reviewing the activity in Ms. Smith's accounts, it was apparent that there was excessive trading (churning) in her account over the period from May 1, 2001 through September 30, 2003. Over the period from May 1, 2001 through September 30, 2003, total security purchases equaled $1,713,624.79 and the average account balance equaled $368,085.03. As a result, the turnover ratio, as measured by the Looper Formula, equaled 11.25 from May 1, 2001 through September 30, 2003. By comparison, courts have found that when the turnover ratio exceeds four, it is reasonable to conclude that there was excessive trading in a client's account, particularly if the investor's objectives are not speculative in nature (Gaughan, 2009).

The consultant also computed the commission-to-equity ratio. The total commissions on all trades in Ms. Smith's account equaled $94,420.39 from May 1, 2001 to September 30, 2003. As a result the Commission-to-Equity ratio equaled 10.62 percent. This implies that the costs associated with trading were so high that Ms. Smith needed to earn an annualized return on her securities portfolio in excess of

10.62 percent in order to profit from her securities portfolio after subtraction of broker commission, which is further evidence of excessive trading activity.

Damages were estimated from May 1, 2001 through November 1, 2003, when Mr. Shady was removed by Establishment Securities as the broker handling the account. November 1, 2003 was chosen as the end date because Ms. Smith began working with a new broker who she was much happier working with and who rebalanced the portfolio with Ms. Smith's involvement.

The first measure of damages involved comparing the portfolio performance of Ms. Smith's portfolio with the portfolio that had been set up by the new Establishment Securities representative as of November 30, 2003. From May 1, 2003 to November 1, 2003, Ms. Smith's account balance declined from $599,893.86 to $226,772.78. By contrast, if the $599,893.86 was continuously invested in a portfolio value weighted as it was on November 30, 2003 with withdrawals from the account by Ms. Smith mirroring actual withdrawals, the portfolio value on November 1, 2003 would have equaled $569,941.35. Hence, using this approach, damages to Ms. Smith over the period from May 1, 2003 to November 1, 2003 equaled $569,941.35 - $226,772.78 = $362,238.07.

In response to a critique of this author's initial report by a defense damages expert, an alternative approach was used by the consultant to compute damages. The second approach involved estimating Ms. Smith's damages under the assumption that in the absence of churning, her portfolio would have remained as it was on May 1, 2001, with 70 percent of the value of the assets invested in General Electric common stock. If the portfolio had remained unchanged from May 1, 2001 to November 1, 2003, it would have declined in value from $599,893.86 to $379,154.30, as compared to its $226,772.78 actual value. Under the second damages approach, the damages equaled $379,154.30- $226,772.78 =$152,381.52.

**QUESTIONS**

1. Ms. Smith had a nondiscretionary account. Do you think this alone made any unauthorized investment change by Mr. Shady unethical?

2. Would Ms. Smith's investments have been unsuitable for her if in the absence of churning, her portfolio had remained invested primarily in General Electric stock?

3. Damages were calculated by the consultant by comparison of the financial performance of investments made by Mr. Shady to the performance of investments in benchmarked portfolios. Do you agree with the consultant's choice of benchmark portfolios?

4. Do you think that the defense expert's criticism of the approach used to obtain a damages figure of $362,238 was appropriate?

5. Should there have been interest accrued on the award from November 2003 until an award of damages? If so, interest on what kind of investment?

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**TEACHING NOTES**

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## GENERAL COMMENTS

When assigning this case to students, the instructor should start with an overview of the role of the SEC, stock exchanges and FINRA in regulating the securities industry. The discussion should then continue on the topic of what constitutes ethical behavior by a broker or investment advisor. Students should be encouraged to chime in about the ethical standards that they believe are appropriate for brokers and investment managers.

## QUESTIONS

1. Ms. Smith had a nondiscretionary account. Do you think this alone made any unauthorized investment change by Mr. Shady unethical?

Discussion of this topics should focus on the meaning of a nondiscretionary account. A perceptive student might notice that if the account was nondiscretionary then any activity by the broker without Ms. Smith's authorization should be viewed as leading to unsuitable investments.

2. Would Ms. Smith's investments have been unsuitable for her if in the absence of churning, her portfolio had remained invested primarily in General Electric stock?

Students should focus on the idea that having her portfolio invested in General Electric meant that she was not benefiting from the risk reduction associated with portfolio diversification. In addition, students might focus on the notion that for a senior citizen who is looking for income from her savings over a shorter term horizon, the risk from holding shares in a single company may well have been too risky.

3. Damages were calculated by the consultant by comparison of the financial performance of investments made by Mr. Shady to the performance of investments in benchmarked portfolios. Do you agree with the consultant's choice of benchmark portfolios?

In answering this question, there is not necessarily one correct answer. Students should be encouraged to speculate on what class or classes of assets would have been appropriate for a senior citizen and then assess portfolio performance for that benchmark portfolio during the period that churning allegedly occurred.

4. Do you think that the defense expert's criticism of the approach used to obtain a damages figure of $362,238 was appropriate?

Students should be asked to critique the method used by the financial consultant to model damages to Ms. Smith. In particular, students should examine whether the damages period was properly specified, as well as the appropriateness of comparing the performance of Ms. Smith's portfolio during the period of churning to a hypothetical benchmark.

5. Should there have been interest accrued on the award from November 2003 until an award of damages? If so, interest on what kind of investment?

Students should quickly realize that the loss of the time value of money is not being recognized unless interest is accrued on the damages. You may want to mention to students that experts are divided on whether the interest should be on a relatively risk free instrument or a risky instrument (Lanzillotti and Esquibel, 1990; Fisher and Romaine, 1990; and Patel, et al., 1982).

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