Volume 79 | Issue 2 Article 7

1990

Ernst & Ernst v. Hochfelder as Applied to Commodities Fraud: No Intent Required

Harry B. Borders
University of Kentucky

NOTES

Ernst & Ernst v. Hochfelder as Applied to Commodities Fraud: No Intent Required

Introduction

> Futures trading is a basic adjunct of the marketing of agricultural and other commodities, and a source of speculative activities by a growing number of American investors.[1]

Due to the risk and complexity of commodity trading, even knowledgeable and experienced commodities investors frequently lose money through futures[2] trading.[3] Since it is difficult to determine exactly why they lost money, investors often make easy targets for fraud by their brokers.

The focus of this Comment is on commodities fraud. One common type of commodities fraud is known as "churning."[4]

---

[1] S. Rep. No. 1131, 93d Cong., 2d Sess. 11, *reprinted in* 1974 U.S. Code Cong. & Admin. News 5843, 5852.

[2] A "future" is a contract providing for future delivery of the actual commodity. A person desiring to trade in a given commodity buys or sells a future. R. Stevenson & E. Jennings, Fundamentals of Investments 445 (3d ed. 1984).

[3] Commodities trading is accomplished through a series of steps. First, the customer places his order with a solicitor or account executive, who transmits the order to the exchange trading floor. Once the order is received on the floor, a runner carries the order to a floor broker located in the trading area (also called the "pits").

The actual futures contracts trading occurs in a loud, active market similar to an auction house. The Commodities Exchange Act, as well as the rules and regulations of the individual commodity exchanges, require that the transaction occur in an open, competitive manner by "outcry or posting of bids and offers." This requirement ensures that all trades are executed at competitive prices.

Once a trade is executed, it must be confirmed through a clearinghouse. The clearinghouse confirms the trade by "matching all buys and sells which are executed" on a particular day. Next, the clearinghouse becomes the seller of all orders to buy and the buyer of all orders to sell, and it is given legal responsibility for the opposite side of every transaction.

The clearinghouse also receives deliveries of futures contracts. When a seller is to make a delivery, he must file a delivery notice with the clearinghouse one day before the intended delivery. Then the clearinghouse assigns the notice of delivery to one of its members for trading. S. Rep. No. 1131, *supra* note 1, at 5856-58.

[4] For examples of churning, see Bowley v. Stotler & Co., 751 F.2d 641, 644 (10th

Churning[5] is defined by the Commodities Futures Trading Commission[6] (hereinafter CFTC) as "excessive trading of an account by a broker for the purpose of generating commissions, without regard for the investment or trading objectives of the customer."[7]

In 1936, the Commodity Exchange Act[8] (hereinafter CEA) was enacted to regulate commodity trading. Section 4b[9] is the general antifraud provision of the CEA. Section 4b reads in part,

> It shall be unlawful (1) for any member of a contract market in connection with any contract of sale of any commodity for future delivery
> (A) to cheat or defraud or attempt to cheat or defraud such other person;
> (B) willfully to make or cause to be made to such other person any false report or statement thereof;
> (C) willfully to deceive or attempt to deceive such other person.[10]

A customer or the CFTC may bring an action under Section 4b(1)(A) against a broker who engages in commodities fraud.[11] It has been well established[12] that two of the elements of a commodities fraud claim are control by the broker over the customer's account[13] and excessive trading in light of the customer's investment

---

Cir. 1985); Evanston Bank v. Conticommodity Services, Inc., 623 F Supp. 1014, 1024 (N.D. Ill. 1985).

[5] Churning will support a claim for relief under section 22(a)(1) of the Futures Trading Act. *See* 7 U.S.C. § 25(a)(1) (1983).

[6] The Commodities Futures Trading Commission (CFTC) is the federal regulatory agency responsible for the administration and enforcement of the Commodity Exchange Act, 7 U.S.C. §§ 1-24 (1988).

[7] *Bowley*, 751 F.2d at 644; *see also* Karlen v. Ray E. Friedman & Co. Commodities, 688 F.2d 1193, 1203 (8th Cir. 1982) (the court noted several factors that evidenced control: plaintiff followed nearly all of the broker's suggestions, lacked experience, and lacked understanding of the transactions); Khalid Bin Alwaleed Foundation v. E. F Hutton & Co., 709 F Supp. 815, 816-17 (N.D. Ill. 1989) (the court stated that an excessive turnover ratio or commission-to-equity ratio must be determined to allege churning).

[8] 7 U.S.C. §§ 1-24 (1988).

[9] 7 U.S.C. § 6b.

[10] *Id.*

[11] 7 U.S.C. § 6b. In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982), the Supreme Court recognized that a customer has a private right of action against his broker for violations of § 4b of the CEA.

[12] *See Bowley*, 751 F.2d at 644; Booth v. Peavey Co. Commoditiy Services, 430 F.2d 132, 133-34 (8th Cir. 1970); *Evanston Bank*, 623 F Supp. at 1024.

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

objectives.[14] However, there has been much debate over whether the mental state required to support a commodities churning claim is scienter.[15]

This Comment examines scienter as a required element of a commodities fraud claim. Part I defines commodities fraud, and in particular commodities churning, and explains how it is shown.[16] Part II details a brief history of futures trading.[17] Part III examines the legislative history of commodities fraud.[18] Part IV presents an objective overview of the caselaw discussing scienter as an element of a commodities fraud claim.[19] Part V presents an analysis of the legislative history, as well as a detailed analysis of the word "defraud" as used in Section 4b(1)(A) of the CEA.[20] Finally, this Comment concludes that scienter is not required to support a commodities fraud claim.[21]

I. WHAT IS COMMODITIES CHURNING AND HOW IS IT SHOWN?

Commodities churning occurs when a broker trades excessively in a customer's account, for the purpose of generating commissions

---

Cir. 1980); *see also Bowley*, 751 F.2d at 644 (jury instructions should focus on who was in control of the account).

One author noted that "the essential question to be resolved is whether the dealer occupied the status in respect to the customer that he may reasonably be held responsible for any of the excessive trading complained of." Shelly v. Noffsinger, 511 F Supp. 687, 691 (N.D. Ill. 1981); *see also* Clayton Brokerage Co. v. Commodities Futures Trading Commission, 794 F.2d 573, 582 (11th Cir. 1986) (considerations to be examined are the intelligence of the client and the amount of trust he places in the broker). In general, control is clearly established where the account is discretionary, a power of attorney has been executed in favor of the broker, and the trades are completed without prior approval by the customer. Costello v. Oppenheimer & Co., 711 F.2d 1361, 1368 (7th Cir. 1983) (an action dealing with securities brokers under the Securities Exchange Act of 1934).

[14] "The essential issue of fact is whether the volume of transactions, considered in light of the nature and objectives of the account, was so excessive as to indicate a purpose on the part of the broker to derive a profit for himself at the expense of his customers." Costello v. Oppenheimer, Inc., 711 F.2d at 1368; *see also Bowley*, 751 F.2d at 644 (excessive trading is an element of churning).

[15] Scienter has been defined by the Supreme Court as a mental state embracing "intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

[16] *See infra* notes 22-31 and accompanying text.

[17] Futures trading is snyonymous with commodities trading. *See infra* notes 32-40 and accompanying text.

[18] *See infra* notes 41-59 and accompanying text.

[19] *See infra* notes 60-79 and accompanying text.

[20] *See infra* notes 81-106 and accompanying text.

[21] *See infra* notes 114-15 and accompanying text. *But see* Johnson, *Applying Hochfelder in Commodity Fraud Cases*, 20 B.C.L. REV. 633, 635 (1978); Note, *The Element of Scienter in Antifraud Provisions of the Commodity Exchange Act*, 39 WASH. AND LEE L. REV. 1175 (1982); BROMBERG & LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD Vol. 5, § 13.3 (1582) (1) (1984); J. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS v.13 §§ 3.01-3.03 (1990).

for himself without regard for the investment goals of the customer. Since churning is one type of fraud,[22] and Rule 9(b) of the Federal Rules of Civil Procedure requires that allegations of fraud be "stated with particularity,"[23] to satisfy Rule 9(b), the plaintiff must identify the commodities involved, the nature of the commodities, the amount and dates of the transactions in question, and produce evidence sufficient to show that the account was excessively traded.[24]

The existence of excessive trading in a commodities account[25] is a question of fact, not a question of law.[26] A universally precise formula for calculating excessiveness is therefore unavailable. "There are, however, indicia of excessive trading that 'may aid the fact-finder by introducing some measure of objectivity or certainty into an otherwise recondite subject. . . .' These indicia include the annualized commission to equity ratio, the turnover rate, and a pattern of in-and-out day trading."[27] Additionally, an investor's

---

[22] A customer bringing a civil action has the burden of establishing, by a preponderance of the evidence, the churning of her account. Hecht v. Harris Upham & Co., 430 F.2d 1202, 1209 (9th Cir. 1970). If the customer makes a prima facie showing of excessive trading for the purpose of generating commissions, "the burden shifts to the [defendants] to produce evidence that there was a legitimate basis for their trading strategy." Parciasepe v. Shearson, Hayden, Stone, Inc., CFTC Docket No. R 79-795-80-123 [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,464 (Jan. 2, 1985); *see also* Dunn v. Contemporary Fin. Corp., CFTC Docket No. 83-R913 [1985-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,955 (Feb. 25, 1986).

[23] FED. R. CIV. P. 9(b).

[24] Khalid Bin Alwaleed Foundation v. E. F. Hutton & Co., 709 F. Supp. 815, 817 (N.D. Ill. 1989).

[25] The standard for excessive trading in the commodities fraud context is generally higher than the standard for excessiveness in the securities fraud context. *See* Griswald v. E. F. Hutton & Co., Inc., 622 F. Supp. 1397, 1407 (D.C. Ill. 1985); Booth v. Peavey Co. Commodity Serv., 430 F.2d 132, 134 (8th Cir. 1970) (commodity accounts are heavily traded accounts as compared to investing accounts).

[26] Costello v. Oppenheimer & Co., 711 F.2d 1361, 1369 (7th Cir. 1983); *Booth*, 430 F.2d at 135.

[27] Bowley v. Stotler & Co., 751 F.2d 641, 646 (3d Cir. 1985) (quoting *Costello*, 711 F.2d at 1369).

The "commission to equity" ratio is the commissions earned by the broker divided by the amount of equity in the customer's account.

The "turnover rate" of an account is "the ratio of the total cost of purchases made for the account during a given period of time to the amount invested. . . . Whether a particular turnover rate is excessive depends on the objectives of a customer." *Costello*, 711 F.2d at 1369, n.11. While numerous courts have used the annual turnover rate of an account as an indicator of excessive trading, in In re Lincolnwood Commodities, Inc. of California, CFTC Docket No. 78-48 [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,147 (Jan. 31, 1984), the CFTC held that since commodities futures contracts are short-term instruments and have inherently fast turnover rates, and because of the experience and sophistication are relevant factors in the determination of whether a broker has churned that customer's account.[28]

Once it has been established that the customer's account has been fraudulently managed, damages must be calculated. Ideally, damages should restore the customer to the position he would have achieved but for the defendant broker's misconduct.[29] However, it is often difficult to determine accurately what results a properly managed account would have achieved.

Excessive commissions received by the broker and excessive decline in the value of the customer's portfolio are two types of damages that usually result from the churning of a customer's account.[30] It is necessary to remedy both of these harms in order to fully compensate the victimized investor.[31]

II. THE HISTORY OF COMMODITIES TRADING

Modern commodity exchanges trace their origin to the medieval trade fairs in Europe during the twelfth century.[32] In the 1700's,

---

volatility of commodity prices, "the length of time that a futures contract is held is not particularly revealing in determining whether a commodities account has been trading excessively." *Id.* at ¶ 28,247. Rather, the CFTC in *Lincolnwood* preferred to rely on the monthly commission-to-equity ratio as an indication of churning. *Id.* at ¶ 28,249.

"In-and-out" trading is defined as "the sale of all or part of a customer's portfolio, with the money immediately expended on other investments, followed shortly by the sale of the newly acquired investments." Karlen v. Ray E. Friedman & Co. Commodities, 688 F.2d 1193, 1203 n.11 (8th Cir. 1982) (citing Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 876 (1967)).

[28] *See* Herman v. T & S Commodities, Inc., 592 F. Supp. 1406, 1416 (S.D.N.Y. 1984); Gochnauer v. A. G. Edwards & Sons, Inc., 810 F.2d 1042, 1049 (11th Cir. 1987) (experience and sophistication of investors is relevant in determining the extent of the fiduciary duty of care in explaining contemplated securities transactions).

[29] *Herman*, 592 F. Supp. at 1421.

[30] Miley v. Oppenheimer & Co., 637 F.2d 318, 326 (5th Cir. 1981).

[31] *Id.* To help simplify the calculation of damages, the Second Circuit proposed the following formula: (1) compute the market value of the customer's portfolio at the time the broker began to aid and abet the fraud and the market value when the fraud stopped, (2) subtract the value of the portfolio when the fraud stopped from the value of the portfolio when the fraud began to determine the customer's "gross economic loss", (3) reduce that loss by the average percentage decline in the value of the Dow Jones Industrial Average, the Standard & Poor's Index or any other well recognized index during the period when the churning was taking place. If, during the relevant period of time, the stock market declined in value by 25 percent, then the gross economic loss should be reduced by 25 percent. Additionally, the customer is entitled to the return of commissions on the transactions falling within this period of time and interest on those commissions. Rolf v. Blyth, Eastman, Dillon & Co., 570 F.2d 38, 49-50 (2d Cir. 1978).

[32] S. REP. No. 1131, 93d Cong., 2d Sess. 11, *reprinted in* 1974 U.S. CODE CONG. & ADMIN. NEWS 5843-5852.

following the example of European ancestors, American producers and merchants began to trade their commodities at the market.[33] These trades were primarily "spot" deliveries[34] for cash.[35]

"Spot" deliveries caused problems for both the farmer and the merchant buyer. The farmers all brought their commodities to the market at harvest time each year. This led to a supply greatly exceeding demand, which depressed the market price for the commodities. Because the commodities were perishable goods, this led to excessive waste. Months later, after the commodities were consumed or spoiled, demand exceeded the supply, prices skyrocketed, and people went hungry.[36]

These problems forced the emergence of future trading of commodities,[37] which developed in the United States between 1850 and 1900. Future trading of commodities developed as a response to the increasing economic need for large scale risk bearing in the agricultural market.[38] During the infancy of the futures[39] market, market regulation was virtually nonexistent, and this led to irresponsible trading. Such irresponsibility led to repeated efforts to abolish futures trading altogether.[40]

III. THE HISTORY OF COMMODITIES FUTURES REGULATION

In 1844, the first bill to prohibit futures trading was introduced, followed by similar proposals over the next fifty years. From 1895 to 1920, the desire to abolish futures trading slowly gave way to efforts to regulate futures trading.[41]

---

[33] *Id.* at 5853. The first trades were for items such as eggs, butter, vegetables and grains.

[34] "Spot" deliveries occur when the merchants pay the full cash price "on the spot." R. S. WURMAN, A. SIEGEL & K. M. MORRIS, THE WALL STREET JOURNAL GUIDE TO UNDERSTANDING MONEY & MARKETS 76 (1989).

[35] *See* S. REP. No. 1131, *supra* note 32, at 5853.

[36] *Id.*

[37] "Trading in futures provides not only the market of today, but of months ahead, and affords guidance to buyers and sellers of agricultural commodities in planning ahead, and in financing and marketing commodities from one season to another." *Id.* at 5854.

[38] *Id.* at 5853.

[39] Futures are current agreements to be performed in the future. The buyer and seller agree on the future date of delivery, the price to be paid at that date, and the quantity and quality of the commodity. Forward contracting of commodities solved the problem of availability and demand. However, it did not help to control the financial risk of loss that accompanied rapidly changing prices which resulted from bad weather, inadequate storage, and the poor economic conditions of the 19th century. *Id.* at 5854.

[40] *Id.* at 5854.

[41] *Id.*

A review of the legislative history of the attempts to regulate the commodities markets reveals that Congress' objectives were initially unclear as to antifraud measures.[42] It is no wonder that there have been many interpretations of Congress' actual intentions.[43] However, a close examination reveals that although initially hesitant, Congress later was intent on developing legislation that does not require scienter.[44]

Regulation of future trading began in 1922[45] with the Grain Futures Act,[46] renamed the Commodity Exchange Act in 1936.[47] In 1928, legislation was introduced to amend the Grain Futures Act to "insure fair dealings and to prevent fraudulent practices. . . ."[48] Although the 1936 Act contained no antifraud provision, the amendment would have made it illegal to "knowingly" defraud a customer.[49] The amendment was rejected, apparently

---

[42] *See infra* notes 45-53 and accompanying text.

[43] *See supra* notes 12-15 and accompanying text.

[44] *See infra* notes 54-59 and accompanying text.

[45] S. REP. No. 947, 90th Cong., 2d Sess. 1 (1968), *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 1673-76.

[46] Grain Futures Act, ch. 369, 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. §§ 1-22).

[47] Commodities Exchange Act, Pub. L. 74-675, §§ 1-13, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. §§ 1-22). The Commodity Futures Trading Commission Act of 1974 (CFTCA), Pub. L. 93-463, 88 Stat. 1389 (1974) (codified at 7 U.S.C. §§ 1-22), substantially amended the CEA. These amendments created the Commodity Futures Trading Commission (CFTC), an independent federal agency, to assume authority over futures trading, replacing the Department of Agriculture. S. REP. No. 1131, 93d Cong., 2d Sess. 11 (1974), *reprinted in* 1974 U.S. CODE CONG. AND ADMIN. NEWS 5843. The CFTCA gave the CFTC exclusive administrative jurisdiction to regulate commodity trading:

> [T]he Commission shall have exclusive jurisdiction . . . with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange, or market. . . . *And provided further*, [t]hat, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and responsibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on the courts of the United States or any State.

7 U.S.C. § 2 (1988).

[48] Grain Futures Act: Hearings on Amendments Before the Subcomm. of the House Comm. on Agriculture, 70th Cong., 1st Sess. 7 (1928) (statement of Mr. J. W. T. Dewel, Chief, Grain Futures Administration, Department of Agriculture).

[49] S. 3575, 70th Cong., 1st Sess. § 3 (1928); H.R. 11952, 70th Cong., 1st Sess. § 3 (1928).

because Congress believed that prosecution under state laws was a sufficient deterrent for fraud.[50]

In 1932, two amendments were introduced that again would have added antifraud provisions to the Grain Futures Act. The first bill was H.R. 7608.[51] Section 4A of this legislation would have made it unlawful "knowingly and with intent to defraud any person, to fail truly, fully, and correctly to account to such, or to cheat or defraud any person in any manner whatsoever"[52] This provision, which clearly would have required scienter, was rejected by the House Committee on Agriculture.[53]

Instead, the Committee on Agriculture favored the second bill, H.R. 12287,[54] which provided that it would be unlawful for a broker to commit any of the following acts:

> (1) to cheat or defraud or attempt to cheat or defraud such person [the broker's customer];
> (2) willfully to make or cause to be made to such person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;
> (3) willfully to deceive or attempt to deceive such person by any means whatsoever in regard to any such order or contract. [55]

In 1936 Congress passed the Commodity Exchange Act,[56] which contained language virtually identical to the language of H.R. 12287 The decision to include the language of H.R. 12287 and reject the language of H.R. 7608, which would have required scienter, reveals Congress' intent to exclude a scienter requirement from the Act.

When it amended the criminal provisions of the CEA in 1978, Congress again evidenced its intent to exclude scienter as a required element of civil claims.[57] This amendment provided that a violation of section 6b[58] would support a conviction only if committed "knowingly" The Conference Committee Report[59] explained that

[50] H.R. 1637, 73rd Cong., 2d Sess. § 32 (1934).
[51] H.R. 7608, 72d Cong., 1st Sess. § 4A (1932).
[52] *Id.*
[53] H.R. REP. No. 1551, 72nd Cong., 1st Sess. (1932).
[54] H.R. 12287, 72d Cong., 1st Sess. § 4b (1932).
[55] *Id.*
[56] 7 U.S.C. § 6b (1988).
[57] Futures Trading Act of 1978, 92 Stat. 865 (1978). This amendment changed a § 6b violation from a misdemeanor to a felony.
[58] 7 U.S.C. § 6b (1988).
[59] S. REP. No. 1239, 95th Cong., 2d Sess. 25 (1978).

the word "knowingly" was specifically intended to require "scienter" as an element of a section 6b criminal violation. However, Congress did not amend the civil provisions of the CEA to include scienter. By failing to add scienter as an element of a civil violation of the CEA when it did so for criminal violations, Congress demonstrated that it intended to distinguish the two causes of action and exclude scienter from the elements of a civil violation.

IV CASES DISCUSSING SCIENTER AS A REQUIRED ELEMENT OF A COMMODITIES FRAUD CLAIM

A. *Cases Requiring Scienter*

Three lines of reasoning have emerged in support of scienter as a requirement for commodities fraud violations.

First, some courts include scienter as an element of commodities fraud as if there has never been any doubt that a commodities fraud violation requires intent to defraud.[60] For instance, in *Schindler v Chas. A. Stockley & Gabriel Brokerage, Inc.*[61] the court said "[t]he state of mind of the trader is of primary importance because the very definition of churning assumes that the purpose of the trading pattern is to generate commissions at the expense of the customer and without regard to the customer's trading objectives."[62] The court, however, never actually defined churning; it simply assumed that the definition included scienter.

Second, some courts[63] hold that if the words of a statute are clear, there is no need to look to the legislative history Supporters of this line of reasoning assert that the words of Section 4b(1)(A) clearly require intent and thus no further analysis is required. The Eighth Circuit in *McIlroy v Dittmer*[64] stated this reasoning:

---

[60] *See* Hill v. Bache, Halsey, Stuart, Shields, Inc., 790 F.2d 817 (10th Cir. 1986) (court rejected liability based on mere negligence and required a degree of intent beyond negligence); Schindler v. Chas. A. Stockley and Gabriel Brokerage, Inc., No. 83 Civ. 2186, slip op. (S.D.N.Y. August 16, 1985) (claim of churning requires three elements: control, excessive trading, and intent to increase commissions); McCurnin v. Kohlmeyer & Co., 347 F Supp. 573 (E.D. La. 1972) ("That section [7 U.S.C. § 6b] is clearly directed only towards willful misconduct.").

[61] *Schindler*, No. 83 Civ. 2186, slip op.

[62] *Id.*

[63] McIlroy v. Dittmer, 732 F.2d 98 (8th Cir. 1984); McCarthy v. PaineWebber, Inc., 618 F Supp. 933, 938 (N.D. Ill. 1985).

[64] *McIlroy*, 732 F.2d at 102.

> Section 4b(A) prohibits "cheat[ing]," "defraud[ing]," and "attempt[ing] to cheat or defraud." The words of the statute themselves negate any inference that Congress meant to proscribe unintentional acts under section 4b(A). Indeed, the words "cheat" and "defraud" themselves imply a degree of intentionality that would probably render the inclusion of "willfully" in Section 4b(A) superfluous. Estabishing a violation of Section 4b(A) requires proof of something more than mere carelessness.[65]

A close reading of the statute does not support this view because "scienter-type" language, such as "knowingly," or "intentionally," is excluded.

Third, at least one court has looked beyond the mere words of the statute and has compared commodities fraud to common-law fraud.[66]

> A common-law action for fraud requires a false representation of a material fact with knowledge or belief on the part of the defendant that the representation is false. The false representation must be made with the intent to induce the other party to rely upon that representation. A fraud action under Section 4b(A) of the CEA is substantially the same.[67]

B. Cases Not Requiring Scienter

Just as some cases fail to explain their inclusion of scienter as an element of a commodities churning claim, some other cases fail to explain their exclusion of scienter.[68] The Third Circuit, in *Bowley v Stotler & Co.*,[69] simply held that the definition of churning "includes two elements: control of an account by a broker, and excessive trading."[70]

In *Drexel Burnham Lambert v Commodity Futures Trading Commission*[71] the D C. Circuit held that "reckless inattention to obvious dangers to a client's interests in arranging a purchase or sale for the client's account triggers liability under section 4b."[72]

---

[65] *Id.*

[66] Greenwood v. Dittmer, 776 F.2d 785 (8th Cir. 1985).

[67] *Id.* at 789.

[68] *See, e.g.*, Bowley v. Stotler & Co., 751 F.2d 641 (3rd Cir. 1985).

[69] *Id.*

[70] *Id.* at 644.

[71] 850 F.2d 742 (D.C. Cir. 1988).

[72] Drexel Burnham Lambert v. Commodity Futures Trading Commission, 850 F.2d 742, 748 (D.C. Cir. 1988); *see also* Evanston Bank v. Conticommodity Services, Inc., 623 F Supp. 1014, 1022 (D.C. Ill. 1985).

In so holding, the court implicitly rejected the theory that an intent to deceive, manipulate, or defraud, as the Supreme Court defined scienter in *Hochfelder*,[73] is required for a section 4b violation.

In *Sall v G. H. Miller & Co.*,[74] the court found that section 6b of the CEA encompassed actual fraud as well as constructive fraud and therefore held that "Congress did not intend § 4b(A) to cover only actions taken with intent to defraud."[75]

In *Ernst & Ernst v Hochfelder*,[76] the U.S. Supreme Court decided that scienter is a requirement for a securities fraud violation.[77] In *Gordon v Shearson Hayden, Stone, Inc.*[78] the CFTC[79] applied the analysis used in *Hochfelder*, and found that scienter is not an element of a commodities fraud violation.[80]

V APPLICATION OF THE *HOCHFELDER* ANALYSIS TO COMMODITIES CHURNING CLAIMS

In *Ernst & Ernst v Hochfelder*,[81] the Supreme Court held that scienter is a requirement of securities fraud. However, the Supreme

---

[73] *See supra* note 15.

[74] 612 F Supp. 1499 (D.C. Colo. 1985).

[75] Sall v. G.H. Miller & Co., 612 F Supp. 1499, 1503 (D.C. Colo. 1985).

[76] 425 U.S. 185 (1976). *See supra* note 15.

In *Hochfelder*, the defendant accounting firm was hired to periodically audit a brokerage firm's books and records. The plaintiffs, who were customers of the brokerage firm, invested money in a securities fund that was later revealed as fraudulently managed. Plaintiffs filed an action against defendant for damages under § 10(b) of the Securities and Exchange Act. It was alleged that the brokerage firm violated § 10(b), and that the defendant had "aided and abetted" the fraud by its failure to properly audit the brokerage firm. The district court granted summary judgment in favor of the defendant. The Seventh Circuit reversed and remanded, holding that one who breaches a duty of inquiry is liable in damages for aiding and abetting a third person's violation of § 10b-5 if the fraud would have been discovered but for the breach of the duty of inquiry. The Supreme Court reversed the Seventh Circuit, holding that a private cause of action will not lie under Rule 10b-5 in the absence of an allegation of "scienter" on the part of the defendant.

[77] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[78] 2 Comm. Fut. L. Rep. (CCH) ¶ 21,016 (April 10, 1980). *But see Evanston Bank*, 623 F Supp. 1014.

[79] The CFTC has exclusive jurisdiction over the regulation of the futures industry, although this exclusive jurisdiction does not preclude a private cause of action for violations of the CEA. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353 (1982); *see supra* note 6.

[80] *But see* CFTC v. Sterling Capital Co., 2 Comm. Fut. L. Rep. (CCH) ¶¶ 21,169, 21,170 (April 9, 1981).

[81] 425 U.S. 185 (1976) ("There is no indication, however, that § 10b was intended to proscribe conduct not involving scienter."). *But see* Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990). Professor Thel states in his article that securities fraud does not require scienter and that the Supreme Court decided *Hochfelder* incorrectly.

Court has not addressed the issue of scienter in the context of commodities fraud. Since commodities fraud is often compared to securities fraud,[82] it is logical to believe that when the Supreme Court finally addresses the issue, it will use a method of analysis similar to the analysis the Court used in *Hochfelder*[83]

In *Hochfelder*, the Supreme Court used the following two-step analysis to reach its conclusion: (1) examine the language of the relevant statute,[84] and (2) examine the legislative history and other relevant authorities.[85] This two step analysis is typical of that used by the Court for statutory construction when the intent of Congress is less than clear[86]

A. Language of the Relevant Statute

The first part of the *Hochfelder* test requires an examination of the language of the statute. Section 4b(A) of the CEA makes it unlawful for a member of a contract market[87] to "defraud" an-

---

[82] *See, e.g.*, First Commodity Corp. v. Commodity Futures Trading Comm'n, 676 F.2d 1 (1st Cir. 1982); CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979); Evanston Bank v. Conticommodity, 623 F Supp. 1014 (N.D. Ill. 1985); Commodity Futures Trading Commission v. J.S. Love & Assocs. Options, 422 F Supp. 652 (S.D.N.Y. 1976); *see also* Johnson, *Applying Hochfelder in Commodity Fraud Cases*, 20 B.C.L. REV 633 (1979).

[83] *Hochfelder*, 425 U.S. 185. *But see* Johnson, *supra*, note 82 at 635 (applying *Hochfelder* to commodity fraud cases and concluding that scienter is a required element).

[84] *Hochfelder*, 425 U.S. at 197; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); F.T.C. v. Bunte Bros., 312 U.S. 349, 350 (1941).

[85] *Hochfelder*, 425 U.S. at 201; *see also* Train v. Colorado Pub. Interest Research Group, Inc., 426 U.S. 1, 9-10 (1976); Philbrook v. Glodgett, 421 U.S. 707, 713 (1975) ("Our objective in a case such as this is to ascertain the congressional intent and give effect to the legislative will."); U.S. v. Gilliand, 312 U.S. 86, 93 (1941) ("If the language of the amended section could be deemed ambiguous, the legislative history of the amendment would dispel any doubt as to the congressional purpose.").

[86] "Where as here, the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear." Blum v. Stenson, 465 U.S. 886, 896 (1984); *see also* Landreth Timber Co. v. Landreth, 471 U.S. 681, 85 (1985); Ford Motor Credit Co. v. Cenance, 452 U.S. 155, 158 (1981); U.S. v. Turkette, 452 U.S. 576, 580 (1981) ("In determining the scope of a statute, we look first to its language."); Consumer Prods. Safety Comm'n v. G.T.E. Sylvania, Inc., 477 U.S. 102, 108 (1980) ("We begin with the familiar canon of statutory construction that the starting point for interpreting a statute is the language of the statute itself."); Touche Ross & Co. v. Redington, 442 U.S. 560, 568 (1979); Greyhound Corp. v. Mt. Hood Stages, Inc., 437 U.S. 322, 330 (1978); *Blue Chip Stamps*, 421 U.S. at 756 (Powell, J., concurring); Harrison v. Northern Trust Co., 317 U.S. 476, 479 (1943) (resort may be had to explanatory legislative history, no matter how clear the statutory words may appear on superficial examination since words are inexact tools at best).

[87] "The words 'member of a contract market' shall mean and include individuals,

other. The common law definition of "fraud" includes both actual fraud and constructive fraud.[88] Actual fraud[89] requires the plaintiff to show that the defendant intended to defraud the plaintiff.[90] Constructive fraud,[91] however, has been consistently held not to require such intent.[92] Further, in *Securities Exchange Commission v Capital Gains Research Bureau, Inc.*,[93] the Supreme Court presumed that Congress has not adopted the "technical" definition of fraud, which includes only actual fraud; rather, fraud is presumed to include constructive fraud. As the CFTC noted in *Gordon v Shearson, Hayden, Store, Inc.*, this construction of the term "defraud" is consistent with the definition of fraud as defined in

---

associations, partnerships, corporations, and trusts owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon." 7 U.S.C. § 2 (1988).

[88] Gordon v. Shearson, Hayden, Stone, Inc., 2 Comm. Fut. L. Rep. (CCH) ¶ 21,016 (April 10, 1980). *But see* Greenwood v. Dittmer, 776 F.2d 785 (8th Cir. 1985).

[89] "Actual fraud consists in deceit, artifice, trick, design, some direct and active operation of the mind; it includes cases of the intentional and successful employment of any cunning, deception, or artifice used to circumvent or cheat another." BLACK'S LAW DICTIONARY 594, 595 (5th ed. 1979); *see also* Perkins School v. Freeman, 741 F.2d 1503 (7th Cir. 1984); U.S. v. Clevenger, 733 F.2d 1356 (9th Cir. 1984); Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981), *cert. denied*, 459 U.S. 1102; Hart v. McLucas, 535 F.2d 516 (9th Cir. 1976).

[90] W PROSSER, HANDBOOK OF THE LAW OF TORTS 685-86 (4th ed. 1971).

[91] "[C]onstructive frauds are such acts or contracts as, though not originating in any actual evil design or contrivance to perpetrate a positive fraud or injury upon other persons, are yet, by their tendency to deceive or mislead other persons deemed equally reprehensible with actual fraud." BLACK'S LAW DICTIONARY 660, 661 (6th ed. 1979).

[92] Moore v. Crawford, 130 U.S. 122, 128 (1889); *see also* Brazee v. Morris, 204 P.2d 475 (Ariz. 1949); Arkansas Valley Compress & Warehouse Co. v. Morgan, 229 S.W.2d 133 (Ark. 1950) (constructive fraud is a breach of either a legal or equitable duty, and does not necessarily involve any guilt, intent to deceive, or actual dishonesty of purpose); *In re* Arbuckle's Estate, 220 P.2d 950 (Calif. App. 1950) ("In its generic sense, constructive fraud comprises all acts, omissions, and concealments involving a breach of legal or equitable duty, trust, or confidence and resulting in damage to another."); Sioux City v. Western Asphalt Paving Corp., 271 N.W 624 (Iowa 1937); Loucks v. McCormick, 424 P.2d 555 (Ka. 1967) (constructive fraud is a breach of either a legal or equitable duty, and does not necessarily involve any guilt, intent to deceive, or actual dishonesty of purpose); Fire Assoc. of Philadelphia v. Vantine Paint & Glass Co., 133 N.W.2d 426 (N.D. 1965); Bank v. Board of Education, 111 N.E.2d 238 (N.Y. 1953); Maxwell v. Land Developers, Inc., 485 S.W.2d 869, 875 (Tenn. Ct. App. 1972) ("Constructive fraud may be established where there is a breach of legal or equitable duty, whether or not fraudulent intent be present."); Purcell v. Robertson, 8 S.E.2d 881 (W Va. 1940).

[93] 375 U.S. 180, 195 (1963). ("The foregoing analysis of the judicial treatment of common law fraud reinforces our conclusion that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure and actual injury to the client."). *But see Greenwood*, 776 F.2d 785 (*Greenwood* is not representative of the more prevalent traditional view and seems to be an isolated case).

1936 when the CEA was enacted.[94] At least one court has held scienter is an element of common law fraud in a commodities context.[95] However, the more widely held view seems to be that common law fraud includes constructive fraud and thus requires no scienter.[96]

Constructive fraud, however, applies only to parties having a fiduciary relationship.[97] For fraud to exist, there must be a breach of the fiduciary duty with ensuing harm to the plaintiff. The cases have repeatedly recognized that futures commission merchants[98] stand in a fiduciary relationship with their customers.[99] The language of section 4b(A) also supports this conclusion.[100]

Further support for this construction of the term "defraud" is found by viewing section 4b in its entirety Section 4b(1)(A) makes it unlawful to "cheat or defraud."[101] Section 4b(1)(B) makes it unlawful "*willfully* to make or cause to be made to such other person any false report or statement. "[102] Section 4b(1)(C) makes it unlawful "*willfully* to deceive or attempt to deceive. . " (emphasis added).[103] The Supreme Court stated, in *United States v Atchison, T & S.F Ry Co.*, that when attempting to interpret a statute, "[t]he presence of a provision in the one part and its absence in the other is an argument against reading it as implied."[104]

---

[94] WEBSTER'S INTERNATIONAL DICTIONARY 332 (2d ed. 1936), defines "fraud," when used in a legal context, to include both actual fraud and constructive fraud. WEBSTER'S treats the term "cheat" as synonymous with "defraud."

[95] *Greenwood*, 776 F.2d at 789.

[96] *See, e.g.*, *Gordon*, 2 Comm. Fut. L. Rep. (CCH) ¶ 21,016 (April 18, 1980); Capital Gains Research Bureau, 375 U.S. at 195.

[97] Fiduciary relationships include trustee and beneficiary, guardian and ward, agent and principal, and attorney and client. A fiduciary is "under a duty not to profit at the expense of the other and not to enter into competition with him without his consent. " RESTATEMENT (SECOND) OF TRUSTS § 2b (1959).

[98] "The words 'futures commission merchant' shall mean and include individuals, associations, partnerships, corporations, and trusts engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery. " 7 U.S.C. § 2 (1988).

[99] Savage v. Commodity Futures Trading Commission, 548 F.2d 192, 196 (7th Cir. 1977); McMann v. SEC, 87 F.2d 377, 378 (2d Cir. 1937); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F Supp. 951, 952-53 (E.D. Mich. 1978); Union Bank of Switzerland v. HS Equities, Inc., 457 F Supp. 515, 522 (S.D.N.Y. 1978).

[100] Section 6(b) applies only to persons who act "for or on behalf of any other person" involved in the making of future contracts. 7 U.S.C. § 6b (1988).

[101] 7 U.S.C. § 6b(A) (1988).

[102] 7 U.S.C. § 6b(B) (1988).

[103] 7 U.S.C. § 6b(C) (1988).

[104] 220 U.S. 37, 44 (1922); *see also* U.S. v. Naftalin, 441 U.S. 768, 773-74 (1979).

In *Hochfelder*, when the Supreme Court held that scienter was required for a securities fraud violation, it placed heavy emphasis on the phrase "manipulation or deceptive device."[105] Manipulation is defined as a "series of transactions involving the buying or selling of a security for the purpose of creating a false or misleading appearance of active trading or to raise or depress the price to induce the purchase or sale by others."[106] "Manipulation," by definition, includes the element of intent. "Manipulation" or similar language does not appear in Section 4b(A) of the CEA, thus providing more evidence that Congress did not intend for scienter to be a required element of a commodities fraud claim.

B. *Legislative History of the CEA*

The second part of the *Hochfelder* test is an examination of the legislative history The legislative history behind the CEA indicates that Congress was unwilling to require scienter as an element of commodities fraud.[107] The first piece of legislation enacted to regulate commodities trading contained no antifraud provision.[108] Once the need for an antifraud provision became apparent, legislation was rejected that would have unmistakably required scienter for a commodities fraud violation.[109] The antifraud provision that Congress finally enacted was void of any language promoting scienter as a requirement of a commodities fraud claim.[110]

Congress, on several occasions, had the opportunity to amend the CEA to clearly require scienter as an element of commodities fraud[111] but declined to do so.[112] When it amended the criminal (but not the civil) provisions of the CEA in 1978, Congress most clearly indicated its intent to exclude a scienter requirement for civil claims.[113] If Congress intended to add a scienter requirement for civil claims, presumably it would have amended the civil provision to include the word "knowingly"

---

105 *Hochfelder*, 425 U.S. at 197. "Use of the word 'manipulation' is especially significant."

106 BLACK'S LAW DICTIONARY 868 (5th ed. 1979); *accord* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 724 (9th ed. 1983). *But see* Thel, *supra* note 81 at 378.

107 *See supra* notes 42-59 and accompanying text.

108 Grain Futures Act, Pub. L. No. 331, 42 Stat. 998 (1922); *see supra* note 46 and accompanying text.

109 *See supra* notes 48-50 and accompanying text.

110 *See supra* notes 56-59 and accompanying text.

111 *See supra* notes 44-59 and accompanying text.

112 *See* 7 U.S.C. § 6b(A) (1988).

113 *See supra* notes 57-59 and accompanying text.

CONCLUSION

Whether scienter is a requirement of a section 4b(A) commodities fraud violation will remain unsettled as long as the courts fail to apply the *Hochfelder*-type analysis in a commodities setting. The cases that have held that scienter is a required element of commodities churning[114] are based on faulty logic or no logic at all. A thorough examination of the legislative history of section 6b of the CEA indicates that Congress has repeatedly refused to include scienter as an element of commodities fraud.[115] On several occasions, Congress has had the opportunity to set the required mental state at scienter, but has steadfastly refused to do so for civil claims. Further, a careful review of the wording of sections 4b(1)(A), (B), and (C) of the CEA provides evidence that the scienter element is not found in Section 4b(1)(A).

Although commodities trading is often compared to securities trading, they involve wholly distinct statutory restrictions. There are, however, similarities between the two that facilitate the use of the *Hochfelder* analysis for a determination of the elements of a commodities churning claim. The use of the *Hochfelder* test leads inescapably to the conclusion that scienter is not an element of a commodities churning claim.

Harry B. Borders

---

[114] *See supra* notes 60-67 and accompanying text.

[115] *See supra* notes 42-59 and accompanying text.