

Death Property and Lawyers a Behavioral Approach

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CORNELL LAW REVIEW

Volume 57

July 1972

Number 6

THE IMPACT OF SECURITIES EXCHANGE ACT RULE 10b-5 ON BROKER-DEALERS*

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* The author gratefully acknowledges the invaluable substantive suggestions of Allan Kramer, Esq., Member of the New York Bar, editorial aid of Ann S. Kheel, stenographic help of Mary Ann Assicurato, and assistance of Ellen K. Jacobs.

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After the stock market disaster of 1929, Congress held extensive hearings with a view toward preventing a recurrence. The initial result of the ensuing legislative program was the Securities Act of 1933,¹ designed to regulate the initial distribution of securities. The Securities Exchange Act² was enacted the following year to control market operations after a public offering, including the actions of brokers, dealers, and national securities exchanges.³

For eight years, relatively little attention was given to the broad grant of regulatory authority in section 10(b) of the Exchange Act.⁴ Then, the Securities and Exchange Commission adopted under that section a broad antifraud rule, Rule 10b-5.⁵ There was never much doubt that criminal or administrative sanctions could be imposed for breaches of the Rule.⁶ Not until 1971, however, did the Supreme Court, culminating twenty-five years of case development, finally hold that a private right of action existed under 10b-5.⁷

The Rule is the most widely litigated provision in the federal securities laws. It applies to six distinct factual patterns: trading on the basis of undisclosed material information; issuing misleading corporate publicity; selectively disclosing important nonpublic data, commonly

¹ 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as "Securities Act" or "1933 Act"].

² 15 U.S.C. §§ 78a-78hh (1970) [hereinafter cited as "Exchange Act" or "1934 Act"].

³ Four other major pieces of regulatory legislation were subsequently adopted: Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1970); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1970); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52 (1970); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (1970).

⁴ It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or 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 or for the protection of investors.

15 U.S.C. § 78j (1970) [hereinafter cited as "section 10(b)" or "10(b)"].

⁵ 17 C.F.R. § 240.10b-5 (1972) [hereinafter cited as "the Rule" or "10b-5"]. The Rule provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of 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, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

⁶ See Exchange Act §§ 15(b)(D), 32(a), 15 U.S.C. §§ 78o, 78ff (1970).

⁷ Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971).

called "tipping"; mismanaging a corporation; manipulating a securities market; and—the topic of this article—trading and other activities of broker-dealers. While broker-dealers may engage in some of the first five activities, the emphasis here will be on the legality under 10b-5 of those actions which only a broker can perform.

Brokers as fiduciaries are subject to rigorous 10b-5 restriction.⁸ Brokers may be held accountable for actions which would not violate the Rule if they were performed by other persons. This higher standard of behavior is suggested by the policies underlying the Rule.⁹ As the Supreme Court has noted, the purpose of all federal securities laws is "to achieve a high standard of business ethics in the securities industry."¹⁰ Brokers' added obligations are not dependent on principles of agency law; they arise out of the brokerage firm's professional status and the nature of the securities business.¹¹

Broker-dealers must conform to a wide variety of laws, rules, and regulations in addition to 10b-5. Many of these provisions govern broker behavior in narrow areas, and consequently can be invoked more easily in certain fact situations than the broad antifraud and anti-manipulative language of Rule 10b-5.¹² A broker may, for example, incur liability for material misrepresentations or omissions in registration statements when acting as an underwriter¹³ or in an oral communication or prospectus,¹⁴ by offering or selling securities without the requisite registration,¹⁵ by extending credit in violation of margin

⁸ Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceedings*, 51 VA. L. REV. 1271, 1281 (1965); Note, *Fiduciary Suits Under Rule 10b-5*, 1968 DUKE L.J. 791, 792 n.7, 804; Note, *Broker Silence and Rule 10b-5: Expanding the Duty to Disclose*, 71 YALE L.J. 736, 742-43, 745-47 (1962); see O'Neill v. Maytag, 339 F.2d 764, 768-69 (2d Cir. 1964) (acts which may not run afoul of 10b-5 when performed by corporate insider may constitute violation if performed by broker, dealer, or investment adviser).

⁹ The Rule seeks to promote equalization of bargaining position; to protect investors, to achieve fairness, and to foster investor trust. *Carroll v. First Nat'l Bank*, 413 F.2d 353, 357 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); *Herpich v. Wallace*, 430 F.2d 792, 801, 806, 808 (5th Cir. 1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 847-48, 851-52, 856, 860 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

¹⁰ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

¹¹ *Knauss, A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 638 (1964); see *Cohen & Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 702-03 (1964); note 45 and accompanying text *infra*.

¹² Remedy under 10b-5, however, is still available despite the applicability of more specific provisions. See generally *SEC v. National Sec., Inc.*, 393 U.S. 453, 468-69 (1969) (overlapping federal securities remedies "neither unusual nor unfortunate").

¹³ Securities Act § 11, 15 U.S.C. § 77k (1970).

¹⁴ Securities Act § 12(2), 15 U.S.C. § 77l(2) (1970).

¹⁵ Securities Act § 12(1), 15 U.S.C. § 77l(1) (1970).

regulations,¹⁶ or by manipulating a security listed on a national securities exchange.¹⁷ Antifraud provisions other than 10b-5 apply to brokers acting in a brokerage capacity,¹⁸ and brokers who are registered investment advisers are also subject to special restrictions.¹⁹ Brokerage firms which are members of a national securities exchange or the National Association of Securities Dealers (NASD) must also conform to additional rules.²⁰ Further, state law is superimposed on the federal securities laws, exchange rules, and NASD rules.²¹ A few recent cases may mark the beginning of a resurgence of state fraud law.²² Nevertheless, federal remedies continue to dominate the cases and the literature in this area.

Broker-dealers' responsibilities under 10b-5 have developed not only through court cases, but also through SEC disciplinary proceedings. In order to obtain relief in court or to impose sanctions on a broker, the Commission need not prove all elements of the offense which would be required to sustain a private right of action.²³ It is uncertain what additional elements a customer suing for damages caused by the broker's 10b-5 violation must demonstrate.²⁴

A problem with effectively analyzing proscribed acts and predicting their consequences is that in the typical broker disciplinary proceeding or court action, a number of offenses are charged with reliance placed on more than one securities act provision. For example, a broker might be accused of making various misrepresentations to his customers, concealing certain facts from them, recommending unsuitable securities, and excessively trading their accounts. In its decision, the SEC or the court may rely on 10b-5, Exchange Act Rule 15c1-2,²⁵ Securities

¹⁶ Exchange Act § 7, 15 U.S.C. § 77g (1970).

¹⁷ Exchange Act § 9, 15 U.S.C. § 78i (1970).

¹⁸ Securities Act § 17(a), 15 U.S.C. § 77q(a) (1970); rules promulgated under Exchange Act §§ 10, 15, 15 U.S.C. § 78j, 78o (1970).

¹⁹ Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (1970).

²⁰ Private rights of action can sometimes be implied for violations of stock exchange and NASD rules. See, e.g., *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1965), cert. denied, 385 U.S. 817 (1966).

²¹ "State law" includes state decisional and statutory law.

²² E.g., *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1968); *Pierce v. Richard Ellis & Co.*, 62 Misc. 2d 771, 310 N.Y.S. 2d 226 (N.Y.C. Civ. Ct. 1970).

²³ E.g., *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854-55 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

²⁴ Issue preclusion could not be asserted by an injured customer against a broker disciplined by the SEC, NASD, or an exchange for his treatment of the customer; correspondingly, the broker could not invoke res judicata as a shield if he were exonerated in the disciplinary action.

²⁵ 17 C.F.R. § 240.15c1-2 (1972).

Act section 17(a),²⁶ and perhaps on other more specific rules. Without greater definition of the grounds of such determinations, counsel is forced to speculate on the parameters of 10b-5. He can be certain of his advice only with respect to egregious breaches of the Rule.

I

THE BREADTH OF BROKER-DEALER LIABILITY

A. *Definition of Broker-Dealer*

The typical, unsophisticated investor imagines that when he places an order with his broker to buy or sell securities, the broker trades on his behalf with another broker who represents a seller or buyer. The broker is truly a broker when he acts in this fashion. The investor might be surprised to learn, however, that many times his broker sells him a security out of the broker's own inventory or purchases it from him for the broker's own account. The brokerage firm then functions as a dealer, and the relationship between the parties is buyer-seller rather than principal-agent.²⁷ The distinction between a firm acting as a broker or as a dealer assumes substantive importance in a variety of contexts. For example, a fiduciary duty is always owed by a broker to a customer but is only sometimes owed by a dealer to a customer.²⁸ The statutory definitions of "broker" and "dealer" codify this functional distinction.²⁹ Exchange Act section 15 requires broker-dealers to register with the Commission if they use the mails or interstate commerce.³⁰ Rule 10b-5, however, applies to broker-dealers

²⁶ 15 U.S.C. § 77q(a) (1970).

²⁷ Douglas & Bates, *Stock "Brokers" as Agents and Dealers*, 43 YALE L.J. 46, 60-61 (1933) cites five characteristics by which to distinguish brokers and dealers: (1) the form of the confirmation, (2) whether a commission is charged, (3) the transfer price of the stock, (4) the source from which the stock is acquired, whether from inventory or the open market, and (5) the manner in which stock is acquired from outside sources.

²⁸ See notes 45-73 and accompanying text *infra*.

Exchange Act Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1972), requires disclosure of the capacity in which the broker acts. This is usually accomplished by a coded designation on a printed form, the significance of which (if it is even noted) must invariably escape the unsophisticated and unwary purchaser.

²⁹ Section 3(a)(4) of the 1934 Act, 15 U.S.C. § 78c(a)(4) (1970), provides:

The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. "Dealer" is defined in Exchange Act § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1970), as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

Unless otherwise noted the term "broker" will include both brokers and dealers.

³⁰ 15 U.S.C. § 78o (1970).

whether or not they are so registered,³¹ as well as to members and non-members of national securities exchanges³² or the NASD.³³

Although the broker-dealer distinction is fairly clear in a typical situation such as a straight sell order, in unusual fact patterns it is sometimes difficult to determine whether a brokerage firm is acting as a broker-dealer or in some other capacity, such as a finder.³⁴ If there were a written contract, one might be able to ascertain from its terms whether the employment was as a broker or as a middleman. Frequently, however, there is no writing, and in those cases there are few guidelines. Potential criteria include: (1) whether the firm typically acts only as a broker for its customers, (2) who pays the firm's compensation and, if the customer pays, the relationship between the fee and the ordinary brokerage commission, and (3) whether the customer has placed the same type of confidence in the brokerage firm that customers typically would.³⁵ In close cases, a firm may be assumed to be acting as a broker-dealer if it engages in only one line of business and is registered under section 15 of the 1934 Act,³⁶ or is a member of an exchange or the NASD.

³¹ H.R. REP. NO. 1418, 88th Cong., 2d Sess. 12 (1964) (brokers engaged only in intrastate business, and who therefore need not register with the SEC, still subject to section 10(b)). The broker in *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), was not registered with the SEC. The district court did not consider this point when finding a violation of the shingle theory, 286 F. Supp. at 707. *See* *D. Earle Hensley Co.*, 40 S.E.C. 849, 852 (1961); *Moore & Co.*, 32 S.E.C. 191, 194-96 (1951).

³² *E.g.*, *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965) (member); *D. Earle Hensley Co.*, 40 S.E.C. 849 (1961) (no indication of membership).

³³ *E.g.*, *Harold Grill*, 41 S.E.C. 321 (1963) (not member); *Bruns, Nordeman & Co.*, 40 S.E.C. 652 (1961) (member).

³⁴ For example, suppose a member firm over the years has acted as a broker for a European bank. The bank informs the firm of its interest in placing notes of any well-known American company with foreign institutions. The brokerage firm subsequently learns that a certain corporation is interested in selling notes and relays this information to the bank. The bank then negotiates directly with the corporation, purchases the notes, and distributes them in Europe. The ultimate purchasers sue the brokerage firm when the corporation defaults on the notes alleging, in substance, that the firm acted as a broker. The firm contends that it was merely a finder for the corporation and the bank, since its sole function was to bring the two parties together.

³⁵ *See* 12 AM. JUR. 2d *Brokers* § 1 (Supp. 1971) (if broker's employment limited to bringing parties together, treat as finder); 12 C.J.S. *Brokers* § 2, at 8 (1938) (broker and middleman distinguished).

In *SEC v. Century Inv. Transfer Corp.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,232 (S.D.N.Y. 1971), the court held, without much discussion, that persons who regularly tried to sell shares of shell corporations to others were "effecting transactions in securities for the account of others," and were therefore "brokers" even though such persons in some transactions could also be characterized as finders.

³⁶ 15 U.S.C. § 78o (1970).

Another classification-of-function problem arises when a customer lends money to his broker or purchases an equity participation in the brokerage firm. This article will discuss later whether the firm is then treated as a broker or as an ordinary seller for 10b-5 purposes.³⁷ A final example of definitional blur occurs when a brokerage firm recommends the purchase of commodity futures to a customer who has been trading only in stocks and bonds. Commodities may not be "securities,"³⁸ and if they are not, the transaction would not be subject to 10b-5. Assuming the securities laws are applicable, however, in this type of case a court must decide whether the firm was acting as a broker for 10b-5 purposes.

Once a firm is held to be acting as a broker or dealer rather than in some other capacity, a question arises as to whom the firm owes a duty. For example, when a broker-dealer violates his duty as a broker to a customer who is buying securities for future resale, can the ultimate purchasers of those securities assert that breach? One case has suggested they cannot.³⁹ There, persons from whom securities were stolen sued the brokerage firms which unknowingly sold the securities for the thieves. The court refused to hold the brokers liable.

[T]here is no . . . federal statutory liability for mere negligence where a broker acts distinterestedly in its usual capacity as a seller of securities in companies in which it has no proprietary interest and *without violation of any duty to its immediate customer* . . . [T]he actual owners were not the defendant-brokers's customers nor even within the cognizance of the defendant-brokers. Consequently, no cause of action under . . . Rule 10b-5 . . . has been established.⁴⁰

This case is by no means dispositive. Absence of contractual privity

³⁷ See notes 222-32 and accompanying text *infra*.

³⁸ See *Milnarik v. M-S Commodities, Inc.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,355 (7th Cir. 1972) (commodities account not investment contract); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 445-46 (N.D. Ill. 1967) (transactions in unregulated securities, if standing alone, provide no basis for federal jurisdiction); *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 365-67 (S.D.N.Y. 1966) (commodity futures not investment contracts).

Some cases have circumvented this obstacle and have applied the securities laws. *E.g.*, *Johnson v. Espy*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,376 (S.D.N.Y. 1972) (if commodities account in fact discretionary and broker represents profits will come from his efforts alone, account is investment contract); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705, 709-10 (D. Minn. 1968) (discretionary commodities account treated as investment contract); *Goodman v. H. Hentz & Co.*, *supra* at 445-46 (single scheme involving commodities and securities); *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra* at 367 (unauthorized transactions in sugar contracts followed by conversion of funds from customer's security account).

³⁹ *Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,748, at 99,272 (N.D. Ill. 1970).

⁴⁰ *Id.* at 99,276 (emphasis added).

does not defeat other types of 10b-5 actions;⁴¹ there seems to be no point in reading such a limitation into broker cases. For example, if a stockholder votes in favor of a merger in reliance on a broker's misleading opinion letter blessing the combination, he should be able to sue the brokerage firm for damages. Similarly, a broker giving investment advice to the public for the sole purpose of reaping personal profits by scalping⁴² should be answerable for an advisee's damages incurred when the advisee followed the advice, regardless of whether the trade was made through the adviser. Four cases support the view that contractual privity is not a *sine qua non* of broker liability. In the first two, a broker who executed trades for a person holding a power of attorney was disciplined for failing to inform the attorney's principals of his double dealing.⁴³ In the other two cases, brokers who knew or should have known that the brokers for whom they were executing trades were converting their customer's property were held liable both as principals and as aiders and abettors or controlling persons.⁴⁴

The cases can be reconciled through a foreseeability argument. A broker-dealer is liable to his customers for violation of any of the special regulations to which a broker typically must conform. He also owes at least some duties to that class of persons he should reasonably expect his message to reach, such as stockholders reading a merger proxy and customers in the four cases mentioned. But he assumes no duty beyond that ordinarily imposed by 10b-5 to those persons whose existence cannot be foreseen.

B. *Theories Governing Broker-Dealer's Responsibilities*

Rule 10b-5 applies to persons who are neither brokers nor dealers. However, broker-dealers and their employees are subject to more stringent standards of liability than other persons who may violate the Rule. The shingle (or implied representation) theory is the source of much of this stricter regulation. Higher standards of conduct are imposed on a brokerage firm simply by virtue of its being in business—because it hangs out its “shingle.”⁴⁵

⁴¹ *E.g.*, *Fischer v. Kletz*, 266 F. Supp. 180, 193 (S.D.N.Y. 1967) (accountant's liability); see notes 43-44 *infra*.

⁴² Scalping is the practice of purchasing a security, recommending it to advisees, and selling out at a profit when the market price increases in response to purchases based on the recommendation.

⁴³ *Moore & Co.*, 32 S.E.C. 191, 196 (1951); *William I. Hay*, 19 S.E.C. 397, 406 (1945).

⁴⁴ *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) (direct and aider and abettor liability); *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104, 122-24 (W.D. Ark. 1949) (direct and controlling persons' liability).

⁴⁵ See note 11 and accompanying text *supra*.

Three years before 10b-5 was promulgated the Commission first enunciated the shingle theory in an administrative proceeding⁴⁶ instituted to discipline a brokerage firm under existing antifraud provisions.⁴⁷ The SEC alleged that the firm, acting as a dealer, sold some securities to customers above market price and purchased others from them substantially below market price without the customer's knowledge. The Commission held:

Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession. It is neither fair dealing, nor in accordance with such standards, to exploit trust and ignorance for profit far higher than might be realized from an informed customer.⁴⁸

Judicial approval of the shingle theory came four years later in *Charles Hughes & Co. v. SEC*.⁴⁹ The Second Circuit affirmed the Commission's revocation of a broker-dealer's license for selling stock to customers at prices substantially in excess of those prevailing in the over-the-counter market without disclosing the mark-up,⁵⁰ remarking that the firm was "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions."⁵¹ Although neither of these decisions concerned a breach of the Rule, the underlying shingle theory concept has now been incorporated into 10b-5.⁵²

The shingle theory, with its implied representation of fairness to a customer, automatically applies to a brokerage firm acting as a broker, and may apply when the firm acts as a dealer, depending on the facts of the case. The issue is not the legal dealer-customer relationship,⁵³

⁴⁶ Duker & Duker, 6 S.E.C. 386, 388 (1939).

⁴⁷ The proceeding was brought under Securities Act § 17(a), 15 U.S.C. § 77q (1970), Exchange Act § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1970), and the predecessors to Exchange Act Rules 15c1-2, 17 C.F.R. § 240.15c1-2 (1972), and 15c1-4, 17 C.F.R. § 240.15c1-4 (1972).

⁴⁸ 6 S.E.C. at 388-89 (footnote omitted).

⁴⁹ 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

⁵⁰ The SEC and the Court of Appeals based their decisions on Securities Act § 17(a), 15 U.S.C. § 77q(a) (1970), and Exchange Act § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1970). Since the activities complained of occurred prior to 1942 (the year in which the Rule was promulgated), 10b-5 could not have been relied upon.

⁵¹ 139 F.2d at 437.

⁵² E.g., Harold Grill, 41 S.E.C. 321, 325 (1963); Barnett & Co., 40 S.E.C. 1, 4 (1960); Best Sec., Inc., 39 S.E.C. 931, 934 (1960); William Harrison Keller, 38 S.E.C. 900, 905 (1959).

⁵³ See generally *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 675 (S.D.N.Y.), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966) (immaterial what confirmation stated; decisive that facts showed agency relationship). For a description of a confirmation slip and the disclosures it contains, see *Chasins v. Smith, Barney & Co., Inc.*, 305 F. Supp. 489, 494-95 (S.D.N.Y.), *motion to amend denied*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970). See also *Cant v. A. G. Becker & Co., Inc.*, [1971-1972 Transfer Binder] CCH

but rather the personal rapport between the parties. A dealer is deemed to have made implied representations under the shingle theory if he has gained the customer's confidence, even though he is acting for his own account and not as an agent.⁵⁴ Dealers escaping the shingle theory's obligations are nevertheless controlled by the duties 10b-5 imposes on persons generally. Substantial problems arise, however, when such dealers engage in actions which are prohibited by 10b-5 at least in part because of the shingle theory. For example, would a dealer violate 10b-5 by misappropriating a customer's funds? A nonprofessional (such as a confidence man) would be liable for taking someone's money without delivering certificates; a fortiori, a dealer should be held liable as well. A more difficult question is whether a dealer not subject to the shingle theory must disclose that he is selling an over-the-counter stock at a price substantially in excess of the market price.⁵⁵ Requiring disclosure by dealers at all times imposes duties identical to those required under the shingle theory. Perhaps the ultimate answer is a form of compromise; a dealer not subject to the shingle theory must disclose his extraordinary mark-up only when it is material. The policies underlying 10b-5 indicate that a lower threshold of materiality and reliance should exist in this situation than in the usual concealment case.⁵⁶

Various formulations have been used to express the representations which a broker-dealer impliedly makes under the shingle theory. In the SEC's first case, the wording was that "the customer be dealt with fairly, and in accordance with the standards of the profession."⁵⁷ Sometimes

FED. SEC. L. REP. ¶ 93,347, at 91,873 (N.D. Ill. 1971) (coded number not adequate disclosure as matter of law). On the other hand, a fiduciary relationship between the broker and customer does not arise as a matter of law. *Avern Trust v. Clarke*, 415 F.2d 1238, 1239-40 (7th Cir. 1969), cert. denied, 397 U.S. 963 (1970).

⁵⁴ This was the situation in the *Charles Hughes* case. See notes 49-51 and accompanying text *supra*.

⁵⁵ In answering this question, it is assumed that the fiduciary theory is inapplicable and quotations of the securities were not available. See notes 70-71 and accompanying text *infra*.

⁵⁶ See notes 8-9 and accompanying text *supra*.

⁵⁷ See text accompanying note 48 *supra*.

The fair dealing formulation could arguably be an implementation of the fairness philosophy underlying the Rule. The "standards of the profession" wording introduces a negligence standard. Leavell, *Investment Advice and the Fraud Rules*, 65 MICH. L. REV. 1569, 1585 (1967). The proper brokers to examine in order to determine negligence are those in the United States as a whole, not those in the geographical area in which the defendant or respondent firm is located. Otherwise, the desired uniformity of 10b-5 law would be defeated. *But see* 6 L. LOSS, *SECURITIES REGULATION* 3726 (2d ed. 1961) [hereinafter cited as *Loss*].

There are at least four sources from which to determine the standards of the profession: prior SEC and court cases, national securities exchange rules, regulations of the NASD, and the comparable rules the Commission has promulgated governing non-members of the NASD (SECO rules).

both ideas appear in a case; at other times only one can be found.⁵⁸ Professor Leavell has discussed at least three other formulations of the shingle theory.⁵⁹ These various formulations, like the profusion of policies underlying 10b-5, permit flexibility by the courts and the Commission when considering dissimilar factual situations. In the last analysis, however, they are merely different ways of expressing the same high standard of broker conduct.⁶⁰

Regardless of the language employed, the shingle theory covers a wide variety of activities. It governs relationships between a broker and his customers and fellow brokers,⁶¹ and applies with equal force to brokerage firms and their salesmen.⁶² From its origin in cases involving implied representation of a reasonable trading price,⁶³ the theory has evolved to encompass various additional representations. A broker is deemed to represent that he has an adequate basis for his recommendation to buy or sell a security; not having that adequate basis is accordingly violative of 10b-5. A recommendation also carries with it an implied warranty that the securities are suitable for the individual customers; if they are not, the broker-dealer again has not complied with the Rule's requirements. By similar reasoning, the shingle theory is responsible, at least in part, for a broker-dealer's liability when he conceals material facts, manipulates the market, engages in boiler room activities,⁶⁴ excessively trades a customer's account, accepts funds or securities while insolvent, delays execution of a trade, buys, sells, or pledges securities without authority, misappropriates a customer's funds or securities, or delays delivery of securities.⁶⁵ The shingle theory in

⁵⁸ *E.g.*, Harold Grill, 41 S.E.C. 321, 325 (1963) (fair dealing); N. Pinkser & Co., Inc., 40 S.E.C. 285, 291 (1960) (both ideas); Best Sec., Inc., 39 S.E.C. 931, 934 (1960) (both ideas); Leonard Burton Corp., 39 S.E.C. 211, 214 (1959) (fair dealing).

⁵⁹ Leavell, *supra* note 57.

⁶⁰ In addition to the fiduciary theory (*see* notes 70-71 and accompanying text *infra*), the author notes that there must be an adequate and reasonable basis for recommending a security, reasonable care demonstrated with regard to a security which was, or should have been, registered under the 1933 Act, and no reckless misrepresentation. *Cf.* note 73 and accompanying text *infra*.

⁶¹ Almost all cases involve broker-customer relations, but a few have treated broker-broker questions. George J. Wunsch, SEC Securities Exchange Act Release No. 8713 (Oct. 7, 1969) (secret profit to salesman at expense of other firms); John D. Ferris, 39 S.E.C. 116, 119 n.9 (1959) (shingle theory applicable to dealings with other dealers); *see* note 158 *infra*.

⁶² Ross Sec., Inc., 41 S.E.C. 509, 514 n.7 (1963); A. J. Caradean & Co., Inc., 41 S.E.C. 234, 235 (1962).

⁶³ *See* notes 46-51 and accompanying text *supra*.

⁶⁴ For an explanation of a boiler room, *see* note 331 and accompanying text *infra*.

⁶⁵ *See* Hiller v. SEC, 429 F.2d 856 (2d Cir. 1970) (adequate justification for opinion required); Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969) (making recommendations without adequate basis violation of 10b-5); Moscarelli v. Stamm, 288 F. Supp. 453, 457

reality can be applied to any act the SEC or courts believe a broker should not perform. The approach is a fiction; the representation is implied and then liability is imposed when the duty it is found to have been breached. A more direct method would be to hold that a broker violates 10b-5 if he engages in proscribed acts, without going through the gymnastics required by the shingle theory.

It can be argued that the implied representations arising out of the shingle theory may be negated by prior actual disclosure to the customer of the offensive practice. As a practical matter, however, few brokerage firms would admit to conduct violative of the theory. There is also the question of what would constitute adequate notice. Awareness by a knowledgeable investor might suffice as, for example, when the firm makes an unreasonable spread and the investor had access to quotations,⁶⁶ but a less sophisticated customer would have to be told in an explicit and understandable manner. Even under these circumstances, the Commission has opined that disclosure does not a fortiori cure the violation.⁶⁷

The shingle theory's applicability in SEC administrative proceedings, reviews by Courts of Appeals of those proceedings, criminal cases, or Commission suits for injunctions is unquestioned. In 1969, however, the Second Circuit stated in dictum that the implied warranty that a broker has an adequate basis for his opinions regarding securities "may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon . . . unfounded representations."⁶⁸ A better view is represented by a California decision in a suit brought by a customer to recover damages from a broker who

(E.D.N.Y. 1968) (excessive trading of account a violation). *But see* Symposium, *The Direction of Management Responsibility*, 18 BUS. LAW 29, 75 (1962). *See generally* 3 Loss 1488-89; 4 Loss 3684-85, 3708; Cohen & Rabin, *supra* note 11, at 704-07; Knauss, *supra* note 11, at 638; Comment, *Current Problems in Securities Regulation*, 62 MICH. L. REV. 680, 736 (1964).

⁶⁶ The SEC rejected this position in an early case:

We emphasize again . . . that the fundamental principle underlying these cases is that any person, regardless of his knowledge of the market or his access to market information, is entitled to rely on the implied representation, made by a registered dealer in securities, that customers will be treated fairly.

United Sec. Corp., 15 S.E.C. 719, 727 (1944).

Likewise, a *dealer* alleged to have violated the shingle theory with regard to a sophisticated customer could argue that the theory was inapplicable because the customer had not placed the requisite confidence in the dealer. *See* text accompanying note 54 *supra*.

⁶⁷ Powell & McGowan, Inc., 41 S.E.C. 933 (1964) (sick, elderly man induced to make subordinated loan to broker who was in financial difficulty; even with full disclosure, broker should not have made this recommendation); Mac Robbins & Co., Inc., 41 S.E.C. 116, 119 n.15 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) (most practices involved, even though brought under 10b-5(2), would be fraudulent irrespective of disclosure); Cohen & Rabin, *supra* note 11, at 703 (shingle theory violation not cured by disclosure).

⁶⁸ Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969) (dictum). *But see* Brennan v.

had traded his account excessively: "It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions."⁶⁹

In addition to the shingle theory, there is a more limited doctrine—the fiduciary theory—from which broker liability may arise. In the leading case of *Hughes v. SEC*,⁷⁰ a dealer who was also an investment adviser was accused of failing to disclose that she was not selling securities to her clients at the best price obtainable. Revocation of the broker's registration was affirmed on review in an opinion which recognized the fiduciary (or trust and confidence) theory for the first time. Under this theory a broker-dealer has a fiduciary duty to disclose any conflicting interest and to act in the customer's best interest, whether acting as a dealer who has gained the customer's confidence and trust or in the capacity of a broker.⁷¹

There are many situations where the shingle and fiduciary theories are simultaneously applicable.⁷² Indeed, a former Chairman of the SEC has stated that the two theories are closely connected and merely represent different ways of expressing the obligations Congress has imposed on the broker-dealer.⁷³

II

BROKER ACTIONS PRIOR TO EXECUTION OF A CUSTOMER'S ORDER

Specific broker duties arise prior to the execution of a customer's order. A broker who recommends the purchase or sale of a certain stock

Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (no discussion of point); *Newkirk v. Hayden, Stone & Co.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621, at 95,321 (S.D. Cal. 1965) ("if a violation of the Act can subject a violator to loss of his license, it should justify an action for damages").

⁶⁹ *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 721-22, 69 Cal. Rptr. 222, 244 (1968). This result is also suggested by the basic policy considerations underlying the Rule. See note 9 *supra*.

⁷⁰ 174 F.2d 969 (D.C. Cir. 1949).

⁷¹ This approach is also referred to as the implied agency theory. *Mason, Moran & Co.*, 35 S.E.C. 84, 89-90 (1953); *Wendell Maro Weston*, 30 S.E.C. 296, 304 (1949); *Herbert R. May & Russell H. Phinney*, 27 S.E.C. 814, 830 (1948). In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963), Mr. Justice Goldberg emphasized the role of investment advisers as fiduciaries.

⁷² See, e.g., *Herbert R. May & Russell H. Phinney*, 27 S.E.C. 814, 830-31 (1948). The shingle theory has been slowly preempting the fiduciary theory. See generally 6 Loss 3707; *Cohen & Rabin, supra* note 11, at 703-04.

⁷³ See *Cohen & Rabin, supra* note 11, at 703-04; *Comment, supra* note 65, at 738-39. *But see Lesh, Federal Regulation of Over-the-Counter Brokers and Dealers in Securities*, 59 HARV. L. REV. 1237, 1253 (1946).

to a customer must have a reasonable basis for his recommendation, and the stock must be suitable for the specific customer; the broker must not conceal or misrepresent facts; he must not manipulate or fail to disclose his control over the market in a security; and he must not engage in boiler room activities.

A. *Reasonable Basis for and Suitability of Recommendations*

A brokerage firm's recommendation to purchase or sell⁷⁴ a security carries with it the implied representations that there is a reasonable basis for the recommendation and that the security is suitable for the customer. There is little authority on what actually constitutes a recommendation. In the clearest case, the broker may say "Consolidated Widgets is a good buy at 27" or "You ought to sell your Universal Conglomerate bonds." Recommendations can be phrased in a considerably more subtle manner, however, and could include, for example, the mailing of a report about an issuer (regardless of who prepared the information) to a customer when the broker knows the customer purchases with reasonable regularity securities of companies about which he receives written material.⁷⁵

⁷⁴ Most authorities discussing the reasonable basis and suitability duties focus on broker recommendations to *buy* a security. The same rules, however, should pertain to recommendations to *sell*. Recommendations not to sell (to hold) a security present additional problems (e.g., plaintiff must be a buyer or seller), but the reasonable basis and suitability rules should apply at least to the extent that such advice could give rise to a private right of action. See *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 218-19 (S.D.N.Y. 1965) (fraud for broker to induce customer not to sell with result that customer's loss greater when he later sells). For simplicity, the focus here will be only on buy recommendations.

⁷⁵ Foreseeability is required because the "general distribution of a market letter, research report or other similiar material would [not] in itself constitute a recommendation." SEC Securities Exchange Act Release No. 8135 (July 27, 1967).

The reasonable basis and suitability rules are only two of the problems a broker-dealer may encounter with respect to his recommendations. A broker's opinion, addressed to teneerees, that a tender offer is fair may be actionable if in fact the offer is unfair (*cf.* *Mills v. Sarjem Corp.*, 133 F. Supp. 753, 766-67 (D.N.J. 1955) (recommendation not actionable since price was fair)), and his recommendation to accept a tender offer should have a reasonable basis. *Kennedy, Tender Moment*, 23 *BUS. LAW.* 1091, 1106 (1968). A broker's recommendation to a trust in violation of state law has given rise to a cause of action for damages. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocoock*, 247 F. Supp. 373 (S.D. Tex. 1965). But a recommendation against purchases and favoring sales of a corporation's stock does not give the issuer a cause of action to recover for the decline in market price. *Defiance Indus., Inc. v. Galdi*, 256 F. Supp. 170, 172 (S.D.N.Y. 1964). Recommendations of a security by a firm making its market may raise special problems. See notes 323-30 and accompanying text *infra*.

There is increasing evidence that selective disclosure of recommendations is a 10b-5 infraction. Thus, the Commission has brought an action against a firm which informed only certain customers of its switch from a buy to a sell recommendation. See *Butcher &*

1. Reasonable Basis for Recommendations

A 1962 release of the Commission is perhaps the most concise statement of the reasonable basis rule:

[I]t is a violation of the anti-fraud provisions [which include 10b-5] for a broker-dealer to recommend a security unless there is an adequate and reasonable basis for the recommendations and further, . . . such recommendations should not be made without disclosure of facts known or reasonably ascertainable, bearing upon the justification for the recommendation. As indicated, the making of recommendations for the purchase of a security implies that the dealer has a reasonable basis for recommending such securities which, in turn, requires that, as a prerequisite, he shall have made a reasonable investigation. In addition, if such a dealer lacks essential information about the issuer, such as knowledge of its financial condition, he must disclose this lack of knowledge and caution customers as to the risk involved in purchasing the securities without it.⁷⁶

There is considerable authority, in accord with this release, that broker recommendations must have a reasonable basis.⁷⁷ The emphasis in recent cases has been upon requiring a reasonable basis for a broker's opinions, predictions of future events, and representations of existing

Sherrerd, Summary of Order for Public Proceedings, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,466 (Nov. 24, 1971). Chairman Casey indicated that this "may well be" a violation. N.Y. Times, Dec. 11, 1971, at 43, col. 5. A case has held that such selective disclosure was a fraud, obtaining business by promising to engage in the practice is prohibited even if no disclosure is selectively made, and a customer receiving the information was not *in pari delicto* and could sue. *Courtland v. Walston & Co., Inc.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,378 (S.D.N.Y. 1971).

In addition to 10b-5, other federal securities provisions apply to certain broker's recommendations. *E.g.*, Securities Act § 5, 15 U.S.C. § 77e (1970) (written information given by an underwriter); Exchange Act § 26, 15 U.S.C. § 78z (1970) (illegal to represent SEC approved security or transaction); Exchange Act Rules 10b-6, 17 C.F.R. § 240.10b-6 (1972) (inducing purchases during distribution), 15c1-3, 17 C.F.R. § 240.15c1-3 (1972) (fraudulent to represent that Commission approved broker), and 15c1-5, 17 C.F.R. § 240.15c1-5 (1972) (cannot induce purchase or sale unless control of broker by issuer, of issuer by broker, or common control is revealed). National securities exchanges and the NASD have also added requirements, but these are limited to written recommendations. 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2474A.10(1); NASD Rules of Fair Practice Art. III, § 1, CCH NASD SEC. DEALERS MANUAL ¶ 2151, at 2018. Recourse to state statutory and common law may also be possible.

⁷⁶ Distribution by Broker-Dealers of Unregistered Securities, SEC Securities Exchange Act Release No. 6721, at 3 (Feb. 2, 1962) (footnotes omitted). This release was directed only at recommendations in relation to unregistered distributions of substantial blocks of securities of relatively obscure companies. These limitations may not represent the parameters of a firm's obligations.

⁷⁷ *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969), *aff'g* Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 6, 8 (Dec. 31, 1968); *Floyd Earl O'Gorman*, SEC Securities Exchange Act Release No. 7959, at 3 (Sept. 22, 1966); *Crow, Brouman &*

facts concerning recommended securities.⁷⁸ Most questions concerning representations will be discussed below,⁷⁹ but the reasonableness of their underlying basis is treated here as it applies to recommendations, opinions, and predictions as well.

The variety of situations which the reasonable basis concept encompasses is not clear. Some aspects are undisputed: its ambit includes oral and written statements⁸⁰ and, although it was originally employed

Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 3 (March 15, 1966); Ross Sec., Inc., 41 S.E.C. 509, 514 (1963); Brown, Barton & Engel, 41 S.E.C. 59, 63 (1962); N. Pinsker & Co., Inc., 40 S.E.C. 285, 291 (1960); Barnett & Co., Inc., 40 S.E.C. 1, 4 n.6 (1960); Best Sec., Inc., 39 S.E.C. 931, 934 (1960); Leavell, *supra* note 57, at 1586.

⁷⁸ Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) (facts); Nees v. SEC, 414 F.2d 211, 219-20 (9th Cir. 1969) (prediction of future growth); SEC v. Broadwall Sec., Inc., 240 F. Supp. 962, 967-68 (S.D.N.Y. 1965) (facts about issuer and predictions and opinions of future price); Richard Bruce & Co., SEC Securities Exchange Act Release No. 8303, at 3, 6 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969) (representations and predictions); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 2 (April 26, 1967) (statements and predictions); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7959, at 3 (Sept. 22, 1966) (predictions and representations); Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 3, 5, 8 (March 15, 1966) (price rise prediction, extravagant statements, and representations); Arnold Sec. Corp., SEC Securities Exchange Act Release No. 7813, at 3-4 (Feb. 7, 1966) (predictions of price rise); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725, at 3-4 (Oct. 18, 1965) (representations and predictions); Harold Grill, 41 S.E.C. 321, 322 (1963) (representations); Alexander Reid & Co., 40 S.E.C. 986, 989-90 (1962) (representations and opinions); Barnett & Co., Inc., 40 S.E.C. 521, 523-24 (1961) (statement that price or market value would rise); Leonard Burton Corp., 39 S.E.C. 211, 214 (1959) (prediction of price increase).

A broker-dealer cannot therefore avoid his responsibilities by characterizing his statements as opinions and predictions rather than as statements of existing fact. Hiller v. SEC, 429 F.2d 856, 858 (2d Cir. 1970); SEC v. Broadwall Sec., Inc., *supra* at 968; Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 20 (Nov. 12, 1965); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 7 (Aug. 20, 1964); Ross Sec., Inc., 41 S.E.C. 509, 514 (1963); Mac Robbins & Co., Inc., 41 S.E.C. 116, 119 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Alexander Reid & Co., *supra*. See also note 114 and accompanying text *infra*. But see SEC v. Rapp, [1957-1961 Transfer Binder] OCH FED. SEC. L. REP. ¶ 91,048 (S.D.N.Y. 1961) (opinion, recognized as such, permissible), *rev'd*, 304 F.2d 786, 791 (2d Cir. 1962) (declining to decide point then, which the court seems to have answered eight years later in *Hiller, supra*). Highly optimistic predictions and opinions are considered to be more deceptive since the customer is entitled to assume that they rest on a particularly strong foundation. Alexander Reid & Co., *supra* at 990.

⁷⁹ See notes 157-232 and accompanying text *infra*. The requirement of a reasonable basis does not mean that estimates are per se violations of 10b-5 if they are slightly inaccurate. See generally SEC v. R.A. Holman & Co., 366 F.2d 446, 467 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967).

⁸⁰ Most cases have involved oral statements. *E.g.*, Harris Clare & Co., Inc., SEC Securities Exchange Act Release No. 8004, at 2-3 (Dec. 9, 1966); Underhill Sec. Corp., SEC Securities Exchange Act Release No. 7668, at 3-4 (Aug. 3, 1965); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 568 (1963); Barnett & Co., Inc., 40 S.E.C. 521, 523 (1961). Some cases

only against boiler room operations,⁸¹ its scope has been significantly expanded.⁸² Since the shingle theory⁸³ is the concept's genesis, brokers cannot escape its reach, although some dealers may not be governed.⁸⁴ A more difficult question concerns the class of issuers to which the

have found violations in broker's reports. *E.g.*, Melvyn Hiller, SEC Securities Exchange Act Release No. 8476, at 2 (Dec. 24, 1968), *aff'd*, 429 F.2d 856, 857-58 (2d Cir. 1970) (unconfirmed report cannot be sent out, even if status disclosed, because it thereby gains authority and credibility); Richard Bruce & Co., SEC Securities Exchange Act Release No. 8303, at 5 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969) (report impermissible if based on unconfirmed material, even if such fact disclosed to customers).

⁸¹ See notes 331-47 and accompanying text *infra*.

⁸² Many cases have required a reasonable basis in the absence of a boiler room. *E.g.*, Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Richard Bruce & Co., SEC Securities Exchange Act Release No. 8303 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969); Walston & Co., SEC Securities Exchange Act Release No. 8165 (Sept. 22, 1967); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 2-4 (April 26, 1967); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7959, at 5 (Sept. 22, 1966). The boiler room cases include Crow, Brouman, & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 2 n.3 (March 15, 1966); Albion Sec. Co., SEC Securities Exchange Act Release No. 7561, at 3 (March 24, 1965); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 572 (1963); Alexander Reid & Co., 40 S.E.C. 986, 992 (1962); Barnett & Co., Inc., 40 S.E.C. 521, 523-24 (1961).

⁸³ Hiller v. SEC, 429 F.2d 856, 857-58 (2d Cir. 1970); Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); Kahn v. SEC, 297 F.2d 112, 115 (2d Cir. 1961) (Clark, J., concurring); Richard Bruce & Co. SEC Securities Exchange Act Release No. 8303, at 5 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963); B. Fennekohl & Co., 41 S.E.C. 210, 216 (1962); Alexander Reid & Co., 40 S.E.C. 986, 990 (1962); Distribution by Broker-Dealers of Unregistered Securities, SEC Securities Exchange Act Release No. 6721, at 3-4 (Feb. 2, 1962). The reasonable basis obligation, of course, "applies with equal force to broker-dealers and to salesmen." Ross Sec., Inc., 41 S.E.C. 509, 514 n.7 (1963). The need for high standards in investment advice was pointedly brought home in a congressional report. See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS pt. 1, H. R. Doc. No. 95, 88th Cong., 1st Sess. 330-87 (1963) [hereinafter cited as SPECIAL STUDY].

⁸⁴ See notes 53-54 and accompanying text *supra*; *cf.* note 108 *infra*. Dealers may have a greater duty if they have a personal interest in selling the security. Phillips v. Reynolds & Co., 297 F. Supp. 736, 737 n.2 (E.D. Pa. 1969) (*dictum*).

As the shingle theory applies both to registered public offerings and to offerings exempt from the 1933 Act, the reasonable basis requirement is applicable to both. See, *e.g.*, Walston & Co., SEC Securities Exchange Act Release No. 8165, at 3 (Sept. 22, 1967) (municipal bonds; acting as underwriter); Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839 (March 15, 1966) (no registration); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725 (Oct. 18, 1965) (underwriter); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566 (1963) (underwriting); Brown, Barton & Engel, 41 S.E.C. 59, 61-62 (1962) (underwriting); Distribution by Broker-Dealers of Unregistered Securities, SEC Securities Exchange Act Release No. 6721 (Feb. 2, 1962) (unregistered distributions). The duty to investigate may at times be even broader than the duties ordinarily imposed under the shingle theory. See SEC v. Chamberlain Associates, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,228 (S.D.N.Y. 1963) (public relations man involved in distribution of stock held to have duty to investigate).

reasonable basis rule applies. Any opinion, prediction of future events, or representation should have a reasonable basis regardless of the type of company involved. A stockbroker may avoid the risk of liability simply by not volunteering any information for which he has no adequate basis.

A recommendation, however, is less specific than an opinion, prediction, or representation and typically is made on a wider variety of securities; hence, a different standard may be justified in determining if it has a reasonable basis. Cases have been primarily concerned with recommendations with respect to securities of speculative and unseasoned companies.⁸⁵ The rationale is that less information is available to the public about these issuers. But with the extension in 1964 of the Exchange Act's periodic reporting requirements to include over-the-counter companies,⁸⁶ and the increase in information now included in those reports,⁸⁷ the distinction between listed and unlisted securities is less important.⁸⁸ Since there is now little difference among types of is-

⁸⁵ None of the cases cited herein invoking the reasonable basis rule pertain to blue chip securities. See *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969) (stock involved was an over-the-counter security and investors "could not readily confirm the information given them"; special duty owed by persons who sell unlisted securities); *Distribution by Broker-Dealers of Unregistered Securities*, SEC Securities Exchange Act Release No. 6721, at 1 (Feb. 2, 1962) (dealing with securities of "relatively obscure and unseasoned companies"); R. MUNDHEIM, CONFERENCE ON SECURITIES REGULATION 76 (1965) (Mr. Heller). Certain securities exchange rules, however, are not limited to over-the-counter issues. 2 CCH AM. STOCK EXCH. GUIDE ¶ 9495-10; 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2474A.10(1).

Of course, not all unlisted securities are obscure and speculative, and perhaps this distinction should be recognized in the cases. In *Crow, Brouman & Chutkan, Inc.*, SEC Securities Exchange Act Release No. 7839, at 5 (March 15, 1966), the Commission rejected the argument that because a security had been traded for four years and was owned by a substantial number of people, it was seasoned and non-speculative. The issue, however, is not whether the security is a bad risk, but whether there was at the time a reasonable basis for the statements made. *Mac Robbins & Co., Inc.*, 41 S.E.C. 116, 131 (1962), *aff'd sub nom. Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963).

⁸⁶ Exchange Act § 12(g), 15 U.S.C. § 78l(g) (1970) (added in 1964), in conjunction with Exchange Act § 13(a), 15 U.S.C. § 78m(a) (1970), extended the periodic reporting requirements to over-the-counter companies having total assets of more than \$1,000,000 and a class of equity securities held of record by 500 or more persons. Exchange Act § 15(d), 15 U.S.C. § 78o(d) (1970), obligates issuers filing a 1933 Act registration statement to file periodic reports unless the securities sold thereunder are thereafter held of record by less than 300 persons.

⁸⁷ The information required in the periodic reports was greatly expanded in 1970. See SEC Securities Exchange Act Release Nos. 9000 (Oct. 21, 1970) & 9004 (Oct. 28, 1970).

⁸⁸ While these developments did tend to put listed and over-the-counter securities on a more equal footing, there are still a few situations in which more information is available for listed securities. For example, all listed securities are subject to the proxy rules whereas only those over-the-counter companies subject to Exchange Act § 12(g), 15 U.S.C. § 78l(g) (1970), must conform to such rules; periodic reports must be filed by all companies having a class of securities traded on a national securities exchange but not all other

suers as regards available information, investors should have the protection of having recommendations of listed securities conform to the reasonable basis rule, albeit perhaps under less stringent standards than those applicable to over-the-counter securities.⁸⁹

Most troublesome is the question of which types of recommendations are governed by the reasonable basis rule. A broker can make a recommendation in a variety of situations: as the lead underwriter in a public offering or as a member of the underwriting group, or while operating a boiler room, engaging in a concerted sales effort or distribution, volunteering similar advice at approximately the same time to a limited number of customers, making an isolated recommendation to one customer on his own initiative, answering a customer's request for advice, or, with what is at best an implied recommendation based on silence,⁹⁰ receiving and executing an unsolicited purchase order. The broker's duties should diminish in proportion to his participation in the sale of the security.

Requiring a firm to have a reasonable basis for a recommendation (and hence to conduct an investigation) creates insurmountable practical problems when the firm is not too actively engaged in selling a security. However, no court has gone so far as to apply the reasonable basis rule to an isolated recommendation, whether initiated by the broker or solicited by his customer.⁹¹ Minimally, a broker ought to have a reasonable basis for recommendations made in any situation in which he gives similar advice to a limited number of investors. Such practical problems do not arise concerning representations, opinions, and predictions since (unlike recommendations) a firm need not make such statements unless it has back-up data. Accordingly, the reasonable basis concept should encompass all such statements.

issuers must make such reports. See Exchange Act §§ 12(g)(4), 15(d), 15 U.S.C. §§ 78l(g)(4), 78o(d) (1970). Information as to over-the-counter companies filed under the Exchange Act can be found only in Washington, but copies of similar information required for listed securities are available at the exchange where the security is listed. *But see* note 103 *infra*. The developments in the 10b-5 requirements concerning corporate disclosure may decrease the significance of these differences.

⁸⁹ See R. MUNDHEIM, *supra* note 85, at 78 (Mr. Heller).

⁹⁰ Silence is within the ambit of conduct covered by the Rule. *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 154 (6th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

⁹¹ The SEC's release on the subject refers only to distributions of substantial blocks of unregistered securities of unseasoned companies. *Distribution by Broker-Dealers of Unregistered Securities*, SEC Securities Exchange Act Release No. 6721, at 1 (Feb. 2, 1962). An example of the confusion can be found in the Mundheim conference where three different views were expressed. See R. MUNDHEIM, *supra* note 85, at 75-76 (Mr. Heller: rules apply only to sales campaign and not to casual distribution); *id.* at 89 (Mr. O'Boyle: rules should apply at all times); *id.* (Mr. Cohen, Chairman of the SEC: Mr. O'Boyle's position beyond

Applicability of the reasonable basis rule is only one open issue. Little authority exists on what constitutes a "reasonable basis." Understandably, the opinions concentrate on what is *not* a reasonable basis. A few cases reject reliance on specific factors⁹² while others discuss facts which should excite suspicion and hence negate the validity of accumulated data,⁹³ but none affirmatively establishes criteria for defining the required basis. Arguably, a firm should be considered to have fulfilled its obligations if, in a reasonable manner, it amasses pertinent facts and rationally analyzes them.⁹⁴ One factor to be considered in determining reasonableness is the broker's role in the transaction. As the number of shares being sold by the broker, the number of customers approached, and the dollar volume involved increase, so should the amount of facts and depth of analysis required. Also to be considered is the type of security with which the broker is dealing. More information and possibly a more rigorous review of the data are necessary for the securities of an obscure over-the-counter company than for those of AT&T. Judge Clark, concurring in a leading case, went much further, stating that a broker "warrants the soundness of statements of stock value, estimates of a firm's earnings potential, and the like."⁹⁵ Although some commentators have objected to the breadth of that statement,⁹⁶ the opinion did limit a broker's exposure to situations where he knows he has no reasonable basis for his recommendation or is " 'grossly careless or indifferent to the existence of an adequate basis.' "⁹⁷ Whatever may in general

anything Commission had held, but does not disagree with O'Boyle's conclusion). *See also id.* at 88 (Mr. White, then General Counsel to the NASD: NASD's reasonable basis rule not limited to distributions).

⁹² A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 3 (April 26, 1967) (broker not justified in relying on rising price of stock); Mac Robbins & Co., Inc., 40 S.E.C. 497, 502-03, *remanded sub nom.* Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961) & Berko v. SEC, 297 F.2d 116 (2d Cir. 1961) (rejecting reasoning that industry growth is basis for recommending stock of company in that field).

⁹³ *See* note 106 and accompanying text *infra*.

⁹⁴ There is authority requiring predictions, opinions, and recommendations to be "responsibly made on the basis of actual knowledge and careful consideration." Alexander Reid & Co., 40 S.E.C. 986, 990 (1962) (footnote omitted); *accord*, Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 383 (1963).

⁹⁵ Kahn v. SEC, 297 F.2d 112, 115 (2d Cir.), *rev'g and remanding* Mac Robbins & Co., Inc., 40 S.E.C. 497 (1961) (emphasis added).

⁹⁶ R. JENNINGS & H. MARSH, SECURITIES REGULATION 774 (2d ed. 1968); 6 Loss 3712; R. MUNDHEIM, *supra* note 85, at 78 (Mr. Heller).

⁹⁷ 297 F.2d at 115. *See* Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) (salesman must not "deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant"; the SEC had held that the broker had a duty to disclose adverse facts he knew or should have known); Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967) (if brokers did not know circumstances, they should have known); Melvyn Hiller, SEC Securities Exchange Act Release No. 8476, at 2 (Dec. 24, 1968), *aff'd*, 429 F.2d

constitute a reasonable basis, the Commission has indicated that in two types of situations an adequate basis can never be demonstrated. First, "predictions of very substantial price rises to named figures with respect to a promotional and speculative security of an unseasoned company cannot possibly be justified. In [the SEC's] experience such predictions have been a hallmark of fraud."⁹⁸ Similarly, the Commission has concluded that there can be no reasonable basis for predictions of earnings or earnings per share for such enterprises.⁹⁹

856 (2d Cir. 1970) (forecast of price rise "made 'with knowledge or reasonable grounds to believe' . . . untrue"). This issue differs from the question of whether the activities were "willful" and hence would subject the actors to a disciplinary proceeding. See A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 4 (April 26, 1967) (willful if intentionally made).

⁹⁸ Alexander Reid & Co., 40 S.E.C. 986, 991 (1962); *accord*, Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Charles P. Lawrence, SEC Securities Exchange Act Release No. 8213, at 3 (Dec. 19, 1967), *aff'd*, 398 F.2d 276 (1st Cir. 1968); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 2 n.3 (April 26, 1967); Harris Clare & Co., SEC Securities Exchange Act Release No. 8004, at 3 (Dec. 9, 1966); Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 6 (March 15, 1966); Arnold Sec. Corp., SEC Securities Exchange Release 7813, at 4 (Feb. 7, 1966); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725, at 4 (Oct. 18, 1965); Underhill Sec. Corp., SEC Securities Exchange Act Release No. 7668, at 4 (Aug. 3, 1965); Albion Sec. Co., SEC Securities Exchange Act Release No. 7561, at 3 (March 24, 1965); Linder, Bilotti & Co., Inc., SEC Securities Exchange Act Release No. 7460, at 2 (Nov. 13, 1964); Equity Gen. Inv. Corp., SEC Securities Exchange Act Release No. 7388, at 4 n.4 (Aug. 13, 1964); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 383 (1963); B. Fennekohl & Co., 41 S.E.C. 210, 215 (1962); Mac Robbins & Co., Inc., 41 S.E.C. 116, 131-32 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963). *But see* SEC v. Rapp, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,048 (S.D.N.Y. 1961) (price rise prediction, recognized as such, permissible), *rev'd*, 304 F.2d 786, 791 (2d Cir. 1962) (expressly finding it unnecessary to decide question).

In Melvyn Hiller, SEC Securities Exchange Act Release No. 8476 (Dec. 24, 1963), *aff'd*, 429 F.2d 856 (2d Cir. 1970), a salesman's comparison of a stock with other securities which had enjoyed a remarkable price rise was equated by the SEC with a prediction of a spectacular price rise. *Accord*, Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400 (Aug. 20, 1964) (favorable comparison with Polaroid "was patently fraudulent"); Irving Grubman, 40 S.E.C. 671, 672-73 (1961); G.J. Mitchell, Jr., Co., 40 S.E.C. 409, 413 (1960); Whitehall Corp., 38 S.E.C. 259, 266-67 (1958). Guarantees of profit and promises that prior losses will be recouped fall into the same category as predictions of a price rise. Irving Friedman, SEC Securities Exchange Act Release No. 8076, at 3 (May 16, 1967).

Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9 (1972), the rule which prohibits false and misleading statements in proxy statements, has a "Note" attached explaining that a prediction of future market value is an example of a statement which "may be misleading." There is no limitation on its application to speculative securities. See note 85 and accompanying text *supra* concerning seasoned securities.

⁹⁹ Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 8 (Dec. 31, 1968), *aff'd sub nom.* Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969) (earnings predictions of sharp increases with respect to speculative security inherently misleading without disclosure of basis and uncertainties); Richard Bruce & Co., SEC Securities

The cases do not concentrate on subsequent events as indicia of the reasonableness of a prediction, opinion, or recommendation. Although a broker is not an insurer of his pronouncements, events occurring after a statement is made should evidence the reasonable basis of those statements in the absence of an intervening event affecting the issuer, the industry in question, or the general economic and financial climate. Thus, a decline or even a leveling of earnings should put into question the basis of a predicted rise in results of operations.

A reasonable investigation is a prerequisite for a reasonable basis. The duty to investigate exists absolutely whenever there is an obligation to have a reasonable basis for statements and recommendations.¹⁰⁰

Exchange Act Release No. 8303, at 6 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969) ("misleading" to predict "increase in earnings of a speculative security" without disclosing uncertainties); James De Mammos, SEC Securities Exchange Act Release No. 8090, at 3 (June 2, 1967) (must disclose basis and uncertainties with respect to a speculative security), *aff'd*, No. 31469 (2d Cir., Oct. 13, 1967); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 17 n.42 (Nov. 12, 1965) (never justified in predicting earnings per share approaching initial offering price for new enterprise); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 383 (1963) (cannot possibly justify predictions of earnings per share equal to the initial offering price for a start-up operation); D.F. Bernheimer & Co., 41 S.E.C. 358, 362 (1963) (specific and definite estimates with regard to new company leud unjustified appearance of predictability of profits).

The "Note" accompanying Exchange Act Rule 14a-9, 17 C.F.R. § 240.14a-9 (1972), states that "predictions of . . . earnings" are among those things which may be misleading.

¹⁰⁰ The Second Circuit held in Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969):

Brokers and salesmen are "under a duty to investigate . . ." Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations made therein.

Id. at 595-96 (footnotes omitted), *quoting* Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967). The court continued: "By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation." 415 F.2d at 597. *See generally* R. MUNDHEIM, *supra* note 85, at 75 (Mr. Heller); Cohen & Rabin, *supra* note 11, at 705; Leavell, *supra* note 57, at 1590; Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070, 1079 (1965); Note, *New and Comprehensive Duties of Securities Sellers to Investigate Disclosure, and Have an "Adequate Basis" for Representations*, 62 MICH. L. REV. 880, 883 (1964); *Distribution by Broker-Dealers of Unregistered Securities*, SEC Securities Exchange Act Release No. 6721, at 3 (Feb. 2, 1962). It has been suggested that no duty to investigate exists if adequate information is available. Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189, 192 (1968). This argument may be a matter of semantics—if facts are publicly known or available to the salesman or broker, he need investigate only that information, assuming he learns nothing to put him on inquiry. The duty to investigate remains, but the scope of the inquiry is limited to the information at hand.

The duty may extend beyond brokers and their salesmen. *See* SEC v. Chamberlain Associates, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,228 (S.D.N.Y. 1963) ("Financial Public Relations Council [*sic*] whose job it was to get market in security started held to have duty to investigate material in report he sent out).

As with the requirement for a reasonable basis, there is no definitive guideline as to what constitutes a "reasonable investigation." Factors utilized to determine whether there was a reasonable basis¹⁰¹ may be used to determine the adequacy of the investigation as well.¹⁰² Under such guidelines a broker exerting any sales pressure should initially examine the filings with the SEC and published data on the security in question.¹⁰³ At some point, as the amount of sales pressure increases, a visit to the issuer and interviews with its management become a necessity.

It is clear that certain data may not be relied on to form a reason-

¹⁰¹ The standard seems to be one of reasonableness. *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969) (degree of investigation "will vary in each case"); *Walston & Co.*, SEC Securities Exchange Act Release No. 8165, at 4 (Sept. 22, 1967) (firm acting as underwriter had to "make diligent inquiry"); *Isthmus S.S. & Salvage Co.*, SEC Securities Exchange Act Release No. 7400, at 8 (Aug. 20, 1964) (underwriter's duty is "to exercise due care, reasonable under all the circumstances"); *Brown, Barton & Engel*, 41 S.E.C. 59, 63 (1962) ("reasonable and diligent inquiry" and "reasonable investigation"); *Distribution by Broker-Dealers of Unregistered Securities*, SEC Securities Exchange Act Release No. 6721, at 3 (Feb. 2, 1962) ("reasonable investigation"); *Charles E. Bailey & Co.*, 35 S.E.C. 33, 41-42 (1953) (underwriter making predictions of price rise held to have a duty "to exercise a degree of care reasonable under the circumstances").

Securities Act § 11, 15 U.S.C. § 77k (1970), imposes liability on underwriters for misleading registration statements. One defense involves a "reasonable investigation" (§§ 11(b)(3)(A),(B), 15 U.S.C. §§ 77k(b)(3)(A),(B) (1970)), and the standard of reasonableness is that "of a prudent man in the management of his own property" (§ 11(c), 15 U.S.C. § 77k(c) (1970)).

Suggestions of what constitutes a reasonable investigation can be found in *R. MUNDHEIM*, *supra* note 85, at 86-93; *Cary, Recent Developments in Securities Regulation*, 63 *COLUM. L. REV.* 856, 865 (1963) (remarks of Mr. Israel); *Wiesen, supra* note 100, at 192.

¹⁰² See text following note 94 *supra*.

In *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969), the court noted that "securities issued by smaller companies of recent origin obviously require more thorough investigation." In *Heft, Kahn & Infante, Inc.*, 41 S.E.C. 379 (1963), the SEC imposed on an underwriter "a special duty to ascertain and disclose the true facts not only at and during the initial offering but also in the period thereafter when [respondent] was conducting an active retail sales campaign." *Id.* at 383 (footnote omitted). In *Brown, Barton & Engel*, 41 S.E.C. 59, 63 (1962), respondents claimed they were not underwriters and therefore should be held to a lesser standard of diligence. The Commission classified them as underwriters within the meaning of Securities Act § 2(11), 15 U.S.C. § 77b(11) (1970), stating however that they nonetheless "had a responsibility to make a reasonable investigation" because they undertook a large distribution of stock. 41 S.E.C. at 64.

In *Armstrong, Jones & Co.*, SEC Securities Exchange Act Release No. 8420, at 8-9 (Oct. 30, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970), the respondent was accused of making predictions of price rises. The Commission rejected as irrelevant the fact that customers initiated most of the transactions.

¹⁰³ *Cf.* Exchange Act Rule 15c2-11(a)(3)(C), 17 C.F.R. § 240.15c2-11(a)(3)(C) (1972) (one way for a broker to reactivate quotations in an inactive security is to have current SEC material on file). The cost of keeping up-to-date microfiche copies of SEC filings is not oppressive.

able basis; instead, further investigation is required. Dependence on an issuer's information may not always be warranted.¹⁰⁴ A salesman in a boiler room may not rely upon literature furnished by his employer, nor blindly accept such material even in the absence of a boiler room situation.¹⁰⁵ Finally, knowledge of any fact which arouses a suspicion

¹⁰⁴ *Hanly v. SEC*, 415 F.2d 589, 597 (2d Cir. 1969) ("salesman may not rely blindly upon the issuer for information concerning a company"); *James De Mamos*, SEC Securities Exchange Act Release No. 8090, at 4 (June 2, 1967), *aff'd*, No. 31469 (2d Cir., Oct. 13, 1967) (prediction of earnings sixteen times greater than prior year); *J.P. Howell & Co., Inc.*, SEC Securities Exchange Act Release No. 8087, at 4 (June 1, 1967), *aff'd sub nom. Vanasco v. SEC*, 395 F.2d 349 (2d Cir. 1968) (statements at variance with prospectus being used); *Irving Friedman*, SEC Securities Exchange Act Release No. 8076, at 5-6 (May 16, 1967) (boiler room raises sufficient doubts); *Floyd Earl O'Gorman*, SEC Securities Exchange Act Release No. 7959, at 3 (Sept. 22, 1966) (cannot rely on company's data in absence of financial information); *Crow, Brouman & Chatkin, Inc.*, SEC Securities Exchange Act Release No. 7839, at 8-9 (March 15, 1966) (in absence of financial statements, not sufficient); *Arnold Sec. Corp.*, SEC Securities Exchange Act Release No. 7813, at 3 (Feb. 7, 1966) (cannot rely on uncertified financials with obviously questionable figure); *Hamilton Waters & Co.*, SEC Securities Exchange Act Release No. 7725, at 4 (Oct. 18, 1965) (phenomenal increase in backlog); *Equity Gen. Inv. Corp.*, SEC Securities Exchange Act Release No. 7388, at 3-4 (Aug. 13, 1964) (contrary to offering circular); *Lawrence Sec., Inc.*, 41 S.E.C. 652, 656 (1963) (representations and recent offering circular conflict); *Charles E. Bailey & Co.*, 35 S.E.C. 33, 42 (1963); *cf. Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (Securities Act § 11 case; underwriters "may not rely solely on the company's officers or on the company's counsel").

One firm, however, was able to convince the Commission that it was entitled to rely on representations from management. *Edgerton, Wykoff & Co.*, 36 S.E.C. 583, 591-93 (1955). In that case, the broker obtained a letter from the issuer's production manager concerning the size of an important contract, asked to see the contract but was told that the parties had gone far beyond its terms, was in constant contact with the company's personnel, relied on false public press releases promulgated by the company, and, although financial statements were not immediately available, discussed the financial condition with the company's attorney and public accountant. The SEC was impressed: "The information released by [the issuer] was confirmed with the only persons who were in a position to give any verification." *Id.* at 593.

More recently, the Second Circuit held that each case must be decided on its facts and "absent actual knowledge or warning signals, a broker-dealer should not be under a duty to retain his own auditor to reexamine the books of every company, the stock of which he may offer for sale." *Levine v. SEC*, 436 F.2d 88, 90 (2d Cir. 1971).

¹⁰⁵ Boiler room cases include *Walker v. SEC*, 383 F.2d 344, 345 (2d Cir. 1967) (do not accept blindly); *Berko v. SEC*, 316 F.2d 137, 142 (2d Cir. 1963), *aff'g Mac Robbins & Co, Inc.*, 41 S.E.C. 116, 128-29 (1962); *Irving Friedman*, SEC Securities Exchange Act Release No. 8076, at 5-6 (May 16, 1967) (boiler room "sufficient reason to doubt" information); *Ross Sec., Inc.*, 41 S.E.C. 509, 515 (1963); *Harold Grill*, 41 S.E.C. 321, 324-25 (1963) ("obviously inadequate information"); *B. Fennekohl & Co.*, 41 S.E.C. 210, 215 (1962) (since boiler room operation, "little if any reliance could be placed on sales literature" by salesman); *see note 343* and accompanying text *infra*; *cf. United States v. Ross*, 321 F.2d 61, 65 (2d Cir.), *cert. denied*, 375 U.S. 894 (1963) (Securities Act § 17(a) case; suspicious on its face); *Herring v. Hendison*, 218 F. Supp. 419, 420 (S.D.N.Y. 1963) (private right of action under Securities Act § 12(2)).

Employers' material may be suspect in non-boiler room situations. *E.g.*, *Hanly v. SEC*,

that the collected data are incomplete or inaccurate should nullify any claim of a reasonable investigation.¹⁰⁶

If a broker is unable after a reasonable investigation to garner sufficient information to form a reasonable basis, he must disclose this to his customers¹⁰⁷ and, at the very least, qualify statements and caution

415 F.2d 589, 596 (2d Cir. 1969) (salesman "must analyze sales literature and must not blindly accept recommendations made therein"); Equity Gen. Inv. Corp., SEC Securities Exchange Act Release No. 7388, at 3-4 (Aug. 13, 1964) (contrary to information contained in current offering circular).

¹⁰⁶ Among the facts which should arouse suspicion are those discussed in Richard Bruce & Co., SEC Securities Exchange Act Release No. 8303, at 6 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969) (knew he faced great competition and past earnings rise nonrecurring); James De Mammos, SEC Securities Exchange Act Release No. 8090, at 4 (June 2, 1967), *aff'd*, No. 31469 (2d Cir., Oct. 13, 1967) (representation by issuer that earnings would increase sixteen fold); J.P. Howell & Co., Inc., SEC Securities Exchange Act Release No. 8087, at 4 (June 1, 1967), *aff'd sub nom.* Vanasco v. SEC, 395 F.2d 349 (2d Cir. 1968) (variance between statement and prospectus being used); Irving Friedman, SEC Securities Exchange Act Release No. 8076, at 5-6 (May 16, 1967) (boiler room "sufficient reason to doubt accuracy of information supplied to him" by issuer and employer; even without boiler room, absence of financial statements should have alerted salesman); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7959, at 3 (Sept. 22, 1966) (in absence of financial information, cannot rely on data from company); Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 6 (March 15, 1966) (absence of current financial statements and inability to find information in financial services); Arnold Sec. Corp., SEC Securities Exchange Act Release No. 7813, at 3 (Feb. 7, 1966) (questionable figure in uncertified financial statements); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 21 (Nov. 12, 1965) (absence of financials should have put broker on notice that he could not rely on information "supplied by the issuer or published sources"); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725 (Oct. 18, 1965) (phenomenal increase in backlog); Equity Gen. Inv. Corp., SEC Securities Exchange Act Release No. 7388, at 3-4 (Aug. 13, 1964) (information contrary to disclosure in current offering circular); Lawrence Sec., Inc., 41 S.E.C. 652, 656 (1963) (conflict between issuer's statements and recent offering circular); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 388-90 (1963) (research assistant writing market letter; although may be entitled to rely normally, since his requests to see information were refused he should have been alerted); D.F. Bernheimer & Co., 41 S.E.C. 358, 362 (1963) ("should have been aware from readily available information" contained in article and stockholder letter that price of sulphur, the issuer's product, was inflated); B. Fennekohl & Co., 41 S.E.C. 210, 217 (1962) (boiler room operation should alert salesman); Charles E. Bailey & Co., 35 S.E.C. 33, 42 (1953) (witnessing of issuer's machine jamming and old dates on purchase orders).

Indications that the brokerage firm and issuer share an office or that a member of the firm is on the issuer's board have been used against the firm since suspicious facts were more easily ascertainable. Hiller v. SEC, 429 F.2d 856, 857 (2d Cir. 1970) (duties more clear because respondent a director of issuer); Shearson, Hammill & Co., *supra* at 18 (partner of registrant director of issuer; should not have assumed turnaround situation because of access to information); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 569 (1963) (shared offices and officers; therefore had easy access to financial information); D.F. Bernheimer & Co., *supra* (officer of registrant was director of issuer; aware of uncertainties).

¹⁰⁷ Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 8 (Dec. 31, 1968) (customer entitled to assume reasonable basis absent disclosure), *aff'd sub nom.* Haully v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) (must disclose absence of essential informa-

investors concerning the dangers of purchasing without such data.¹⁰⁸

Brokers have asserted, with uniform lack of success in administra-

tion); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 382-83 (1963) (prediction implies adequate basis exists); B. Fennekohl & Co., 41 S.E.C. 210, 215 (1962) (failure to disclose lack of adequate financial information); Distributions by Broker-Dealers of Unregistered Securities, SEC Securities Exchange Act Release No. 6721, at 3-4 (Feb. 2, 1962) (if broker "lacks essential information about the issuer, such as knowledge of its financial condition, he must disclose this"); Barnett & Co., Inc., 40 S.E.C. 1, 4 (1960) (no disclosure of absence of reasonable basis for price rise prediction).

¹⁰⁸ Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) (disclose risks to investors); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7959, at 3 (Sept. 22, 1966) (withhold or qualify recommendation or at least caution customers); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 21 (Nov. 12, 1965) (withhold or appropriately qualify representations or, at very least, caution investors); Harold Grill, 41 S.E.C. 321, 322, 325 (1963) (caution customers); B. Fennekohl & Co., 41 S.E.C. 210, 215 (1962) (withhold or qualify statements; caution customers); Distributions by Broker-Dealers of Unregistered Securities, SEC Securities Exchange Act Release No. 6721, at 3 (Feb. 2, 1962) (caution customers); Mac Robbins & Co., Inc., 40 S.E.C. 497, 503, *rev'd sub nom.* Berko v. SEC, 297 F.2d 116 (2d Cir. 1961) & Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961) (should have cautioned customers). The Commission has taken a different tack on occasion. *See, e.g.,* Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 9 (March 15, 1966) (should refrain from recommending security and caution investors about buying without current information).

Even when the broker has obtained facts providing an adequate basis for his views, he must clearly reveal to his clients any known or reasonably ascertainable data adverse to his statements. Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 7-8 (Dec. 31, 1968) ("known or reasonably ascertainable adverse information which rendered [statements] materially misleading"; absent disclosure, customer entitled to assume broker knows no "adverse factors which might affect the customer's investment decision"), *aff'd sub nom.* Hanly v. SEC, *supra* (disclose known and reasonably ascertainable facts); Richard Bruce & Co., SEC Securities Exchange Act Release No. 8303, at 6 (April 30, 1968), *aff'd sub nom.* Gross v. SEC, 418 F.2d 103 (2d Cir. 1969) (reveal uncertainties and known facts); Crow, Brouman & Chatkin, Inc., *supra* at 3 (guilty concealment of known precarious financial condition); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 382-83 (1963) (prediction implies no known facts which would make it unreliable); D.F. Bernheimer & Co., 41 S.E.C. 358, 361 (1963) (disclose "known or reasonably available information"); Mac Robbins & Co., Inc., *supra* at 131-32 (must make "adequate disclosure of material adverse information"; boiler room); Distributions by Broker-Dealers of Unregistered Securities, *supra* ("facts known or reasonably ascertainable"); N. Pinsker & Co., Inc., 40 S.E.C. 285, 291 (1960) (recommendation should be accompanied by "known or easily ascertainable facts"); Barnett & Co., Inc., 40 S.E.C. 1, 4 (1960) (no disclosure of issuer's lack of capital and income; must disclose "known or reasonably ascertainable facts"); Best Sec., Inc., 39 S.E.C. 931, 934 (1960) ("known or easily ascertainable facts"); Leonard Burton Corp., 39 S.E.C. 211, 214 (1959) (must disclose uncertainties); Van Alstyne, Noel & Co., 33 S.E.C. 311, 321-22, 324 (1952) (fair portrayal required disclosure of unfavorable financial statements; not sufficient just to state loss occurred); *cf.* RESTATEMENT (SECOND) OF AGENCY § 390 & comment *b* (1958) (must disclose information known to agent or which would have been discovered in an attentive search). The "reasonably ascertainable" language of the cases may derive from the duty to make a reasonable investigation, i.e., to obtain "reasonably ascertainable" data.

In the *Van Alstyne* case, *supra*, the Commission held that the duty of disclosure may

tive actions, the following defenses to the reasonable basis rule: the customer was sophisticated,¹⁰⁹ knew the security was speculative,¹¹⁰ received a prospectus,¹¹¹ did not rely on the statement,¹¹² did not believe the statement,¹¹³ understood the broker to be expressing an opinion,¹¹⁴ or realized a profit;¹¹⁵ the prediction fortuitously came true;¹¹⁶ the

extend to include the fact that previous optimistic statements had not materialized (33 S.E.C. at 324), and rejected the broker's claim that the issuer's financial information supplied to the respondent was confidential and hence should not be disclosed. *Id.* at 321.

Although the cases do not limit the duty to disclose adverse information, surely a materiality concept must be implied. *See* Rule 10b-5(2).

The decisions seem to refer to adverse facts about the issuer, but in an appropriate case the duty should extend to unfavorable data concerning the industry in which the issuer is engaged, the security vis-à-vis the issuer (such as the fact that a bond is subordinated), or the market for the security (for example, that there are few bids but a plethora of offers). *See* Van Alstyne, Noel & Co., *supra* at 329-30 (misrepresentation of amount of stock available and big buy order); Henry P. Rosenfeld, 32 S.E.C. 731, 739 (1951) (misrepresentation by underwriter of number of shares remaining unsold).

¹⁰⁹ Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 9 (Dec. 31, 1968), *aff'd sub nom.* Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969) (sophisticated and knowledgeable customer does not warrant less stringent standard); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 4 (April 26, 1967); Leonard Burton Corp., 39 S.E.C. 211, 214 (1959).

¹¹⁰ Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7959, at 4 (Sept. 22, 1966); Underhill Sec. Corp., SEC Securities Exchange Act Release No. 7668, at 6 (Aug. 3, 1965); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 7 (Aug. 20, 1964); Alexander Reid & Co., 40 S.E.C. 986, 989 (1962); Leonard Burton Corp., 39 S.E.C. 211, 214 (1959) (customer's independent knowledge of speculative nature of securities no defense).

¹¹¹ Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 569 (1963); Ross Sec., Inc., 41 S.E.C. 509, 510 (1963).

¹¹² Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Irving Friedman, SEC Securities Exchange Act Release No. 8076, at 5 (May 16, 1967); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 4 (April 26, 1967); Linder, Bilotti & Co., Inc., SEC Securities Exchange Act Release No. 7460, at 3 (Nov. 13, 1964); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 7 (Aug. 20, 1964); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963).

¹¹³ Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963) (clients not misled); Irving Friedman, SEC Securities Exchange Act Release No. 8076, at 5 (May 16, 1967) (not defense that investor not misled); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 7 (Aug. 20, 1964).

¹¹⁴ Alexander Reid & Co., 40 S.E.C. 986, 989 (Feb. 8, 1962); *see* note 78 *supra*.

¹¹⁵ Berko v. SEC, 316 F.2d 137, 143 (2d Cir. 1963).

¹¹⁶ Ross Sec., Inc., 41 S.E.C. 509, 514 n.6 (1963); Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 382 n.4 (1963) (must be warranted at time made; future price rise may be due to broker's activities).

broker was naive,¹¹⁷ acted in good faith,¹¹⁸ was just puffing,¹¹⁹ or invested his own money in the security.¹²⁰

Private litigants have been much less successful than the Commission in attempting to enforce the reasonable basis rule. In two confusing opinions,¹²¹ the federal district court for the Eastern District of Penn-

¹¹⁷ A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 3 (April 26, 1967).

¹¹⁸ Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 21 (Nov. 12, 1965); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 7 (Aug. 20, 1964); Floyd Earl O'Gorman, SEC Securities Exchange Act Release No. 7743, at 4 (Nov. 12, 1963); Alexander Reid & Co., 40 S.E.C. 986, 990-91 (1962).

¹¹⁹ Irving Friedman, SEC Securities Exchange Act Release No. 8076, at 5 (May 16, 1967); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725, at 6 (Oct. 18, 1965); Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963); B. Fennekohl & Co., 41 S.E.C. 210, 215-16 (1962). *But see* SEC v. Chamberlain Associates, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,228 (S.D.N.Y. 1963) (for mining stock sales talk and puffing permissible); Bowman v. Hartig, 334 F. Supp. 1323, 1328 (S.D.N.Y. 1971) (no private right of action for salesman's puffing where reasonable person would not rely); Phillips v. Reynolds & Co., 294 F. Supp. 1249, 1256 (E.D. Pa.), *motion to amend denied*, 297 F. Supp. 736 (E.D. Pa. 1969) (puffing not grounds for civil liability unless grossly exaggerated).

¹²⁰ Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 10 (Dec. 31, 1968), *aff'd sub nom.* Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969); A.T. Brod & Co., SEC Securities Exchange Act Release No. 8060, at 4 (April 26, 1967); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 21-22 (Nov. 12, 1965); Isthmus S.S. & Salvage Co., SEC Securities Exchange Act Release No. 7400, at 8 (Aug. 8, 1964); D.F. Bernheimer & Co., 41 S.E.C. 358, 361 (1963).

Other rejected defenses are discussed in Nees v. SEC, 414 F.2d 211, 218-19 (9th Cir. 1969) (customers speculating); Richard J. Buck & Co., *supra* at 9 (prior business and social relationships discounted); Armstrong, Jones & Co., SEC Securities Exchange Act Release No. 8420, at 9-10 (Oct. 3, 1968) (irrelevant that customer initiated transaction and no defense that no type of fraudulent representation made), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970); Crow, Brouman & Chatkin, Inc., SEC Securities Exchange Act Release No. 7839, at 6 (March 15, 1966) (cannot rely on movement of stock prices); Shearson, Hammill & Co., *supra* at 20 (that deficit in accordance with budget no excuse for nondisclosure); Isthmus S.S. & Salvage Co., *supra* at 8 (broker's belief that a good buy). The absence of a boiler room will not justify a variation from the rules. *See* notes 81-82 and accompanying text *supra*.

A salesman may be disciplined for violating the reasonable basis rule although he makes no affirmative misrepresentation. *See* Hanly v. SEC, *supra*.

¹²¹ Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa.), *motion to amend denied*, 297 F. Supp. 736 (E.D. Pa. 1969). The court dealt with inside information and the fact that the defendant was not an insider rather than the duties of a broker in making a recommendation or statement under the reasonable basis rule. 294 F. Supp. at 1255; 297 F. Supp. at 738. The court also cited a commentator for the proposition that actions which violate disciplinary standards (as, it would seem, the defendant's did) should provide the basis for damage actions, although holding to the contrary. 294 F. Supp. at 1255 n.6. The court justified the absence of disclosure of a deficit on the ground that the broker's description of prospects was generally sufficient to indicate the security's speculative nature (297 F. Supp. at 738), a defense clearly unavailable in administrative proceedings. *See* note 110 and accompanying text *supra*. The court did, however, limit its holding by noting that

sylvania refused to assess damages against a brokerage firm which recommended the purchase of a speculative security without disclosing the issuer's large deficit. Such action would, however, subject the broker to disciplinary sanctions.¹²²

A broker should be civilly liable for failure to perform his duties under the reasonable basis rule if the customer can show that the concealed information was material and was not public knowledge.

2. *The Suitability Doctrine*

The outlines of the suitability doctrine are currently developing under the rules of the NASD, SECO Rule 15b10-3,¹²³ and the federal antifraud provisions.¹²⁴ Since the suitability concept is in its infancy with regard to 10b-5,¹²⁵ this topic is best treated by discussing both 10b-5 and these other provisions.¹²⁶

Under a simplified view of the suitability rule, a broker-dealer would have to elicit data concerning his customer's investment objectives and financial needs, and, after investigation of the issuer, could recommend¹²⁷ only those securities he believed to be consistent with those objectives and needs. He must correlate his customer's situation with the security he recommends, after investigating both.¹²⁸ This for-

the result might have been different had the information concerning the deficit not been available publicly through the issuer's annual report. 294 F. Supp. at 1255 n.5.

¹²² The court could have reached the same result by relying on the fact that the information in question was public knowledge and the investors would not have been influenced by the disclosure in any case. The Second Circuit has interpreted the case to the effect that the reasonable basis rule "may not be as rigidly enforced in a civil action where an investor seeks damages" and that "a broker is not a virtual insurer of his recommendations even where he does not disclose all material facts." *Hanly v. SEC*, 415 F.2d 589, 596 & n.13 (2d Cir. 1969).

¹²³ The SECO rules, promulgated under Exchange Act § 15(b)(10), 15 U.S.C. § 78o(b)(10) (1970), established standards for broker-dealers who are not members of a national securities association.

¹²⁴ The N.Y. Stock Exch. Rule 405, 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2405, commonly referred to as the "know your customer rule," was originally designed to protect member firms but has been developing as a suitability rule as well. SPECIAL STUDY pt. 1, at 316; see Am. Stock Exch. Rule 411, 2 CCH AM. STOCK EXCH. GUIDE ¶ 9431.

¹²⁵ See notes 144-56 and accompanying text *infra*.

¹²⁶ The ethically-oriented NASD and SECO rules may impose more stringent standards than the fraud-oriented Rule 10b-5. For example, the NASD's suitability concept includes churning of accounts. See note 353 and accompanying text *infra*.

¹²⁷ Recommendations to purchase or exchange securities as well as to sell should be included within the 10b-5 suitability concept. See generally the NASD and SECO rules, quoted in note 128 *infra*, which cover purchases, sales, and exchanges.

¹²⁸ The NASD rule is found in Art. III, § 2 of the Association's Rules of Fair Practice, CCH NASD SEC. DEALERS MANUAL ¶ 2152:

In recommending to a customer the purchase, sale or exchange of any security,

mulation may be too limited in some respects. Speculative securities, for example, are obviously unsuitable for some customers. By analogy, a speculative *transaction* such as a short sale or possibly even the use of a margin account may also be inappropriate, regardless of the type of security involved.¹²⁹ One commentator has suggested that suitability should extend beyond recommendations by brokers and encompass almost any purchase of a security by a customer.¹³⁰

The above statements of the suitability precept may be too broad in certain particulars. First, there is some doubt as to whether suitability duties arise only when a broker initially possessed data about his customer, or whether a broker has an affirmative obligation to gather information concerning the investor. The SEC considers the latter to be the proper interpretation under 10b-5,¹³¹ but the situa-

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

Exchange Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1972), is substantially similar:

Every nonmember broker or dealer . . . who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer

The rationale underlying the suitability concept is that investment objectives and the customer's situation should jointly govern investment decisions.

¹²⁹ Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock, 247 F. Supp. 373, 376-77, 379-80 (S.D. Tex. 1965) (short sales and margin accounts discussed along with modicum of suitability); see 2 CCH N.Y. STOCK EXCH. MANUAL ¶ 2405.10 (supplemental material to the "know your customer" rule; margin accounts may not be permissible for certain clients because of corporate limitations).

¹³⁰ Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 449 & n.9. On the other hand, when proposing and promulgating the SECO rule, the Commission spoke only in terms of recommendations. SEC Securities Exchange Act Release Nos. 7984 (Oct. 25, 1966) & 8135 (July 27, 1967). In the second release, the SEC stated that "a general distribution of a market letter, research report or other similar material would [not] in itself constitute a recommendation." SEC Securities Exchange Act Release No. 8135, *supra* at 3.

¹³¹ The Commission has reached this result under 10b-5 in boiler room cases where typically the broker places long-distance telephone calls to unknown persons. Barnett & Co., Inc., 40 S.E.C. 1, 4 n.7 (1960), *citing Best Sec., Inc., infra*; Best Sec., Inc., 39 S.E.C. 931, 933 (1960) (boiler room tactics "not conductive [*sic*] . . . to a determination of its suitability for the customer"). Affirmances of NASD cases reach the same conclusion. See Gerald M. Greenberg, 40 S.E.C. 133, 137 (1960) (substantial part of business was telephone calls to strangers); Philips & Co., 37 S.E.C. 66, 68-69 (1956) (three customers, one in second transaction with respondent, one in first transaction with any broker, and one in latest of several dealings with respondent). The SECO rule reflects this philosophy of the Commission. See note 128 *supra*.

tion remains unclear under the NASD rule.¹³² Second, there has been some suggestion that suitability does not apply unless the customer relies on his broker's recommendation. Clarification of this latter issue may be found in an analysis of the underlying rationale of the doctrine. The suggestion has merit if suitability is a question of who should bear the risk of an unsuitable investment, with the loss falling on the broker unless he can pass the risk back to the investor as, for example, by showing lack of reliance on the part of the customer.¹³³ On the other hand, reliance should be irrelevant (at least in administrative proceedings) if the shingle theory dictates the 10b-5 suitability duties.¹³⁴

¹³² See note 128 *supra*. The NASD rule provides that the member must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts, if any, disclosed by such customer." NASD Rules of Fair Practice Art. III, § 2, CCH NASD SEC. DEALERS MANUAL ¶ 2152 (emphasis added). The Commission, when reviewing an NASD imposed sanction, in effect eliminated the words "if any" from the NASD rule. Gerald M. Greenberg, 40 S.E.C. 133, 137-38 (1960). The NASD, however, has not acquiesced in this interpretation; its position seems to place a premium on ignorance and encourage salesmen to learn as little as possible about their customers—an unfortunate result. NASD, 1964 REPORT TO MEMBERS 8 ("no affirmative obligation to ascertain a customer's resources and needs was imposed upon a salesman"; test of suitability not imposed on securities industry); R. MUNDHEIM, *supra* note 85, at 105 (Mr. White, NASD General Counsel: not amending NASD rule to delete "if any" clause; rule does not impose affirmative obligation to ascertain suitability). The NASD's disposition of the *Shearson, Hammill* case has been seen as a definite retreat from *Greenburg*. SPECIAL STUDY pt. 1, at 311-12. Compare the disposition of the *Shearson, Hammill* case in an SEC disciplinary action discussed in note 139 *infra* where the Commission held certain actions the NASD had excused to be violations of 10b-5, an anomalous result indeed.

¹³³ Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233, 239 (1966); Mundheim, *supra* note 130, at 450 (rebuttable presumption of reliance is basis for suitability except where broker is order clerk). But query whether even a broker acting as an order clerk ought not to have some duties if he suspects the ordered security is unsuitable. Cf. *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), *cert. denied*, 370 U.S. 915 (1962) (insurance policies sold; agent held liable under common law for violation of suitability requirement in part based on customer's reliance).

A number of 10b-5 suitability cases contain reliance-type language. See Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960) (request for broker's advice); Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 824 (1948) (had trust and confidence). Reliance may be a factor in a 10b-5 private right of action. Compare *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249, 1256 (E.D. Pa.), *motion to amend denied*, 297 F. Supp. 736 (E.D. Pa. 1969), with *Affiliated Ute Citizens v. United States*, 40 U.S.L.W. 4448 (U.S. April 24, 1972).

¹³⁴ Richard N. Cea, SEC Securities Exchange Act Release No. 8662, at 9 (Aug. 6, 1969) (suitability part of duties flowing from shingle theory); Best Sec., Inc., 39 S.E.C. 931, 933-34 (1960) (boiler room, including suitability, violative of shingle theory); 6 Loss 3719 (quoting Chairman Cohen's speech); Comment, *supra* note 65, at 741 (suitability one aspect of shingle theory); see notes 45-69 and accompanying text *supra* (shingle theory discussed).

In the *Cea* case, *supra* at 8, the Commission concluded that the broker did not have to occupy a fiduciary relationship to the customer before the suitability doctrine came into force.

A broker-dealer governed by the suitability concept must gather information about the security and about his customer. The investigation required by the reasonable basis rule is one source of data about the security.¹³⁵ Since suitability apparently applies to a broader range of situations than does the reasonable basis rule,¹³⁶ a broker will upon occasion be required to investigate a security solely to ascertain if it is suitable. Such an inquiry would be less extensive than under the reasonable basis rule, since it would delve only as deeply as is necessary to determine if the security meets the customer's needs. The scope of such a suitability probe should include at least the speculativeness of the security, its potential for producing income, and its chances for capital appreciation. The customer is the best and most logical source of data about himself. If he is unwilling to disclose such information after reasonable interrogation by the broker, the broker should be permitted to make any recommendation unless he knows or has reason to believe the security is unsuitable.¹³⁷ When the Commission promulgated its SECO suitability rule, it enunciated a most detailed list of facts needed about a customer:

[A] broker or dealer . . . [is] expected to make reasonable inquiry concerning the customer's investment objectives, and his financial situation and needs. Information concerning financial situation and needs would ordinarily include information concerning the customer's marital status, the number and age of his dependents, his earnings, the amount of his savings and life insurance, and his security holdings and other assets.¹³⁸

¹³⁵ See notes 100-06 and accompanying text *supra*.

¹³⁶ Suitability is not limited to speculative securities or some type of major selling effort as the reasonable basis rule may be. See notes 90-91 and accompanying text *supra* (applicability of reasonable basis rule).

¹³⁷ SEC Securities Exchange Act Release No. 8135 (July 27, 1967) (promulgating the SECO rule; can make recommendations); Mundheim, *supra* note 130, at 449 n.10 (not required to prevent sale).

Other sources of information might include the nature of the customer's account; for example, a nontrading investment account would suggest that speculative securities are unsuitable. Recent, widely disseminated news stories in the mass media might also qualify; for example, a story about the client in the town's newspaper indicating that he had fallen on hard times might be information of which the broker should be aware.

¹³⁸ SEC Securities Exchange Act Release No. 8135, at 3 (July 27, 1967). The Release goes on to state that the broker-dealer "may rely on the information furnished by the customer." *Id.* But a broker suspecting or having reason to suspect the inaccuracy of the facts he receives should not be permitted to disregard the questions raised, but should have an affirmative duty to inquire further.

Other authorities formulate the requirements differently. See *e.g.*, John P. Fleming, SEC Securities Exchange Act Release No. 8129, at 1 (July 21, 1967) ("financial needs, circumstances [and] objectives"); Boren & Co., 40 S.E.C. 217, 222 (1960) (NASD appeal; should ask about "the customer and his needs"); Gerald M. Greenberg, 40 S.E.C. 133, 138

The essence of suitability involves the efficacy of a broker's efforts to reach an accommodation between his customer and the security, a topic on which there is virtually no guidance. In the type of extreme cases which are usually the subject of disciplinary proceedings, the standard to which a broker's analysis must conform is unimportant because application of any criterion would indicate a violation.

A more refined analysis will eventually evolve under 10b-5. One alternative would be to absolve a broker if he used reasonable business judgment; another would involve invoking a more stringent rule.¹³⁹

(1960) (NASD sanction affirmed; "customer's other security holdings, his financial situation, and his needs"); Best Sec., Inc., 39 S.E.C. 931, 933 (1960) ("financial situation and investment objectives"); Mundheim, *supra* note 130, at 448, 474 ("risk threshold" should be determined; a broader term than "investment objective"). See also Exchange Act Rule 15b10-6(a)(1)(B), 17 C.F.R. § 240.15b10-6(a)(1)(ii) (1972) (SECO broker making recommendation must keep record of "customer's occupation, marital status, investment objectives" and other information concerning customer's financial situation and needs).

Release No. 8135, *supra*, continues: "The nature and extent of the inquiry to be made by the broker-dealer will depend on all the facts and circumstances." As an example, the Release states that the interval between recommendations may be of such brevity that the broker need merely ask if any material change has taken place. *Id.*

¹³⁹ Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 430 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (negligence not sufficient under 10b-5; plaintiff apparently attempted to argue breach of NASD suitability rule was evidence of 10b-5 breach); Leavell, *supra* note 57, at 1576-77 (NASD rule could logically be construed as imposing a standard of skill and care in securities analysis, although not generally thought of as doing so). The NASD and SECO rules by their terms establish a reasonable basis standard—a negligence standard. When a practice, therefore, is completely devoid of any sound basis, there can be no reasonable grounds for believing a security suitable, irrespective of what customers may have told the broker. Thomas Arthur Stewart, 20 S.E.C. 196, 207 (1945) (NASD appeal).

Implicit in the suitability obligation is the mandate that salesmen be adequately trained to be able to make a determination when in possession of the facts. C. Gilman Johnston, SEC Securities Exchange Act Release No. 7390, at 3 (August 14, 1964) (NASD sanction review); see note 558 and accompanying text *infra*.

Concerning a broker's obligations when his customer changes his investment objectives, see Fishman, *supra* note 133, at 248; Mundheim, *supra* note 130, at 475.

Examples of what the SEC considers unsuitable securities within 10b-5 include stock not paying a dividend sold to an unemployed widow who counted on income and to another elderly woman who had stated she wanted capital gains and dividends (Century Sec. Co., SEC Securities Exchange Act Release No. 8123, at 6 (July 14, 1967), *aff'd sub nom.* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969)); speculative securities of a brokerage house sold to a 79 year-old retired man who was living alone (Powell & McGowan, Inc., 41 S.E.C. 933, 934-35 (1964)); a highly speculative security sold through misrepresentations and omissions to customers who had indicated a need for non-speculative securities producing a reasonable income (Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 824 (1948)); speculative securities in a boiler room (Best Sec., Inc., 39 S.E.C. 931, 933 (1960)); and speculative securities sold to a customer asking for "securities not subject to fluctuations and yielding a higher income" than present portfolio (Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960)).

In Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 22 (Nov. 12, 1965), the Commission noted that "the record also contains glaring examples of

The formula which is eventually adopted should not transform the broker into an insurer of his investment advice, nor should it evaluate recommendations in the bright gleam of hindsight.¹⁴⁰ Rather, it should encourage the broker to compare his customer with the security prior to making any recommendation.¹⁴¹

Once a broker concludes that a security is unsuitable, by whatever balancing process the Rule may require, he must convey his view to the customer in clear and understandable terms.¹⁴² After disclosure, the broker should be allowed to execute unsolicited orders for securities he believes are inappropriate, but he may not make unsuitable recommendations.¹⁴³

recommendations to investors in USAMCO stock [a speculative security] made to customers contrary to their investment needs" (footnote omitted). Possibly a mild rebuke was directed at the NASD based upon the Association's exoneration of certain conduct which the SEC condemned. See note 132 *supra*. More likely though, the SEC was holding the action to be a violation of 10b-5 since it cited two antifraud suitability cases as authority for the clause quoted above and placed the discussion under the topic "Fraud in USAMCO Transactions" and the subtopic "Fraudulent Representations." Among the objectionable sales of USAMCO stock were those to a 13 year-old boy, a 70 year-old widow of limited means who desired safe investments, another widow of limited means who was interested in high quality securities, a customer of limited income having three young children, a husband and wife earning \$8,000 annually with \$6,000 in savings who did not wish to speculate, and a woman earning \$5,000 per year who did not want to speculate but had safety, long-term growth, and occasional dividends as her investment objectives.

There may be securities which are unsuitable for all, or at least most, investors (Standard Bond & Share Co., 34 S.E.C. 208, 210-11 (1952) (NASD appeal; bonds which issuer stated would not be repaid when due in the near future)), and no security is suitable for all customers. Boren & Co., 40 S.E.C. 217, 222 (1960) (NASD review; cannot assume mutual funds suitable for all customers).

140 SEC Securities Exchange Act Release No. 8135, at 3 (July 27, 1967) (proposing SECO suitability rule; do not second-guess broker or make him insurer; judge on facts available at time of recommendation); Fishman, *supra* note 133, at 247-48 (do not make broker an insurer or subject his system of securities analysis to evaluation; subsequent price performance not relevant); Mundheim, *supra* note 130, at 448, 475 (do not use for investment judgment or to make brokerage firm insurer of market performance; subsequent price movement "irrelevant").

141 If a broker fails to conform to the suitability rule, few defenses are available in administrative proceedings. Philips & Co., 37 S.E.C. 66, 70 (1956) (NASD appeal; rejected defenses that customers mature and intelligent and considered stock suitable, that customers had exercised their own independent judgment, and that customers had even recommended stock to two other customers); Thomas Arthur Stewart, 20 S.E.C. 196, 208 n.12 (1945) (in SEC review of NASD decision, findings that customers pleased, did not perceive groundlessness of recommendations, and got their money back in subsequent transactions not considered sufficient defenses); cf. First Sec. Corp., 40 S.E.C. 589, 592 (1961) (churning cases under NASD rule; motivation and intent irrelevant). Indeed, to take the extreme case, a broker who does not attempt to ascertain whether or not an investment is suitable should be held to have violated the doctrine even if by chance he recommends a suitable security on which the customer realizes a large profit.

142 Cf. Powell & McGowan, Inc., 41 S.E.C. 933, 934-35 (1964).

143 Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d. 690, 719, 69 Cal.

A difficult and unresolved problem is the extent to which 10b-5 incorporates the suitability doctrine. The SECO suitability rule was not adopted under the antifraud provisions.¹⁴⁴ The earlier *Special Study of the Securities Markets*, however, could be construed as having urged the Commission to adopt a suitability concept under the general antifraud rules.¹⁴⁵ The SEC indicated its belief in its power to incorporate a suitability provision into 10b-5 by promulgating under another antifraud provision a very strict suitability requirement for purchases of life insurance-security combinations,¹⁴⁶ and has applied suitability under the Rule to boiler room activities¹⁴⁷ and certain other situations.¹⁴⁸ Generally, however, actions may have to be more egregious to

Rptr. 222, 242 (1968) (common-law cases; "refrain from acting except upon [customer's] express orders"); Mundheim, *supra* note 130, at 449 (permissible to sell).

¹⁴⁴ In the proposing release (SEC Securities Exchange Act Release No. 7984, at 2 (Oct. 25, 1966)), the Commission noted that the SECO suitability rule would "supplement" the existing antifraud rules, but in the promulgating release (SEC Securities Exchange Act Release No. 8135, at 3 (July 27, 1971)), the Commission stated that the rule would not be "adopted under the antifraud provisions of the Exchange Act, [and] would not affect the obligations of broker-dealers under those provisions."

¹⁴⁵ The Study recommended that "greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of 'suitability.'" SPECIAL STUDY pt. 1, at 329. In light of the remainder of the recommendation, it is probable that the Study was addressing the SEC in its overseer capacity. R. MUNDHEIM, *supra* note 85, at 104 (Mr. Loomis, then General Counsel of the SEC and later a member of the Commission); Mundheim, *supra* note 130, at 459.

¹⁴⁶ Exchange Act Rule 15c2-5(a)(2), 17 C.F.R. § 240.15c2-5(a)(2) (1972), which applies to all sales, requires that a written statement be delivered to the customer concerning suitability.

¹⁴⁷ Barnett & Co., Inc., 40 S.E.C. 1, 4 n.7 (1960); Best Sec., Inc., 39 S.E.C. 931, 933 (1960); see Mac Robbins & Co., 41 S.E.C. 116, 120 (1962) (boiler room case; boiler rooms operate "without any concern for the suitability of such securities in light of the customers' investment needs or objectives"), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963).

¹⁴⁸ Alfred B. Tallman, Jr., SEC Securities Exchange Act Release No. 8830 (March 2, 1970) (no indication in opinion of any gross abuse but suitability violation still sustained); Richard N. Cea, SEC Securities Exchange Act Release No. 8662, at 7-9 (Aug. 6, 1969) (opinion does not state actions are gross violations although disciplining broker); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 22 (Nov. 12, 1965) ("glaring examples of recommendations . . . contrary to their needs"); Powell & McGowan, Inc., 41 S.E.C. 933, 935 (1964) (recommendation "so grossly inappropriate as to constitute overreaching and a violation" of 10b-5); Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960) (absence of suitability where customer informed broker of investment objectives and broker induced her to purchase unsuitably speculative securities); Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 823-24 (1948) (induced purchases of speculative securities by misrepresentations; customers had disclosed investment objectives).

Another 10b-5 requirement akin to suitability may be violated when a broker advises or permits a customer to purchase mutual fund shares in quantities which preclude volume discounts. Shearson, Hammill & Co., *supra* at 34-35 (salesman revealed break point but should not have let customer purchase below it just to give salesman a gift); Mason, Moran & Co., 35 S.E.C. 84, 87-92 (1953) (concealment of break point).

violate 10b-5 than to run afoul of the ethically-based NASD and SECO rules.¹⁴⁹

Some commentators have objected to the importation of suitability into the Rule because its incorporation would (1) force the Commission to pass on the merits of the securities involved (which it has not done in the past¹⁵⁰) and to evaluate the terms of the transaction rather than the broker's conduct in effecting the trade,¹⁵¹ (2) impose the additional costs of defending private suits on the securities community,¹⁵² and (3) raise problems of adequately training brokerage personnel.¹⁵³ The validity of these objections is open to question.¹⁵⁴ In addition, the first is based on the assumption that suitability requires the Commission to second guess a broker's judgment—that is, to determine whether the security was indeed suitable. Instead, the rule should be regarded as procedural in nature.¹⁵⁵ The broker is required to elicit information

¹⁴⁹ See R. MUNDHEIM, *supra* note 85, at 103-04 (Mr. Loomis, then SEC General Counsel and later Commissioner: SEC should not use suitability as 10b-5 concept except for "absolute indifference to standard of responsible conduct"); cases cited in note 148 *supra*. But see note 139 *supra* (Shearson, Hammill case discussion).

¹⁵⁰ R. MUNDHEIM, *supra* note 85, at 99 (Mr. O'Boyle); Comment, *supra* note 65, at 742; cf. Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 431 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (dictum) (private rights of action under NASD suitability rule would involve judicial review of market judgments). See also Securities Act § 23, 15 U.S.C. § 77w (1970) & Exchange Act § 26, 15 U.S.C. § 78z (1970) (action or inaction of Commission not approval of transaction or security); Securities Act Rule 425, 17 C.F.R. § 230.425 (1972), and Exchange Act Rule 15c1-3, 17 C.F.R. § 240.15c1-3 (1972) (cannot state Commission has approved security).

¹⁵¹ R. MUNDHEIM, *supra* note 85, at 99 (Mr. O'Boyle); Comment, *supra* note 65, at 742.

¹⁵² R. MUNDHEIM, *supra* note 85, at 101 (Mr. O'Boyle).

¹⁵³ *Id.* at 102.

¹⁵⁴ The Commission in the past has reviewed the speculativeness of securities, the point on which it might have to rule under the suitability theory. In a number of 10b-5 suitability cases, it has held securities to be speculative. John P. Fleming, SEC Securities Exchange Act Release No. 8129, at 1 (July 21, 1967); Ramey Kelly Corp., 39 S.E.C. 756, 759 (1960); Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 824 (1948). Additionally, it faces this problem to a certain extent when reviewing appeals from NASD sanctions. See Fishman, *supra* note 133, at 245 (SEC has evaluated securities indirectly); notes 85-89 and accompanying text *supra* (for the reasonable basis rule, SEC has concentrated on speculative securities of unlisted companies); note 331 and accompanying text *infra* (boiler-room activities apply to speculative securities). Finally, state securities commissions evaluate securities on a regular basis.

Concerning the broker's conduct objection, the Commission *would* be evaluating the broker's performance of his suitability duties rather than the terms of the trade.

Finally, the arguments that brokerage firms would have to incur expenses in defending suits and would have difficulty in training their personnel, when carried to their logical conclusions, suggest that no 10b-5 private right of action should exist and that brokerage firms should train employees only to the level of competency that is most economical. It is unlikely that these positions will be found any more acceptable in the future than they have been in the past.

¹⁵⁵ Fishman, *supra* note 133, at 248.

about the customer and the security and compare the data; if he fails to *obtain* the information, he should be disciplined. But failure to correctly *evaluate* datum once it has been obtained should be grounds for action only on a showing of lack of reasonable business judgment or some comparable standard.

There have been few cases, thus far, to justify the industry's fear of liability in private rights of action, but the trend is in that direction.¹⁵⁶

B. *Misrepresentation to or Concealment from Customers*

A brokerage firm's obligation to tell the whole truth arises out of the shingle theory, concepts of agency or implied agency, and the Rule's general duty to disclose.¹⁵⁷ A brokerage firm is governed by this obligation, whether acting as a broker or dealer in a particular trade,¹⁵⁸ and since an agent-broker is subject to this requirement, privity of contract need not be proved. This duty is in addition to other disclosure responsibilities imposed on broker-dealers¹⁵⁹ and is applicable

¹⁵⁶ The Seventh Circuit has indicated that section 15 of the Exchange Act, 15 U.S.C. § 78o (1970), and therefore, by easy analogy, Rule 10b-5, can give rise to a private right of action for suitability doctrine violations. *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970). Also, a California court applying state law held that a broker had acted "fraudulently" when violating the suitability doctrine. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 720, 69 Cal. Rptr. 222, 243 (1968). This is oblique authority for a 10b-5 cause of action. Other courts have successfully avoided deciding whether a private party can recover. *E.g. Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969) (dismissing NASD rule claim; 10b-5 claim not subject of motion to dismiss); *Phillips v. Reynolds & Co.*, 294 F. Supp. 1249, 1255-56 (E.D. Pa.), *motion to amend denied*, 297 F. Supp. 736 (E.D. Pa. 1969) (may be actionable but plaintiff cannot recover since was aware of level of risk); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 429-31 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (estoppel bars 10b-5 claim; indication of reluctance to grant remedy and proof of violation of NASD rule not sufficient to prove 10b-5 case).

¹⁵⁷ RESTATEMENT (SECOND) OF AGENCY § 381 comment d, § 390 (1958) (agency at common law requires disclosure); Note, *Churning: A Critical Analysis*, 14 N.Y.L.F. 315, 334 (1968) (agency and implied agency). See generally notes 45-73 and accompanying text *supra* (shingle and implied agency theories).

¹⁵⁸ In *Phillips v. Reynolds & Co.*, 297 F. Supp. 736, 737 n.2 (E.D. Pa. 1969), the court noted that a brokerage firm acting as a dealer may have an even greater duty of disclosure.

Misrepresentations by a broker-dealer are just as objectionable if made to a customer or to other broker-dealers. *Pennaltna & Co., Inc.*, SEC Securities Exchange Act Release No. 8063, at 8-10 (April 27, 1967), *aff'd*, 410 F.2d 861, 868-70 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970); *Gearhart & Otis, Inc.*, SEC Securities Exchange Act Release No. 7329, at 22-23 (June 2, 1964), *aff'd*, 348 F.2d 798 (D.C. Cir. 1965); *Van Alstyne, Noel & Co.*, 33 S.E.C. 311, 317-31 (1952) (*semble*); see note 61 and accompanying text *supra*.

¹⁵⁹ See rules promulgated under Exchange Act §§ 15(c)(1), (2), 15 U.S.C. §§ 78o(c)(1), (2) (1970). See also rules under Exchange Act § 10, 15 U.S.C. § 78j (1970).

as well to the special situation in which broker-dealers sell securities in their own enterprise.¹⁶⁰

A broker-dealer's prediction, representation, or opinion must have a reasonable basis supported by data gathered in a reasonable investigation.¹⁶¹ The sounder authorities indicate that a broker may also not "puff" his merchandise.¹⁶² Further, commentators have indicated that a broker's duty of disclosure is greater than that of an ordinary investor.¹⁶³ In light of the basic policies underlying the Rule,¹⁶⁴ a broker-dealer's special relationship to the securities system and his usually superior knowledge suggest that he should indeed be held to a higher standard.¹⁶⁵ By lessening the burden of proof for establishing one or more elements of a 10b-5 offense, including reliance by a customer or materiality of the information, such a higher standard might be effectuated. In other words, a misstatement or omission by a broker might be actionable while the identical statement made under the same circumstances by another person would not be. The law in this area is not yet sufficiently clear to reach a final determination on this point.¹⁶⁶ Nevertheless, a broker can be disciplined in administrative actions if he "willfully"¹⁶⁷ misrepresents or omits material facts, whether or not the

¹⁶⁰ See notes 222-32 and accompanying text *infra*.

¹⁶¹ See notes 76-122 and accompanying text *supra*. These duties may lack universal applicability.

¹⁶² See note 119 and accompanying text *supra*.

¹⁶³ Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939, 942 (1962); Note, *supra* note 8, 71 YALE L.J. at 747; see Note, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1143 (1950):

[T]he corporate insider and the corporation may have a broader duty to disclose than that owed by independent brokers and dealers, who in turn have a broader duty than that owed by the ordinary in-and-out investor, who may in their [*sic*] turn have no higher duty to disclose than that imposed by common law, which was usually no duty at all.

In complete accord is Weeks & McCormick, *Broker-Dealer Disclosure of Corporate Inside Information*, 18 CLEV. ST. L. REV. 549, 561 (1969). See also Mason, Moran & Co., 35 S.E.C. 84, 90 (1953) (prospectus requirements "were not intended to abrogate the greater disclosure duties traditionally imposed on brokers and dealers in a fiduciary position").

While some of the above was mere speculation during the Rule's infancy, much remains meritorious. See Comment, *Securities and Exchange Commission Rule X-10B-5: Guided Missile or Flying Saucer?*, 32 TEX. L. REV. 197, 200-01 (1953); Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U.L. REV. 695, 705-06 (1967); Note, *supra*, 71 Yale L.J. at 742, 745.

¹⁶⁴ See note 9 *supra*.

¹⁶⁵ This conclusion pertains to misrepresentations made by a broker-dealer to his customers, to prospective customers, or to the public at large (as when a broker gives an opinion as to the fairness of a merger or tender offer). See notes 39-44, 158 and accompanying text *supra*.

¹⁶⁶ Professor Knauss has suggested that as a broker's involvement with his customer increases, so does the broker's duties of disclosure. Knauss, *supra* note 11, at 636.

¹⁶⁷ Exchange Act § 15(b)(5)(D), 15 U.S.C. § 78o(b)(5)(D) (1970).

customer ultimately relies.¹⁶⁸ In a private action, a plaintiff should recover if he shows that he relied on the broker's material misrepresentation, that the broker knew or should have known of the falsity of the representation or omission, and that a causal connection existed between his loss and the broker's statement.¹⁶⁹

Whether a firm should bear responsibility along with its employee is essentially a question for agency law and relates to the duty to supervise.¹⁷⁰ Conversely, misrepresentations made in sales literature should be imputed to a brokerage firm's employee only if a reasonable employee with the same experience in the securities business should have been aware that the representations were being made and were untrue.¹⁷¹

Some representations or omissions can be made by any party to a transaction.¹⁷² Others, which are listed below, are either solely within the province of broker-dealers or take on particular significance when made by them. Not all have been held violations of the Rule. Although cases typically involve more than one misrepresentation or concealment in addition to other fraudulent activities, any representation or omis-

¹⁶⁸ See note 112 and accompanying text *supra*.

¹⁶⁹ *Smith v. Bear*, 237 F.2d 79, 87-88 (2d Cir. 1956) (no reliance requirement voiced; customer can recover loss proximately resulting from misrepresentation or omission); *Chasins v. Smith, Barney & Co.*, 305 F. Supp. 489, 495-96 (S.D.N.Y.), *motion to amend denied*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167, 1170-72 (2d Cir. 1970) (material fact concealed and customer relied); *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 706-07 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (flagrant violation for broker to send letter to customers lying about reason for late delivery of securities and concealing firm's insolvency and tremendous volume of short sales); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435, 443 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (broker "rescinds" sale to customer without informing her that stock had trebled between sale and rescission; customer followed advice with few exceptions in other transactions); *Hendricks v. Flato Realty Invs.*, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,290, at 97,387-88 (S.D. Tex. 1968) (intent to defraud not necessary but reliance is); *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 445 (N.D. Ill. 1967) (dictum) (misrepresentations clearly give rise to private right of action); *Stockwell v. Reynolds*, 252 F. Supp. 215, 218-19 (S.D.N.Y. 1965) (misrepresentations which induce retention are actionable); *Glickman v. Schweickart & Co.*, 242 F. Supp. 670, 672-73 (S.D.N.Y. 1965) (cause of action exists when alleged that misrepresentation made with scienter and relied on). *But see Phillips v. Reynolds & Co.*, 294 F. Supp. 1249, 1255-56 (E.D. Pa.), *motion to amend denied*, 297 F. Supp. 736 (E.D. Pa. 1969) (opinions not actionable; also, no reliance).

¹⁷⁰ As to the latter, see notes 542-58 and accompanying text *infra*.

¹⁷¹ See *Dlugash v. SEC*, 373 F.2d 107, 109 (2d Cir. 1967) (even if broker-dealer did not know information being shown by salesmen false, should have known). This is a different topic from the liability of supervisory or controlling personnel. See Exchange Act § 20(a), 15 U.S.C. § 78t (1970); notes 541-58 and accompanying text *infra*.

¹⁷² See generally A. BROMBERG, *SECURITIES LAW: FRAUD—SEC RULE 10b-5*, at § 4.2 (1969); 3 *Loss* 1448-74; 6 *id.* at 3558-647.

sion by itself could constitute a 10b-5 infraction under certain circumstances.

The following are a few of the misrepresentations and omissions peculiar to stockbrokers: concealing the identity of their principals;¹⁷³ concealing illegal pledges;¹⁷⁴ concealing their addresses;¹⁷⁵ concealing their directorships or officerships in the issuer;¹⁷⁶ concealing their financial condition;¹⁷⁷ concealing their interest in securities purchased for a customer's account;¹⁷⁸ concealing any long¹⁷⁹ or short¹⁸⁰ position in a security; concealing their manipulation of the market;¹⁸¹ concealing their sales of a security they are recommending;¹⁸² concealing market maker status;¹⁸³ concealing misappropriation of customer's securities;¹⁸⁴ concealing potential bar by regulatory authority from conducting business;¹⁸⁵ concealing tender offers;¹⁸⁶ concealing that a prospectus is no longer accurate;¹⁸⁷ concealing relevant information to induce customer

¹⁷³ Kenneth Leo Bauer, 26 S.E.C. 770, 775-76 (1947).

¹⁷⁴ SEC v. Charles Plohn & Co., 433 F.2d 376, 377 (2d Cir. 1970).

¹⁷⁵ Kenneth Leo Bauer, 26 S.E.C. 770, 775-76 (1947).

¹⁷⁶ Haley & Co., 37 S.E.C. 100, 106 (1956) (concealing that salesman was issuer's organizer and president); William I. Hay, 19 S.E.C. 397, 405 (1945).

¹⁷⁷ SEC v. Charles Plohn & Co., 433 F.2d 376, 377 (2d Cir. 1970); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 706 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); see notes 479-86 and accompanying text *infra* (broker executing while insolvent); note 229 and accompanying text *infra* (when selling broker's own securities).

¹⁷⁸ Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 427 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970). See generally Joseph Garofolo, SEC Securities Exchange Act Release No. 9429, at 2 (Nov. 22, 1971) (concealing control over issuer); Exchange Act Rules 15c1-5, 15c1-6, 17 C.F.R. §§ 240.15c1-5, 240.15c1-6 (1972).

¹⁷⁹ Chasins v. Smith, Barney & Co., 305 F. Supp. 489, 495 (S.D.N.Y.), *motion to amend denied*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167, 1170-72 (2d Cir. 1970) (in connection with concealment of market making function).

¹⁸⁰ Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

¹⁸¹ E.g., Richard N. Cea, SEC Securities Exchange Act Release No. 8662, at 4-5 (Aug. 6, 1969); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 12 (Nov. 2, 1965); Harry Marks, 25 S.E.C. 208, 216-19 (1947); see notes 233-68 and accompanying text *infra* (broker manipulating, controlling, and making a market).

¹⁸² Reynolds & Co., 39 S.E.C. 902, 913 (1960); see notes 475-76 and accompanying text *infra* (self-preferment by broker).

¹⁸³ See notes 323-30 and accompanying text *infra*.

¹⁸⁴ See notes 500-26 and accompanying text *infra*.

¹⁸⁵ Cf. William J. Stelmack Corp., 11 S.E.C. 601, 608 (1942) (decided under other two general antifraud rules; bar possible because of false financial reports filed with the New York State Attorney General).

¹⁸⁶ Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963, 966 (2d Cir. 1969), *aff'g* [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,301, at 97,433 (W.D.N.Y. 1968).

¹⁸⁷ Charles E. Bailey & Co., 35 S.E.C. 33, 43 (1953); Van Alstyne, Noel & Co., 33 S.E.C. 311, 331-32 (1952).

to purchase,¹⁸⁸ sell,¹⁸⁹ or hold¹⁹⁰ securities; concealing true market price;¹⁹¹ misrepresenting the availability of a security;¹⁹² misrepresenting that the issue has been oversubscribed;¹⁹³ misrepresenting that they themselves have bought stock;¹⁹⁴ misrepresenting that they have a research department;¹⁹⁵ misrepresenting that they possess inside information;¹⁹⁶ misrepresenting their age or experience;¹⁹⁷ misrepresenting that they have sold the customer's securities;¹⁹⁸ misrepresenting that their partners will continue to hold the issuer's stock;¹⁹⁹ misrepresenting that their research department recommended the security;²⁰⁰ misrepresenting that they are members of a national securities exchange;²⁰¹ misrepresenting that they will disseminate a report in the future on the issuer;²⁰² misrepresenting that they would not buy at a certain price;²⁰³ misrepresenting that they would repurchase stock;²⁰⁴ misrepresenting knowledge

¹⁸⁸ E.g., *Hanly v. SEC*, 415 F.2d 589, 593-94 (2d Cir. 1969); *Nees v. SEC*, 414 F.2d 211, 218-19 (9th Cir. 1969); *Smith v. Bear*, 237 F.2d 79, 88 (2d Cir. 1956); *Haley & Co.*, 37 S.E.C. 100, 106 (1956).

¹⁸⁹ *M.S. Wien & Co.*, 23 S.E.C. 735, 746 (1946).

¹⁹⁰ *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 218 (S.D.N.Y. 1965).

¹⁹¹ See generally notes 397-478 and accompanying text *infra* (broker's secret profits).

¹⁹² *Indiana State Sec. Corp.*, 38 S.E.C. 118, 119 (1957); *Van Alstyne, Noel & Co.*, 33 S.E.C. 311, 329-31 (1952); *Henry P. Rosenfeld*, 32 S.E.C. 731, 739 (1951).

¹⁹³ *R.A. Holman & Co., Inc.*, SEC Securities Exchange Act Release No. 7770, at 5 (Dec. 15, 1965), *aff'd*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967).

¹⁹⁴ *Hanly v. SEC*, 415 F.2d 589, 593-94 (2d Cir. 1969); *Batkin & Co.*, 38 S.E.C. 436, 449 (1958); *Haley & Co.*, 37 S.E.C. 100, 105 (1956) (broker misrepresenting that he invested great deal); see *Cortlandt Inv. Corp.*, SEC Securities Exchange Act Release No. 8678, at 4 (Aug. 29, 1969) (disclosure that broker purchased stock but concealment that he sold before statement made).

¹⁹⁵ *J. Logan & Co.*, 41 S.E.C. 88, 90, 98 (1962), *aff'd per curiam sub nom. Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964).

¹⁹⁶ See notes 582-83 and accompanying text *infra*.

¹⁹⁷ *Shapiro v. Schwamm*, 279 F. Supp. 798, 800 (S.D.N.Y. 1968); *Henry P. Rosenfeld Co.*, 32 S.E.C. 731, 734 (1951).

¹⁹⁸ *Klein v. Auchincloss, Parker & Redpath*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,627, at 98,824 (S.D.N.Y. 1970), *rev'd on other grounds*, 436 F.2d 339 (2d Cir. 1971).

¹⁹⁹ *Bruns, Nordeman & Co.*, 40 S.E.C. 652, 662 (1961).

²⁰⁰ *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 20 (Nov. 12, 1965).

²⁰¹ *J. Logan & Co.*, 41 S.E.C. 88, 90 (1963), *aff'd per curiam sub nom. Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964).

²⁰² *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 218 (S.D.N.Y. 1965).

²⁰³ *R.D. Bayly & Co.*, 19 S.E.C. 773, 784 (1945).

²⁰⁴ *R.A. Holman & Co., Inc.*, SEC Securities Exchange Act Release No. 7770, at 6 (Dec. 15, 1965), *aff'd*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967).

of one of their customers;²⁰⁵ misrepresenting margin;²⁰⁶ misrepresenting the method of financing the purchase;²⁰⁷ misrepresenting the fact that others have purchased the security;²⁰⁸ misrepresenting the number of issuer's shares they owned;²⁰⁹ misrepresenting the reason for the decline in a security's price;²¹⁰ misrepresenting the reason for lateness of a delivery;²¹¹ misrepresenting relevant information to induce a customer to hold,²¹² purchase,²¹³ or sell²¹⁴ a security; misrepresenting information in order to obtain possession of a customer's securities;²¹⁵ and misrepresenting the true market price.²¹⁶

Any misstatement or omission by a broker-dealer is objectionable whether made orally²¹⁷ or in a written document such as a market letter,²¹⁸ report,²¹⁹ or solicitation letter.²²⁰ Concealment of a 10b-5 offense may in and of itself constitute a violation of the Rule.²²¹

²⁰⁵ *Klopp v. SEC*, 427 F.2d 455, 461 (6th Cir. 1970) (SEC did not base sanction on substantial evidence).

²⁰⁶ See notes 381-96 and accompanying text *infra*.

²⁰⁷ *Glickman v. Schweickart & Co.*, 242 F. Supp. 670, 673 (S.D.N.Y. 1965) (misrepresenting that means of financing was usual and involved no greater risk than normal margin transactions); see notes 381-96 and accompanying text *infra* (margin violations).

²⁰⁸ *Batkin & Co.*, 38 S.E.C. 436, 449 (1958) (misrepresentation that a member of the duPont family bought security).

²⁰⁹ *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 19 (Nov. 12, 1965); *Batkin & Co.*, 38 S.E.C. 436, 449 (1958).

²¹⁰ *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 218 (S.D.N.Y. 1965).

²¹¹ See notes 528-38 and accompanying text *infra*.

²¹² *Nees v. SEC*, 414 F.2d 211, 219 (9th Cir. 1969); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 218 (S.D.N.Y. 1965).

²¹³ *E.g.*, *Smith v. Bear*, 237 F.2d 78, 87-88 (2d Cir. 1956); *Courtlandt Inv. Corp.*, SEC Securities Exchange Act Release No. 8678, at 4 (Aug. 29, 1969); *Richard N. Cea*, SEC Securities Exchange Act Release No. 8662, at 4 (Aug. 6, 1969); *G.J. Mitchell, Jr., Co.*, 40 S.E.C. 409, 413 (1960).

²¹⁴ *Richard N. Cea*, SEC Securities Exchange Act Release No. 8662, at 5 (Aug. 6, 1969); *Futures Unlimited, Inc.*, SEC Securities Exchange Act Release No. 7181 (Dec. 3, 1963); *Mercer Hicks Corp.*, 32 S.E.C. 212, 214 (1951); *M.S. Wien & Co.*, 23 S.E.C. 735, 746 (1946).

²¹⁵ *Bernard & Co.*, SEC Securities Exchange Act Release No. 8273, at 1 (March 15, 1968) (misrepresenting to get customer to furnish securities as collateral for broker's bank loan); *Amalgamated Inv., Inc.*, SEC Securities Exchange Act Release No. 8253, at 1 (Feb. 9, 1968) (after obtaining securities, broker sold them without authorization); *Kenneth Leo Bauer*, 26 S.E.C. 770, 773 (1947); see notes 500-27 and accompanying text *infra* (misappropriation by broker).

²¹⁶ See generally notes 397-478 and accompanying text *infra* (broker's secret profits).

²¹⁷ *E.g.*, *Richard N. Cea*, SEC Securities Exchange Act Release No. 8662, at 4 (Aug. 6, 1969); *Adams & Co.*, 41 S.E.C. 501, 502-03 (1963); *Bristol Sec. Co.*, 39 S.E.C. 763, 764 (1960); *Herbert R. May & Russell H. Phinney*, 27 S.E.C. 814, 824 (1948).

²¹⁸ *Cortlandt Inv. Corp.*, SEC Securities Exchange Act Release No. 8678, at 4-5 (Aug. 29, 1969); *J.H. Goddard & Co., Inc.*, SEC Securities Exchange Act Release No. 7618, at 2-3 (June 4, 1965); *G.J. Mitchell, Jr., Co.*, 40 S.E.C. 409, 411-13 (1960) (sales literature); *Shelley, Roberts & Co.*, 38 S.E.C. 744, 749 (1958) (sales literature). See Proposed Exchange Act Rule

Misrepresentation and concealment have also been found when a broker-dealer raises capital by selling his own securities. The same principles apply whether the instrument sold represents stock or debt,²²² or whether the customer pays in cash, contributes securities of other issuers,²²³ or makes a loan to a firm or one of its employees.²²⁴ Unlike other broker-customer transactions, in these situations the financial interests of the parties are diametrically opposed; thus, a broker in such circumstances should perhaps be held to a higher standard than the ordinary issuer of securities because of his position vis-à-vis his customer and the securities industry. Further, only full and meticulous disclosure will suffice when the broker occupies a position of trust and confidence.²²⁵ Such a high standard is in contrast to that applicable in sales to members of the public who are not customers or in loans from a bank. Neither of these situations should require significantly greater duties of disclosure than those required of an ordinary issuer.²²⁶ Nevertheless, a number of false statements may be made, any one of which could be sufficient under the proper circumstances to constitute a

10b-15, SEC Securities Exchange Act Release No. 8425 (Oct. 10, 1968) (requirements for disclosure in sales communications and advertisements).

²¹⁹ E.g., Shearson, Hammill & Co., SEC Securities Act Release No. 7743, at 15-17 (Nov. 12, 1965).

²²⁰ James F. Morrissey, 25 S.E.C. 372, 377-78 (1947).

²²¹ See notes 268 & 319-21 and accompanying text *infra*.

²²² Superior Sec. Co., Inc., SEC Securities Exchange Act Release No. 7767, at 1 (Dec. 10, 1965) (common stock); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 22-23 (Nov. 12, 1965) (loan with right back in stock); Lile & Co., Inc., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) (loan); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963) (common stock and debt); Mercer Hicks Corp., 32 S.E.C. 212, 213 (1951) (units of common stock and preferred stock); see Pickard & Co., Inc., SEC Securities Exchange Act Release No. 8447, at 1 (Nov. 14, 1968) ("inducing persons to subordinate their securities and cash to general creditors of registrant" by misrepresentations and omissions).

²²³ Tadashi Yamamoto, SEC Securities Exchange Act Release No. 8536, at 1 (Feb. 25, 1969) (securities from customers); Lile & Co., Inc., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) (funds obtained); Gill-Harkness & Co., 38 S.E.C. 646, 648-49 (1958) (cash and securities).

²²⁴ Francis R. Gregory, SEC Securities Exchange Act Release No. 8491, at 1 (Jan. 13, 1969) (to registered representative); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 22-23 (Nov. 12, 1965) (to employee); Lile & Co., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) (to firm).

²²⁵ Lile & Co., Inc., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) ("particularly questionable" to obtain loans where trust and confidence exist; candid disclosure required); Gill-Harkness & Co., 38 S.E.C. 646, 650 (1958) (trust and confidence requires full and meticulous disclosure of all pertinent information); Wendell Maro Weston, 30 S.E.C. 296, 304 (1949) (fiduciary duties necessitate meticulous disclosures).

²²⁶ Because of a broker's greater knowledge of the securities business, and general policy considerations underlying 10b-5, a higher standard is suggested under all circumstances.

breach of the Rule. Among these are misrepresentations and omissions regarding the application of proceeds of sale,²²⁷ the business,²²⁸ financial condition,²²⁹ and organization of the firm,²³⁰ and the safety²³¹ and value of the security sold.²³²

C. *Broker Manipulating, Controlling, or Making the Market for a Security*

It is possible for brokers to engage in a number of manipulative and related schemes by virtue of their unique position in the securi-

²²⁷ Tadashi Yamamoto, SEC Securities Exchange Act Release No. 8536 (Feb. 25, 1969) (not really to be used for exchange seat); Charles P. Lawrence, SEC Securities Exchange Act Release No. 8213, at 2-3 (Dec. 19, 1967), *aff'd*, 398 F.2d 276 (1st Cir. 1968); Copley & Co., SEC Securities Exchange Act Release No. 7679, at 1 (Aug. 13, 1965) (loan from bank); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963) (source of stock sold); Gill-Harkness & Co., 38 S.E.C. 646, 651 (1958) (implied representation that buying from firm where sale actually made of president's stock).

²²⁸ Lile & Co., Inc., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) (business good and hoped to open branch office); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963) (business, commissions, and earnings potential of firm praised); Gill-Harkness & Co., 38 S.E.C. 646, 651 (1958) (firm expanding); *cf.* William J. Stelmack Corp., 11 S.E.C. 601, 607 (1942) (decided under Securities Act § 17(a) and Exchange Act Rule 15c1-2; failure to disclose in offering circular serious violation of applicable laws).

²²⁹ Pickard & Co., SEC Securities Exchange Act Release No. 8447, at 1 (Nov. 14, 1968) (financial condition and withdrawals of capital concealed); Superior Sec. Co., SEC Securities Exchange Act Release No. 7767, at 1 (Dec. 10, 1965) (misrepresentations regarding minimum capital, president's investments, and subordination agreements); Jerome, Richard & Co., SEC Securities Exchange Act Release No. 7688, at 1-2 (Aug. 27, 1965) (loss concealed); Lile & Co., Inc., SEC Securities Exchange Act Release No. 7644, at 4 (July 9, 1965) (loss and net capital difficulties not revealed); Powell & McGowan, Inc., 41 S.E.C. 933, 935 (1964) (concealment of losses, violation of SEC net capital rule and capital deficiency); Gill-Harkness & Co., 38 S.E.C. 646, 650-51 (1958) (operating losses, net capital deficiency under SEC rules, and insolvency); Wendell Maro Weston, 30 S.E.C. 296, 299 (1949) (concealment of losses); Hammill & Co., 28 S.E.C. 634, 637 (1948).

²³⁰ Jerome, Richard & Co., SEC Securities Exchange Act Release No. 7688, at 1-2 (Aug. 27, 1965) (concealment that two outsiders controlled operations); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963) (misrepresentations concerning integrity of management).

²³¹ Francis R. Gregory, SEC Securities Exchange Act Release No. 8491, at 1 (Jan. 13, 1969); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963); Gill-Harkness & Co., 38 S.E.C. 646, 651 (1958); *see* Copley & Co., SEC Securities Exchange Act Release No. 7679, at 1 (Aug. 13, 1965) (misleading statement concerning market value of stock used to secure bank loan).

²³² Tadashi Yamamoto, SEC Securities Exchange Act Release No. 8536, at 1 (Feb. 25, 1969) (would pay 6% interest); Francis R. Gregory, SEC Securities Exchange Act Release No. 8491, at 1 (Jan. 3, 1969) (misrepresentation of intent to pay interest on note and ability to repay note); Futures Unlimited, Inc., SEC Securities Exchange Act Release No. 7181, at 1 (Dec. 3, 1963); Gill-Harkness & Co., 38 S.E.C. 646, 651 (1958) (value would increase substantially and pay 5% or 6% dividend); Mercer Hicks Corp., 32 S.E.C. 212, 213-14 (1951) (failure to disclose assets of less than cost of stock sold and dividends paid out of capital surplus).

ties market.²³³ Three points should initially be noted. First, even though the majority of cases deal with stock manipulation, some decisions are concerned with debt instruments.²³⁴ The same principles should apply regardless of the type of security involved. Second, individuals employed by broker-dealer firms, as well as the firms themselves, are capable of violating the Rule, although few suits have proceeded solely against an individual.²³⁵ Finally, brokers must conform to a number of requirements, in addition to 10b-5, pertaining to manipulative activities.²³⁶

Authorities dealing with securities listed on a national securities exchange are discussed separately from those dealing with securities which are not, both for convenience and because of the differences between the two markets.

1. *National Securities Exchanges*

For our purposes it can be assumed that two types of brokers operate within the framework of national securities exchanges: those who buy or sell listed securities for their customers, and others, called specialists,²³⁷ who attempt to keep an orderly market by preventing

²³³ For a discussion of manipulation generally, see 3 Loss 1529-622; 6 *id.* 3752-79. Any form of manipulation discussed there should be equally applicable to brokers. The remainder of this section will deal with those forms of manipulation available only to brokers.

²³⁴ Halsey, Stuart & Co., Inc., 30 S.E.C. 106 (1949), M.S. Wien & Co., 23 S.E.C. 735 (1946), and Kidder Peabody & Co., 18 S.E.C. 559 (1945), involved manipulation of debt securities.

²³⁵ One proceeding against an individual was Harry Marks, 25 S.E.C. 208 (1947) (manager of firm's branch office). Numerous proceedings against firms have also included individuals as respondents. *E.g.*, Delafield & Delafield, SEC Securities Exchange Act Release No. 8480 (Dec. 26, 1968) (partner of brokerage firm); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965) (members of executive committee and personnel in branch office).

²³⁶ As with most other 10b-5 violations committed by broker-dealers in the sale of securities, Securities Act § 17(a), 15 U.S.C. § 77q(a) (1970), applies. In addition, manipulation on exchanges is covered by Exchange Act § 9(a), 15 U.S.C. § 78i(a) (1970), activities in the over-the-counter market are subject to Exchange Act Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1972), and concealing control of an over-the-counter market while engaged in a distribution is prohibited by Exchange Act Rule 15c1-8, 17 C.F.R. § 240.15c1-8 (1972). Stock exchanges, the NASD, and common law also impose their limitations. *See* Am. Stock Exch. Gen. Rule 4, 2 CCH AM. STOCK EXCH. GUIDE ¶ 9224 (cannot purchase security at successively higher or lower prices for certain purposes); N.Y. Stock Exch. Rule 435(6), 2 CCH N.Y. STOCK EXCH. GUIDE ¶ 2435 (may not participate in any manipulative operation); NASD Rules of Fair Practice Art. III, § 5, CCH NASD SEC. DEALERS MANUAL ¶ 2155 (quotation must be bona fide).

²³⁷ The role of the specialist is discussed in SPECIAL STUDY pt. 2, at 57-171; G. LEFFLER, THE STOCK MARKET 203-18 (3d ed. 1963); Wolfson & Russo, *The Stock Exchange Specialist*, 4 REV. OF SEC. REG. 897 (1971); Note, *supra* note 163, 42 N.Y.U.L. REV. at 697-700.

substantial price fluctuations. In simplified form, a trade on an exchange is consummated when a broker with an order from his customer to buy (or sell) a security approaches the specialist, who either matches the order against one or more sell (or buy) orders placed with him by other brokers or, if necessary to offset an imbalance in buy and sell orders, sells (or buys) for his own account. Both types of brokers have opportunities to engage in manipulative practices.

In the leading case involving a specialist,²³⁸ the defendant specialist was found guilty of violating 10b-5 when he helped rig a market by disclosing confidential bids and offers placed with him and recorded on his books and, occasionally, by buying to support the market. By extrapolation, a specialist would violate the Rule by buying or selling for any reason other than to maintain a fair and orderly market, or by disclosing data on his books without a legitimate reason to someone who then traded the security or tipped the information to someone else who traded.²³⁹

Brokers other than specialists are also able to engage in a number of manipulative activities on exchanges. Almost all actions that violate Exchange Act section 9(a)²⁴⁰ are also prohibited by 10b-5. In one case,²⁴¹ a broker violated Rule 10b-5 by effecting eighty-three percent of the sales in a particular stock on the American Stock Exchange in an afternoon, thereby depressing the price of the stock for the purpose of inducing a large stockholder to sell his shares to the broker's customers. In another decision,²⁴² analogous to the over-the-counter market domination cases,²⁴³ the Seventh Circuit found a violation of

²³⁸ *United States v. Re*, 336 F.2d 306, 314-15 (2d Cir.), *cert. denied*, 379 U.S. 904 (1964); see Shipman, *Two Current Questions Concerning Implied Private Rights of Action Under the Exchange Act: Authority of the Administrative Agency to Negate Existence for Violation of Self-Regulatory Requirements*, 17 W. RES. L. REV. 925, 987 (1966) (specialists and floor traders within 10b-5).

²³⁹ See *Re, Re & Sagarese*, 41 S.E.C. 230 (1962), for the Commission's view concerning the seriousness of a 10b-5 violation by a specialist. See also Exchange Act § 11(b), 15 U.S.C. § 78k(b) (1970).

Should a specialist learn from a holder of a large block that the holder is going to sell in the near future, the specialist would violate 10b-5 if he began to go short in anticipation of, and to induce the sale of, the block. See text accompanying note 241 *infra*.

²⁴⁰ 15 U.S.C. § 78i(a)(2) (1970).

The second, and most important subdivision of § 9(a) proscribes any effecting of "a series of transactions . . . creating actual or apparent active trading . . . or raising or depressing the [security's] price . . . for the purpose of inducing [its] purchase or sale . . . by others." *Id.*

²⁴¹ *Delafield & Delafield*, SEC Securities Exchange Act Release No. 8480 (Dec. 26, 1968).

²⁴² *R.J. Koeppel & Co. v. SEC*, 95 F.2d 550, 552 (7th Cir. 1938).

²⁴³ See notes 248-331 and accompanying text *infra*.

Securities Act section 17(a)(2)²⁴⁴ when the broker did two-thirds of the trading in a listed stock, made the closing trade on many days, usually raising the closing price over the preceding day's close, increased the price approximately 200 percent during the period, made sales in the over-the-counter market,²⁴⁵ sold his own stock at many times its cost, and hired persons to tout the stock. When he finally stopped supporting the market, the stock price abruptly fell to one-third its prior level.²⁴⁶ As in the over-the-counter market cases, manipulation and failure to disclose such activities are independent violations of the Rule.²⁴⁷

2. Over-the-Counter Market

As distinguished from the central marketplace of a securities exchange, the over-the-counter market consists of numerous brokers offering to buy or sell securities by telephone or teletype. To facilitate this process, they place bid and asked quotations²⁴⁸ in sheets which are

²⁴⁴ 15 U.S.C. § 77q(a)(2) (1970). Rule 10b-5 was not promulgated until four years after the case was decided; however, the conduct alleged would have also been in violation of 10b-5 because of the similarity of the provisions. The court's citation to the second clause of § 17(a) is evidence that disclosure was not made.

²⁴⁵ Although the principal market for listed securities is typically an exchange, they may be traded in the over-the-counter market.

²⁴⁶ *Accord*, *Thornton v. SEC*, 171 F.2d 702 (2d Cir. 1948) (sales of listed security in over-the-counter market based on price on exchange without disclosure of defendant's manipulation of exchange market); Archie H. Chevrier, SEC Securities Exchange Act Release No. 7579 (April 22, 1965) (out of 204,890 shares traded, defendant bought 153,600 and sold 137,300; under these and other circumstances, violated Exchange Act § 9(a)(2)); Adams & Co., 33 S.E.C. 444, 446-47, 456-57 (1952) (10b-5 violation not to disclose activities proscribed by Exchange Act § 9(a)(2)); *cf.* *Coplin v. United States*, 88 F.2d 652 (9th Cir.), *cert. denied*, 301 U.S. 703 (1937) (Securities Act § 17(a)(2) case decided before promulgation of the Rule; failure by defendant, who did over 75% of trading at increasing bids, to disclose rise in price due to his actions); *Kidder Peabody & Co.*, 18 S.E.C. 559, 571 (1945) (Exchange Act Rule 15c1-2 violation to conceal from public that market price not reached independently).

²⁴⁷ *In SEC v. Otis & Co.*, 106 F.2d 579, 582-83 (6th Cir. 1939), *aff'g* 18 F. Supp. 100, (N.D. Ohio 1936), a broker was held to have violated Securities Act § 17(a)(2), 15 U.S.C. § 77q(a)(2) (1970) (and surely would have been held to have acted contrary to 10b-5 had it then been promulgated) but not Exchange Act § 9(a)(2), 15 U.S.C. § 78i(a)(2) (1970), when he traded without disclosing that persons owning about one-third of the issuer's stock agreed to restrict the disposition of their shares and that the broker's purchases of the stock on the exchange stimulated the market. The infirmity was failure to reveal that sales were not "at the market"—the price in a free market. This case has been interpreted to mean that anything which interferes with the demand or supply of a security must be disclosed. *See Note, Manipulation of the Stock Market Under the Securities Laws*, 99 U. PA. L. REV. 651, 676 (1951).

²⁴⁸ Brokers have the option of inserting quotations consisting of a bid price at which they might be willing to buy, an asked price at which they would consider selling, or, if

circulated to the financial community. More recently, an automated system dubbed NASDAQ²⁴⁹ has supplemented the sheets by providing quotations for some over-the-counter securities. While neither the sheets nor NASDAQ reflects actual transactions, the quotations they contain are evidence of a security's price.²⁵⁰ Usually two or more firms, called market makers, regularly enter bids on a security.²⁵¹ A broker can influence the market of an over-the-counter security by either manipulating the price of the security or controlling and dominating the market.

Manipulation is clearly a breach of 10b-5, whereas making a market just as certainly is not. It is unclear if control and domination of a market is proscribed,²⁵² although concealment of manipulation, market making, or control and domination may be independent violations. Disclosure of manipulation or control and domination may be insufficient to cure the original wrong.²⁵³

Manipulation continues to constitute a basis for administrative actions and for private suits, although the SEC has recently shifted its emphasis to the control and domination approach.²⁵⁴ In manipulation cases, the SEC typically states that a violation of Exchange Act section

they do not desire to quantify their position, "BW" (bid wanted) or "OW" (offer wanted) quotations.

²⁴⁹ NASDAQ refers to the computerized quotation system of the NASD.

²⁵⁰ Moore & Co., 32 S.E.C. 191, 195 n.6 (1951). The bids are not legally binding offers but are exploratory in nature. Barrett & Co., 9 S.E.C. 319, 323 (1941). For a fuller discussion, see notes 423-26 *infra*.

²⁵¹ Exchange Act Rule 17a-9, 17 C.F.R. § 240.17a-9 (1972), requires reports of market makers, and defines a market maker as

a dealer who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an interdealer quotations system or otherwise) as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.

²⁵² One author states that the SEC's reliance on nondisclosure may be due to the private nature of the over-the-counter market in which trades are not publicized. Bloomenthal, *The Case of the Subtle Motive and the Delicate Art—Control and Domination in the Over-the-Counter Securities Markets*, 1960 DUKE L.J. 196, 203.

²⁵³ In *Shelley, Roberts & Co.*, SEC Securities Exchange Act Release No. 5837 (Dec. 22, 1958), the Commission held that a disclosure that respondent "controlled the market in the . . . stock and would manipulate and drive or push the market up" was "misleading in failing to disclose that such action would be illegal under the anti-fraud provisions." *Id.* at 8; *accord*, Bloomenthal, *supra* note 252, at 203. In *Associated Investors Sec., Inc.*, 41 S.E.C. 160 (1962), although the proposed manipulative plan was disclosed in an offering circular pertaining to the securities, the disclosure was not even discussed as a possible defense. Practically, disclosure as a cure may be unimportant since few brokers will admit to such activity. See generally notes 66-67 and accompanying text *supra*.

²⁵⁴ See notes 269-321 and accompanying text *infra*. Manipulation can be practiced even though the broker does not control the market. Note, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509, 532 (1947).

9(a)(2)²⁵⁵ is also a 10b-5 offense,²⁵⁶ and then proves the 9(a)(2) elements:²⁵⁷ effecting “a series of transactions”²⁵⁸ which creates actual or apparent trading in the security or alters its price, for the purpose of inducing others to purchase or sell such security. Manipulation under 10b-5 is not limited to wash sales, matched orders, or other fictitious devices commonly employed in pre-1934 manipulative schemes. The act of buying, selling, or issuing quotations with intent to affect prices is sufficient.²⁵⁹ Clear evidence that the manipulative activities were for the purpose of inducing others to buy or sell is rarely present. The SEC will presume such purpose if a broker buys at rising prices and sells out at the raised prices.²⁶⁰ Manipulation of one market may also affect another. Thus, manipulation of the “inside market”²⁶¹ constitutes a manipulation of the “outside market,”²⁶² and manipulation of a stock

²⁵⁵ 15 U.S.C. § 78i(a)(2) (1970).

²⁵⁶ Duval Sec., Inc., SEC Securities Exchange Act Release No. 7655 (July 23, 1965) (10b-5 case using manipulation to assist unregistered distribution); R.L. Emacio & Co., 35 S.E.C. 191, 199-200 (1953) (manipulation prior to becoming underwriter); Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 111 (1949) (§ 9(a)(2) applies to over-the-counter market through 10b-5); cf. SEC Securities Exchange Act Release No. 3505 (Nov. 16, 1943) (Securities Act § 17(a) and Exchange Act § 15 make Exchange Act § 9(a)(2) applicable to over-the-counter markets); Masland, Fernon & Anderson, 9 S.E.C. 338, 345-47 (1941) (Exchange Act Rule 15c1-2 case involving § 9(a)(2)-type manipulation); Barrett & Co., 9 S.E.C. 319, 328 (1941) (Exchange Act Rule 15c1-2; gives at least the same protection to over-the-counter markets as Exchange Act § 9(a) gives to securities exchanges); Martin, *Broker-Dealer Manipulation of the Over-the-Counter Market—Toward a Reasonable Basis for Quotations*, 25 BUS. LAW. 1463, 1466 (1970); Note, *supra* note 247, at 675.

²⁵⁷ Subsection (2) is not the only subsection of Exchange Act § 9(a), 15 U.S.C. § 78i(a) (1970), to which 10b-5 applies for over-the-counter securities. Section 9(a) contains four other subdivisions which should be equally applicable.

²⁵⁸ “Transactions” include either purchases and sales or bids in the sheets. Adam & Co., 33 S.E.C. 444, 450 n.7 (1952); Kidder Peabody & Co., 18 S.E.C. 559, 569-70 (1945). “OW” (offer wanted) or “BW” (bid wanted), as well as numerical quotations, can be a “transaction.” M.S. Wien & Co., 23 S.E.C. 735, 739-40, 745 (1946) (10b-5 over-the-counter manipulation decision). A bid on NASDAQ would also qualify as a “transaction.” As few as three transactions have been held to satisfy the “series” requirement. See Kidder Peabody & Co., *supra* at 568.

²⁵⁹ American Bank & Trust Co. v. Barad Shaff Sec. Corp., 335 F. Supp. 1276, 1281 (S.D.N.Y. 1972) (roundrobin sales at increasing prices); R.L. Emacio & Co., 35 S.E.C. 191, 199-200, 202 (1953) (quotations for requisite purpose and having proscribed effect violated 10b-5); Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 112 (1949) (10b-5 over-the-counter case in which SEC stated that “a manipulation can be accomplished without wash sales, matched orders, or other fictitious devices”).

²⁶⁰ Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 124 n.28 (1949). Further, “only the strongest countervailing evidence will be sufficient to overcome the presumption.” *Id.*

²⁶¹ The “inside price” relates to sales among brokerage firms; the “outside price” relates to the amount the public is charged.

²⁶² Cf. Barrett & Co., 9 S.E.C. 319, 325 (1941) (Exchange Act Rule 15c1-2 case; the markets move together).

exchange price while the broker is trading the same security in the over-the-counter market has also been condemned.²⁶³

The most common of the other forms of manipulation is the placing of bids in the sheets (or presumably NASDAQ) by a broker engaged in a distribution.²⁶⁴ Less common is the situation in which a broker does not distribute all his shares to the public in an offering.²⁶⁵ In one instance the SEC disciplined a broker for promising in an offering circular to maintain the market for a security at increasingly higher levels.²⁶⁶ Finally, a major securities firm has been condemned for establishing and maintaining a work-out market.²⁶⁷

In these situations, in addition to the 10b-5 violation arising from the manipulative activity, a second 10b-5 offense for concealment of a

²⁶³ *Thornton v. SEC*, 171 F.2d 702, 703 (2d Cir. 1948) (sales in over-the-counter market without disclosure of manipulation on exchange breaches 10b-5); *Adams & Co.*, 33 S.E.C. 444, 457 (1952) (same); cf. *Russell Maguire & Co., Inc.*, 10 S.E.C. 332, 347-49 (1941) (Securities Act § 17(a) violated by an over-the-counter distribution attended by manipulation on exchange, even if Exchange Act § 9(a)(2) not breached).

²⁶⁴ Exchange Act Rule 10b-6, 17 C.F.R. § 240.10b-6 (1972), governs bidding during distributions. Conformity to Rule 10b-6 should insure against a 10b-5 breach. But bidding during a distribution unprotected by Rule 10b-6 violates 10b-5. See, e.g., *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965) (bidding during underwriting); *Strathmore Sec., Inc.*, SEC Securities Exchange Act Release No. 8207 (Dec. 13, 1967), *petition for review denied*, 407 F.2d 722 (D.C. Cir. 1969) (underwriter did not place all shares in Regulation A offering and made bids during further distribution); *Duval Sec., Inc.*, SEC Securities Exchange Act Release No. 7655 (July 23, 1965) (bids during unregistered distributions); *Woods & Co., Inc.*, 41 S.E.C. 725, 726 (1963) (broker bid for, and got other brokers to bid for, stock he was distributing).

²⁶⁵ Withholding shares from the public and placing them instead with officers, directors, and other persons associated with the issuer was condemned in *H. Hentz & Co.*, SEC Securities Exchange Act Release No. 8973 (Sept. 2, 1970), and *Hopp & Co.*, SEC Securities Exchange Act Release No. 8887 (May 21, 1970). The practice of placing a large percentage of an underwriter's shares in hot issues with insiders was discussed in SEC Securities Exchange Act Release No. 6097, at 3 (Oct. 23, 1959), where the Commission noted that the Rule may be violated by such activity since the initial supply of the security is restricted and the public is not informed that the market is controlled by the persons who then sell. In *R.A. Holman & Co.*, SEC Securities Exchange Act Release No. 7770 (Dec. 15, 1965), *aff'd*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967), an underwriter was disciplined for placing shares of an offering with relatives and friends, repurchasing them immediately after the offering, and subsequently selling them to the public.

²⁶⁶ *Associated Investors Sec., Inc.*, 41 S.E.C. 160, 167-69 (1962).

²⁶⁷ In *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965), a work-out market was described as a situation where "no sell orders from customers were to be accepted or executed by registrant unless offsetting buy orders for at least an equal number of shares were on hand." *Id.* at 12 (footnote omitted). A work-out market also resulted in the discipline of Richard N. Cea, SEC Securities Exchange Act Release No. 8662, at 4-5 (Aug. 6, 1969).

material fact is made out by a broker's failure to disclose his activity to his clients.²⁶⁸

The elements required to prove manipulation have been more clearly delineated than those necessary to show control and domination of an over-the-counter market.²⁶⁹ The Commission recognized this in one of its early opinions:

Every over-the-counter dealer who "specializes" in a security, in the sense that he effects a high percentage of the transactions in the security, and in the sense that he is the principal buyer and seller and is most familiar with the affairs of the issuer and the state of the market, to some extent dominates the market . . . His trading volume may be the backbone of the market in the security and his determination to pay more or less may be determinative of market movements.²⁷⁰

The absence of a definitive standard for domination and control cases has been criticized.²⁷¹ The Commission's opinions, which significantly outnumber court decisions in this area, must be assigned partial blame. The SEC's hesitation to establish guidelines may stem from its belief that any maximum level of activity permitted would soon become the normal trading pattern, and from its recognition of the variety of factors which can contribute to market domination. The imbroglio is compounded because domination and control cases usually include other 10b-5 violations as well.²⁷² One way to treat this topic is simply

²⁶⁸ R.L. Emacio & Co., 35 S.E.C. 191, 200 (1953) (failure to disclose that defendant arbitrarily fixed and maintained prices was a violation); Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 112 (1949) (manipulation of "utmost materiality" to buyers); cf. Barrett & Co., 9 S.E.C. 319, 328-29 (1941) (Exchange Act Rule 15c1-2 violated by concealment of manipulation); cases cited in note 319 *infra* (violation to conceal control and domination of market).

²⁶⁹ Control and domination of a market can be effected by one firm alone (as is most often the case) or by two or more brokers acting in concert. Examples of the second situation are Sterling Sec. Co., 39 S.E.C. 487 (1959) (in concert with another broker); S.T. Jackson & Co., 36 S.E.C. 631 (1950); see cases cited in notes 302-04 *infra* (use of other brokers in scheme); cf. Barrett & Co., 9 S.E.C. 319 (1941) (Exchange Act Rule 15c1-2 case in which two or three brokers established joint account).

²⁷⁰ Norris & Hirshberg, Inc., 21 S.E.C. 865, 874-75 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

²⁷¹ Martin, *supra* note 256, at 1469-70, after discussing the absence of standards, draws an analogy to the broker's duty to investigate (see notes 74-122 and accompanying text *supra*) and suggests that a broker be held to violate 10b-5 only if he has no reasonable basis for his quotation. However, given the myriad facts on which a decision is based, and time to think about the situation, only rarely would a broker who is controlling the market be unable to supply some justification for his bid. See note 313 and accompanying text *supra*.

²⁷² Martin, *supra* note 256, at 1465, notes that two-thirds of the SEC cases involved misrepresentation, over one-third involved a violation of Exchange Act Rule 10b-6, 17 C.F.R. § 240.10b-6 (1972), and one-quarter involved unreasonable mark-ups. Also, the Commission often discusses only a violation of a narrow rule under Exchange Act § 15

to list²⁷³ those factors that have been relied on for the conclusion that a market was dominated.

Factors connected with a *broker's market activity* which the courts and the SEC have relied upon in finding market domination include: the broker bid on most days;²⁷⁴ few others bid at the same time;²⁷⁵ respondent-broker accounted for a large percentage of the trading;²⁷⁶ the broker kept increasing his bid;²⁷⁷ the broker was often high bid-

(c)(1), 15 U.S.C. § 78o (1970), without mentioning whether the broad antifraud rules (such as 10b-5) are also breached.

²⁷³ The listing is in no particular order. The factors assume a bull manipulation (one which raises the price of the security). In a bear manipulation (depressing stock prices), which is practically unheard of, many of the *supra* factors would necessarily be reversed. In addition to those listed below, Bloomenthal, *supra* note 252, at 207, suggests that a finding of control and domination may be easier to justify when customers repose special trust in the broker and he controls their investment decisions. The presence of other 10b-5 violations, such as misrepresentations concerning the stock, no doubt aid in finding domination. *Id.* at 215.

The presence of one or more factors will not compel a conclusion that domination and control exist. Concomitantly, the absence of one or more factors will not dictate the opposite result. Furthermore, many are good market-making practices despite evidencing control and domination. The guideline approach, however, seems the best available.

²⁷⁴ Pennaluna & Co. v. SEC, 410 F.2d 861, 869 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970), *aff'g* SEC Securities Exchange Act Release No. 8063 (April 27, 1967) (bids on all but two days during a three-month period); J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618 (June 4, 1965) (quotations on all but 11 days during a year period); Advanced Research Associates, Inc., 41 S.E.C. 579, 604 (1963) (responsible for all quotes for seven months with insignificant exceptions); Theodore A. Landau, 40 S.E.C. 1119, 1126 (1962) (bids on 72 of 75 days); Bruns, Nordeman & Co., 40 S.E.C. 652, 657 (1961) (bids on 80 of 82 days); *cf.* Daniel & Co., Ltd., 38 S.E.C. 9, 11-12 (1957) (Exchange Act Rule 15c1-2; bids on 45 of 56 days and no bids on other 11 days); Barrett & Co., 9 S.E.C. 319, 325 (1941) (Exchange Act Rule 15c1-2 decision; bids every day).

²⁷⁵ Advanced Research Associates, Inc., 41 S.E.C. 579, 604 (1963) (with insignificant exceptions, responsible for all bids in seven-month period); Theodore A. Landau, 40 S.E.C. 1119, 1126 (1962) (only numerical bid on 57 of 75 days and others not too active); Sterling Sec., Co., 39 S.E.C. 487, 491 (1959) (only dealer making market in Los Angeles area); Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 182 (1953) (only bid in sheets for three months, except for four days); Harry Marks, 25 S.E.C. 208, 216 (1947) (no one else making quotations); *cf.* Daniel & Co., Ltd., 38 S.E.C. 9, 11-12 (1957) (Exchange Act Rule 15c1-2 used; bids by others on 11 of 56 days). *But see* Edgerton, Wykoff & Co., 36 S.E.C. 583, 587 (1955) (sole bidder for two months of six-month period but no violation of 10b-5).

²⁷⁶ Pennaluna & Co. v. SEC, 410 F.2d 861, 869 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (by far greatest volume); J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618 (June 4, 1965) (primary wholesale and retail seller); Advanced Research Associates, Inc., 41 S.E.C. 579, 605 (1963) (73% of purchases and 65% of sales). As to whether only the buy side or sell side of a market can be dominated, see SEC v. Otis & Co., 18 F. Supp. 100, 102 (N.D. Ohio 1936), *aff'd*, 106 F.2d 579 (6th Cir. 1939) (domination of buy side of market).

²⁷⁷ Pennaluna & Co., SEC Securities Exchange Act Release No. 8063 (April 27, 1967), *aff'd*, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (kept raising its bid); F.S. Johns & Co., Inc., SEC Securities Exchange Act Release No. 7972 (Oct. 10, 1966), *aff'd*

der;²⁷⁸ the respondent was usually the broker raising the bids;²⁷⁹ the broker placed bids only when necessary to maintain the price;²⁸⁰ the broker could set prices arbitrarily;²⁸¹ substantially all trades were made at prices quoted by the broker;²⁸² the broker traded at or near the bid price;²⁸³ the broker could have purchased below the bid price but instead raised his bid;²⁸⁴ the broker increased his bid price even though he was long;²⁸⁵ the broker purchased at a price higher than the

sub nom. Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967) & Winkler v. SEC, 377 F.2d 517 (2d Cir. 1967) (price went up although no demand for buying); Advanced Research Associates, Inc., 41 S.E.C. 579, 604 (1963) (bids went up over period); Bruns, Nordeman & Co., 40 S.E.C. 652, 657 (1961) (stock doubled and defendant raised bid nine times; increasing bids most commonly used means to create false appearance of activity); S.T. Jackson & Co., 36 S.E.C. 631, 651-52 (1950) (price kept increasing); Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 182 (1953) (bids kept going up); cf. Duval Sec., Inc., SEC Securities Exchange Act Release No. 7655 (July 23, 1965) (over-the-counter manipulation case; "arbitrary and increasing prices"); Gob Shops of America, Inc., 39 S.E.C. 92, 99-101 (1959) (proceeding to issue stop order with regard to offering circular which did not disclose broker's domination of market; bid raised nine times in 82 days; SEC stated that "[t]he insertion of increasingly higher bids in the sheets is the most universally employed device to create a false appearance of activity in the over-the-counter market"); Barrett & Co., 9 S.E.C. 319, 327 (1941) (decision interpreting Exchange Act Rule 15c1-2; stock advanced 14 times due to defendant's bid).

²⁷⁸ Pennaluna & Co., v. SEC, 410 F.2d 861, 869 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (out of 56 days with at least two firms bidding, defendant was high bidder on 34 days and equal to high bidder on 13 days); J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618, at 3 (June 4, 1965) (during a one-year period, defendant was high bidder on 86 days and equal to high bidder on 96 others); Bruns, Nordeman & Co., 40 S.E.C. 652, 657 (1961) (high bid on 51 of 82 days and equal to high bid on 23 other days); Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 182 (1953) (other's quotations generally lower); cf. Daniel & Co., Ltd., 38 S.E.C. 9, 11-12 (1957) (Exchange Act Rule 15c1-2 used; respondent's bid higher or equal to other bids); Barrett & Co., 9 S.E.C. 319, 325 (1941) (Exchange Act Rule 15c1-2 applied; always higher).

²⁷⁹ J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618, at 3 (June 4, 1965) (of 94 times price was raised during period, 39 times done by defendant alone and 22 by defendant and others at same time); Bloomenthal, *supra* note 252, at 211 n.43.

²⁸⁰ Cf. R.L. Emacio & Co., 35 S.E.C. 191, 198 (1953) (over-the-counter manipulation case; broker making bids only when necessary to peg prices); SEC Securities Exchange Act Release No. 3056, at 4 (Oct. 27, 1941) (manipulation may not exist if broker let price settle before selling, but other factors, such as purchases "particularly calculated to raise market prices," still suggest manipulation). In Edgerton, Wykoff & Co., 36 S.E.C. 583, 588 (1955), the hearing examiner concluded that respondent had raised prices on strategic days, but the Commission held that such a finding was not proven.

²⁸¹ Harry Marks, 25 S.E.C. 208, 216-17 (1947).

²⁸² *Id.* at 216.

²⁸³ Advanced Research Associates, Inc., 41 S.E.C. 579, 605 (1963); Bloomenthal, *supra* note 252, at 211 n.43; cf. Gob Shops of America, Inc., 39 S.E.C. 92, 102 (1959) (stop order proceeding alleging offering circular failed to disclose domination of market; bulk of sales made at or below broker's own bid quotations).

²⁸⁴ Advanced Research Associates, Inc., 41 S.E.C. 579, 605 (1963).

²⁸⁵ Pennaluna & Co., SEC Securities Exchange Act Release No. 8063 (April 27, 1967),

bid on the prior day;²⁸⁶ the broker increased his bid although he could satisfy the demand from his inventory;²⁸⁷ the broker suggested that his customers purchase the security;²⁸⁸ there was little likelihood of an independent market developing;²⁸⁹ a limited number of shares were being traded by the public;²⁹⁰ the price declined when the broker stopped bidding;²⁹¹ respondent bought for his customers at higher prices than other brokers were paying on the same day;²⁹² the broker repurchased securities from others for more than he sold them;²⁹³ the broker was short but continued to sell short at increasing prices he set;²⁹⁴ and the broker maintained a wide spread between his bid and asked prices to cover his short position.²⁹⁵

Opinions have also considered the *broker's profit motive*, including whether respondent-broker was relatively inactive in the security until an opportunity came for him to make a profit, such as becoming an underwriter for an offering²⁹⁶ or obtaining a large block

aff'd, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970); *cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 102 (1959) (stop order proceeding because offering circular failed to reveal domination); R.L. Emacio & Co., 35 S.E.C. 191, 195 (1953) (over-the-counter manipulation case where broker frequently had long position when he made high bid); Barrett & Co., 9 S.E.C. 319, 325 (1941) (Exchange Act Rule 15c1-2 decision). Such activity is clearly incompatible with the usual role of a market maker.

²⁸⁶ Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 182 (1953) (done in ten cases).

²⁸⁷ J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618 (June 4, 1965).

²⁸⁸ Bloomenthal, *supra* note 252, at 214-17 (SEC has not taken this position in so many words).

²⁸⁹ *Id.* at 207. In Norris & Hirshberg, Inc., 21 S.E.C. 865, 875 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949), the SEC held that there was no domination "to the extent that there exists the possibility of an independent market in the security."

²⁹⁰ Bloomenthal, *supra* note 252, at 207-08; *cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 101, 103 (1959) (proceeding to suspend offering circular for failure to reveal market domination; small supply and broker bought up more); Barrett & Co., 9 S.E.C. 319, 324 (1941) (Exchange Act Rule 15c1-2 case; float only 10% of issued stock).

²⁹¹ Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 182 (1953) (decline from \$1.65 to \$1.00); *cf.* R.J. Koeppe & Co. v. SEC, 95 F.2d 550, 552 (7th Cir. 1938) (Securities Act § 17(a)(2) case involving manipulation on an exchange and over-the-counter sales; price receded two-thirds after defendant stopped buying); Gob Shops of America, Inc., 39 S.E.C. 92, 101 (1959) (stop order proceeding instituted because offering circular concealed market domination; price "rapidly dropped").

²⁹² S.T. Jackson & Co., 36 S.E.C. 631, 652 (1950) (could have supplied out of inventory).

²⁹³ *Id.* (bought from customers and dealers).

²⁹⁴ Sterling Sec. Co., 39 S.E.C. 487, 492 (1959).

²⁹⁵ *Id.*

²⁹⁶ Floyd A. Allen & Co., Inc., 35 S.E.C. 176, 178-81 (1953); *see* Duval Sec., Inc., SEC Securities Exchange Act Release No. 7655 (July 23, 1965) (distribution of stock in violation of Securities Act § 5); *cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 99, 105 (1959) (bids raised when brokerage firm knew it was to be underwriter; decision involved stop order

of the security;²⁹⁷ whether he had a source from which to obtain the security so that he could sell out at higher prices (the source might consist of options,²⁹⁸ a large block of the security,²⁹⁹ or a hidden source of supply such as a large stockholder or a fictitious account³⁰⁰); and whether the broker liquidated his inventory quickly after the price rose.³⁰¹

Another set of factors might involve *the use of other brokers* in the scheme, including situations in which other, ostensibly independent brokers bid without disclosing that they were acting for respondent;³⁰² in which respondent guaranteed to purchase securities from other brokers at a profit to them if they placed bids;³⁰³ and in which

on offering circular which concealed broker's domination of market); R.L. Emacio & Co., 35 S.E.C. 191, 194 (1953) (10b-5 over-the-counter manipulation decision).

²⁹⁷ Pennaluna & Co., SEC Securities Exchange Act Release No. 8063 (April 27, 1967), *aff'd*, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970).

²⁹⁸ *Cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 98 (1959) (stop order proceeding on offering circular which failed to disclose domination of market; broker had warrants); Masland, Fernon & Anderson, 9 S.E.C. 338, 342-43 (1941) (warrants to purchase stock; Exchange Act Rule 15c1-2 case); Barrett & Co., 9 S.E.C. 319, 328 (1941) (Exchange Act Rule 15c1-2 manipulation decision; manipulated to price where options could be profitably exercised).

²⁹⁹ Pennaluna & Co., SEC Securities Exchange Act Release No. 8063 (April 27, 1967), *aff'd*, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970); *cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 98 (1959) (in stop-order proceeding instituted for failure to disclose market domination, SEC noted that firm had "substantial long position" and that its partners also had stock interests so they had direct financial reason to advance stock price). In Theodore A. Landau, 40 S.E.C. 1119, 1124 (1962), respondent bought stock for his wife at a low price prior to the offending actions.

³⁰⁰ J.H. Goddard & Co., Inc., SEC Securities Exchange Act Release No. 7618 (June 4, 1965) (purchases from controlling stockholder); Wayne Jewell Co., SEC Securities Exchange Act Release No. 7235 (Feb. 12, 1964) (controlling persons sell after other brokers confirm purchase).

³⁰¹ S.T. Jackson & Co., 36 S.E.C. 631, 653 (1950) (infer manipulative purpose if raises price and immediately makes sales from inventory at higher prices); *cf.* Gob Shops of America, Inc., 39 S.E.C. 92, 105 (1959) (stop order issued because offering circular did not disclose domination of market; partners of broker sold their stock); M.S. Wien & Co., 23 S.E.C. 735, 744 (1946) (10b-5 over-the-counter manipulation case).

³⁰² Tager v. SEC, 344 F.2d 5, 7 (2d Cir. 1965) (two other broker-dealers persuaded to make bids in sheets); Woods & Co., Inc., 41 S.E.C. 725, 726 (1963) (bids by other brokers at respondent's request); Advanced Research Associates, Inc., 41 S.E.C. 579, 604 (1964) (bids made in respondent's own name or through other brokers); *cf.* M.S. Wien & Co., 23 S.E.C. 735, 739-40, 743-44 (1946) (using another broker-dealer to make respondent's bid impermissible if other broker is ostensibly independent and both raise bid at same time); Masland, Fernon & Anderson, 9 S.E.C. 338, 345 (1941) (Exchange Act Rule 15c1-2 manipulation decision; quotes supplied by respondent who bought back stock from bidders at a profit to them). This practice is dangerous because it creates the appearance of a more active market, thus inducing purchases of the security by others.

³⁰³ SEC v. Pearson, 426 F.2d 1339, 1342 (10th Cir. 1970) (other brokers induced to enter bids in advance of market with understanding that another broker-dealer would repurchase securities bought as result of those bids at still higher price); F.S. Johns & Co., Inc., SEC Securities Exchange Act Release No. 7972 (Oct. 10, 1966) (defendant

respondent made bids for another broker when respondent must have known of that broker's distribution.³⁰⁴

The following factors have been successfully employed as defenses to a charge of controlling and dominating the market: an independent market existed;³⁰⁵ the broker dealt with informed people who had access to information about the issuer and the market;³⁰⁶ other brokers bid higher than respondent and he generally did not raise his bid when he was high bidder;³⁰⁷ the broker raised and lowered his bid;³⁰⁸ the broker bought and sold during the same period;³⁰⁹ the volume of his purchases approximated that of his sales;³¹⁰ after buying and driving up the price, he permitted the market to settle before selling;³¹¹ and respondent stabilized within the meaning of Exchange Act Rule 10b-7.³¹² On the other hand, certain defenses have been rejected: the security was undervalued before the price was raised and the increased price reflected its true value;³¹³ investors suffered no financial loss;³¹⁴ the

guaranteed to repurchase securities from other bidders at profit to them), *aff'd sub nom.* Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967) (other broker's disciplinary proceeding upheld) & Winkler v. SEC, 377 F.2d 517 (2d Cir. 1967).

³⁰⁴ Theodore A. Landau, 40 S.E.C. 1119, 1124 (1962) (defendant could not have been mere trading house for other broker since "could not have been ignorant" of such broker's distribution); see Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967) (defendant should have known that his bids were part of scheme).

³⁰⁵ Norris & Hirshberg, Inc., 21 S.E.C. 865, 875 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949). Query if this is not the equivalent of stating the desired conclusion as a factor to be weighed.

³⁰⁶ 21 S.E.C. at 875 (informed persons "can weigh investment in the security as against investment in others").

³⁰⁷ Edgerton, Wykoff & Co., 36 S.E.C. 583, 587-88 (1955) (of 12 days when high bidder, on eight days bid was same on one or more prior days).

³⁰⁸ *Id.* (of 28 days on which other brokers had higher bids, on 13 days defendant lowered bid from prior day). *But see* Gob Shops of America, Inc., 39 S.E.C. 92, 99 (1959) (market dominated even though raised bids nine times and lowered them twice).

³⁰⁹ Bloomenthal, *supra* note 252, at 213.

³¹⁰ *Id.* at 214.

³¹¹ *Cf.* SEC Securities Exchange Act Release No. 3056 (Oct. 27, 1941) (discussion of Exchange Act § 9(a)(2); rebuttable presumption).

³¹² 17 C.F.R. § 240.10b-7 (1972); see Bloomenthal, *supra* note 252, at 214.

³¹³ S.T. Jackson & Co., 36 S.E.C. 631, 653 (1950) (no defense since market price not set by free market forces); *cf.* Halsey, Stuart & Co., Inc., 30 S.E.C. 106, 112 (1949) (10b-5 over-the-counter manipulation case; good faith belief that stock undervalued no defense); M.S. Wien & Co., 23 S.E.C. 735, 745 (1946) (over-the-counter manipulation; immaterial that security had value equal to advanced prices); Masland, Fernon & Anderson, 9 S.E.C. 338, 344 (1941) (Exchange Act Rule 15c1-2 construed in manipulation case; no defense since antimaniplative provisions are designed to protect investors and with "equal force" to keep market open). In Gob Shops of America, Inc., 39 S.E.C. 92, 101-02 (1959), the Commission stated that "respondents' assertion that the price of other stocks had also risen is . . . no defense."

³¹⁴ *Cf.* Chasins v. Smith, Barney & Co., Inc., 306 F. Supp. 177, 178 (S.D.N.Y. 1969),

manipulation was disclosed;³¹⁵ state securities officials approved the scheme;³¹⁶ the broker acted in good faith;³¹⁷ and the broker was sometimes long and other times short.³¹⁸

The broker's concealment of domination and control from his customers is an omission to state a material fact and a 10b-5 breach. Sales "at the market" carry a representation that the market is free, open, and competitive.³¹⁹ The broker need not actually represent that a sale is "at the market" or that there is no domination, since under the shingle theory he is deemed to represent impliedly that any price he quotes is the market or bears a reasonable relationship to the market.³²⁰ Whether disclosure will protect a broker who has manipulated or controlled the market is uncertain.³²¹

In a private suit for damages against a brokerage firm which allegedly "made, created and controlled" prices while distributing stock, a court noted that recovery could be had under Exchange Act Rule 15cl-8,³²² and indicated that a 10b-5 claim might also exist if the allegations were true and the broker's actions had injured plaintiff.³²³

In addition to manipulating or dominating and controlling the market, brokerage firms may run afoul of 10b-5 if they fail to disclose to their customers who trade in a stock that they are a market maker.

aff'd, 438 F.2d 1167 (2d Cir. 1971) (does not matter that plaintiff did not pay more for stock if defendant broker failed to disclose he was market maker); *M.S. Wien & Co.*, 23 S.E.C. 735, 745 (1946) (over-the-counter manipulation; immaterial "that the purchasers may have suffered no out-of-pocket loss"); *Russell Maguire & Co., Inc.*, 10 S.E.C. 332, 350 (1941) (Securities Act § 17(a) decision regarding exchange prices; absence of loss to investors no defense).

³¹⁵ See note 253 and accompanying text *supra*.

³¹⁶ *Associated Investors Sec., Inc.*, 41 S.E.C. 160, 169 (1962).

³¹⁷ *Id.*

³¹⁸ *Bloomenthal*, *supra* note 252, at 214.

³¹⁹ *E.g.*, *J.H. Goddard & Co., Inc.*, SEC Securities Exchange Act Release No. 7618 (June 4, 1965); *Advanced Research Associates, Inc.*, 41 S.E.C. 579, 607 (1963); *Bruns, Nordeman & Co.*, 40 S.E.C. 652, 659 (1961); *Sterling Sec. Co.*, 39 S.E.C. 487, 491-92 (1959); *S.T. Jackson & Co.*, 36 S.E.C. 631, 654-55 (1950).

Exchange Act Rule 15cl-8, 17 C.F.R. § 240.15cl-8 (1972), requires a broker to disclose to his customer that no independent market exists for an over-the-counter security which the broker is distributing. Exchange Act Rule 15cl-5, 17 C.F.R. § 240.15cl-5 (1972), is not relevant since it deals with a broker controlling the issuer of securities rather than the market for the securities.

³²⁰ See note 400 and accompanying text *infra* (broker's secret profits). The shingle theory is discussed in notes 45-69 and accompanying text *supra*.

³²¹ See note 66 and accompanying text *supra* (disclosure must be clear and understandable). See also notes 447-48 and accompanying text *infra*.

³²² 17 C.F.R. § 240.15cl-8 (1972).

³²³ *Schraufnagel v. Broadwall Sec., Inc.*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,827, at 95,850 (S.D.N.Y. 1966).

In the signal case in this area, *Chasins v. Smith, Barney & Co., Inc.*,³²⁴ the Smith, Barney firm, at the request of a customer, prepared a report strongly recommending that he purchase certain stocks in which it made a market, knowing that he would rely on the report. The customer accepted the advice, despite disclosure of the firm's role as principal in the sale, and was sold stock from the firm's own inventory. The district court imposed liability on Smith, Barney, noting that its market making activities were material,³²⁵ even though the firm's market making status could be ascertained from the quotation sheets,³²⁶ other brokers were also making a market so that Smith, Barney may not have been the dominating factor, and Smith, Barney charged no more than if the securities had been obtained through regular channels. When the Second Circuit considered the case on appeal,³²⁷ it held that the market making function was a material fact since disclosure "would indicate the possibility of adverse interests which might be reflected in Smith, Barney's recommendations."³²⁸ The customer, having shown causation in fact, was permitted to recover. *Chasins* was soon distinguished in one district court case,³²⁹ but has met with approval in two more recent cases.³³⁰ As yet, no ascertainable standard for determining when market making activity must be disclosed has been established.

D. Boiler Room Activities

The boiler room³³¹ persists despite efforts to curb it.³³² Boiler room operations violate 10b-5,³³³ and persons engaged in such activities

³²⁴ 305 F. Supp. 489, *aff'd*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1970).

³²⁵ 305 F. Supp. at 495-96.

³²⁶ For an interesting contrast, see notes 444-45 and accompanying text *infra*.

³²⁷ 438 F.2d 1167 (2d Cir. 1970).

³²⁸ *Id.* at 1172. The Court of Appeals noted that the Commission had been considering a rule regarding disclosure of market making status. *Id.*

³²⁹ Batchelor v. Legg & Co., 52 F.R.D. 553 (D. Md. 1971).

³³⁰ Cant v. A.G. Becker & Co., Inc., [1971-1972] CCH FED. SEC. L. REP. ¶ 93,347 (N.D. Ill. 1971); see *Affiliated Ute Citizens v. United States*, 40 U.S.L.W. 4448 (U.S. April 24, 1972).

³³¹ The boiler room has been described as a concerted, high-pressure effort—typically by telephone—to sell a large volume of one or several promotional or speculative low-priced securities to unknown persons without any concern for the suitability of such securities in the light of the customers' investment needs or objectives and by the use of false and deceptive means. The sales techniques used are by their very nature not conducive to an unhurried, informed and careful consideration of the investment factors applicable to the securities involved. The securities are frequently of a newly established company in an industry enjoying an active period of expansion which has attracted wide public attention.

are held to a higher standard than that imposed in more conventional circumstances.³³⁴ Although a sizable portion of the SEC's administrative actions have arisen in this area,³³⁵ the boiler room is more important historically than as a current abuse covered by the Rule. A number of selling practices first found to be 10b-5 infractions when conducted in boiler rooms were subsequently found to be violative of the Rule in a broader range of situations.³³⁶

Mac Robbins & Co., Inc., 41 S.E.C. 116, 119-20 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) (footnotes omitted). See generally Hanly v. SEC, 415 F.2d 589, 597 n.14 (2d Cir. 1969); United States v. Ross, 321 F.2d 61, 64 (2d Cir.), *cert. denied*, 375 U.S. 894 (1963); 44 N.Y.U.L. REV. 1191, n.3 (1969). For a more detailed discussion, see SPECIAL STUDY pt. 1, at 265-68; Note, *A Symptomatic Approach to Securities Fraud: The SEC's Proposed Rule 15c2-6 and the Boiler Room*, 72 YALE L.J. 1411, 1411-16 (1963).

³³² In 1962, the SEC proposed Exchange Act Rule 15c2-6 which was designed to eliminate boiler rooms. See SEC Securities Exchange Act Release No. 6885 (Aug. 15, 1962). The proposed rule would have made solicitations by telephone of stocks under \$10 illegal unless certain exceptions applied, and additionally would have imposed rather extensive bookkeeping requirements. The proposal was strongly criticized (*see, e.g.*, Note, *supra* note 331, at 1420-21, 1426-27), and the Commission eventually withdrew it. See SEC Securities Exchange Act Release No. 7517 (Jan. 22, 1965). One unresolved difficulty was to define "boiler room" without encompassing other, legitimate practices. See Cohen, Book Review, 35 U. CHI. L. REV. 399, 406 (1968).

³³³ See, *e.g.*, United States v. Goldberg, 401 F.2d 644, 647 (2d Cir. 1968), *cert. denied*, 393 U.S. 1099 (1969) (criminal case); Vanasco v. SEC, 395 F.2d 349 (2d Cir. 1968) (affirmance of barring of salesman who worked in boiler room); Seaboard Sec. Corp., SEC Securities Exchange Act Release No. 7967 (Sept. 30, 1966); Triangle Investors Corp., SEC Securities Exchange Act Release No. 7902 (June 20, 1966); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725 (Oct. 18, 1965); Woods & Co., Inc., SEC Securities Exchange Act Release No. 7178 (Nov. 29, 1963); J. Logan & Co., 41 S.E.C. 88 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); Best Sec., Inc., 39 S.E.C. 931 (1960).

³³⁴ Berko v. SEC, 316 F.2d 137, 142 (2d Cir. 1963) (higher duty to prospective customers owed in boiler room situation); *see* Hanly v. SEC, 415 F.2d 589, 597 n.14 (2d Cir. 1969) ("high duty of truthfulness"); Harold Grill, 41 S.E.C. 321, 324-25 (1963) ("particularly high degree of inquiry required"). Since the *Berko* decision, the law has expanded brokers' duties in situations where a boiler room is not present, so the Second Circuit's statement may currently have less force.

³³⁵ *But see* 44 N.Y.U.L. REV. 1191, 1193 & n.16 (1969), where the writer claims that "virtually all" cases involved boiler rooms—a probable overstatement.

³³⁶ See notes 74-156 and accompanying text *supra* (doctrine of suitability and duty to investigate before recommendation).

The *Mac Robbins* litigation is instructive in this regard. The SEC first held that a firm and nine of its salesmen violated 10b-5 by using false sales material and making recommendations without adequate basis. Two salesmen appealed to the Second Circuit, which remanded the case to the Commission to determine if the Commission was attempting to establish a rule for all cases or merely for boiler room operations. The SEC clarified its decision by limiting its holding to boiler rooms, and the Second Circuit affirmed. *Mac Robbins & Co.*, 40 S.E.C. 497, *remanded sub nom.* Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961) & *Berko v. SEC*, 297 F.2d 116 (2d Cir. 1961), *on remand sub nom.* *Mac Robbins & Co.*, 41 S.E.C. 116 (1962), *aff'd sub nom.* *Berko v. SEC*, 316 F.2d 137 (2d Cir. 1963).

A typical boiler room operation involves making misrepresentations or omitting material facts by long-distance telephone, recommending a security without adequate basis, advising on securities regardless of their suitability to the customer, and in some cases churning accounts—each an independent violation of the Rule.³³⁷ Not every element need be present for a broker to run afoul of 10b-5, nor need there be a specific finding that a boiler room exists.³³⁸ The absence of misrepresentations and omissions and churning of customers' accounts should not exonerate a broker.³³⁹ Similarly immaterial should be the method of communication employed in the campaign³⁴⁰ and the speculativeness of the security.³⁴¹ Thus, in the boiler room context,³⁴² where the suitability of the touted security is not considered or the customers are unknown, *any* high-pressure campaign constitutes an infraction of the 10b-5 suitability requirement. The Rule's duty to investigate is also violated whenever recommendations are made without adequate basis.³⁴³

No customer has yet recovered in a reported decision under

³³⁷ See notes 74-232 and accompanying text *supra*; notes 348-80 and accompanying text *infra*.

³³⁸ James De Mammos, SEC Securities Exchange Act Release No. 8090, at 4 (June 2, 1967), *aff'd*, No. 31469 (2d Cir., Oct. 13, 1967) (unnecessary to determine whether operation truly boiler room).

³³⁹ R. MUNDHEIM, *supra* note 85, at 90 (Mr. Cohen) (although the SEC had not then so held, boiler room even without misrepresentations may violate 10b-5); Cohen & Rabin, *supra* note 11, at 707.

³⁴⁰ Of course, a means of interstate commerce or the mails must be used at some point in the scheme. See note 5 *supra*.

³⁴¹ Although the typical suitability situation involves speculative securities sold to an elderly widow, there seems to be no theoretical reason why the suitability doctrine could not also be breached by a broker's sale of blue chip securities to a swinger who asked for recommendations on speculative investments. See note 136 and accompanying text *supra*.

³⁴² This is not to suggest that in the absence of a boiler room situation the suitability doctrine and duty to investigate may not be violated. See notes 74-156 and accompanying text *supra*.

³⁴³ A salesman in a boiler room cannot satisfy his duty to investigate the issuer by relying on material furnished by his employer. See Alfred Miller, SEC Securities Exchange Act Release No. 8012, at 5 (Dec. 28, 1966) (cannot rely on controlling person's information during high pressure sales campaign); M.J. Merritt & Co., Inc., SEC Securities Exchange Act Release No. 7878, at 5 (May 2, 1966) ("reliance was hardly warranted" in boiler room); Harold Grill, 41 S.E.C. 321, 324-25 (1963) (reliance on "obviously inadequate information furnished by [salesman's] employer" insufficient); Mac Robbins & Co., Inc., 41 S.E.C. 116, 128-29 (1962), *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963) (do not set rule where no boiler room exists, but where one is in operation, cannot rely); *cf.* United States v. Ross, 321 F.2d 61, 65 (2d Cir.), *cert. denied*, 375 U.S. 894 (1963) (Securities Act § 17(a); apparent that boiler room operation going on and literature specious on its face). See also note 105 and accompanying text *supra*.

10b-5³⁴⁴ against a broker for losses sustained on securities sold in a boiler room operation. A cause of action must surely exist, however, if the customer can prove a causal relationship³⁴⁵ between his injury and the broker's acts,³⁴⁶ in addition to the elements ordinarily necessary for an SEC disciplinary proceeding.³⁴⁷

III

BROKER ACTIONS IN CONNECTION WITH A CUSTOMER'S ORDER

In the course of executing a trade for a customer, a broker can commit a catalog of deeds proscribed by Rule 10b-5, including excessively trading his account (or churning), violating the margin rules, obtaining secret profits and other illegal compensation, executing trades while insolvent, sending inaccurate confirmations, trading without authorization, and unreasonably delaying execution.

A. *Churning*

A broker or dealer churns—excessively trades, engages in excessive activity, or overtrades—when, to obtain commissions, he causes securities in his customer's account to be bought and sold with a frequency greater than is mandated by the customer's financial needs and resources and the size of his account.³⁴⁸ Churning may result in discipline through an administrative action, a private suit for damages, and criminal prosecution.³⁴⁹

³⁴⁴ Recovery has been permitted under Securities Act § 12(2), 15 U.S.C. § 77l (1970). See *Herring v. Hendison*, 218 F. Supp. 419 (S.D.N.Y. 1963).

³⁴⁵ No reliance by customers need be proved in a disciplinary proceeding. *Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725*, at 6 (Oct. 18, 1965). Compare *Affiliated Ute Citizens v. United States*, 40 U.S.L.W. 4448 (U.S. April 24, 1972).

³⁴⁶ In a case where plaintiff-customer alleged that his broker was operating a boiler room, the court never discussed the factors necessary for recovery, having concluded that no such operation in fact existed. *Avern Trust v. Clarke*, 415 F.2d 1238, 1240-41 (7th Cir. 1969), *cert. denied*, 397 U.S. 963 (1970) (securities not speculative and no high pressure selling or misrepresentations).

³⁴⁷ See generally notes 331-43 and accompanying text *supra*.

³⁴⁸ Other definitions can be found in *Moscarelli v. Stamm*, 288 F. Supp. 453, 457 (E.D.N.Y. 1968); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 432 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Behel, Johnsen & Co.*, 26 S.E.C. 163, 165 (1947). Compare Note, *supra* note 157, at 315-16, with Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

³⁴⁹ The Rule is violated whether the securities in the account are traded on an exchange or in the over-the-counter market. *R.H. Johnson & Co.*, 36 S.E.C. 467, 476-80 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956) (in one account all but two securities listed and in another both listed and over-the-counter). The purchase of speculative securities, however, may make the charge of churning easier

The 10b-5 duty to refrain from overtrading arises from the ubiquitous shingle theory, as well as principles of express or implied agency.³⁵⁰ Rule 10b-5 is violated when a broker-dealer is in fact a common-law agent or possesses an amount of customer trust and confidence sufficient to create an implied agency relationship. The Rule, therefore, reaches trading done by a brokerage firm in either a broker-agent or dealer-principal capacity.³⁵¹

The Rule is not the only prohibition against excessive trading. Exchange Act Rule 15c1-7(a)³⁵² prohibits churning, but only where the customer has granted formal discretionary authority. The NASD has promulgated a rule proscribing excessive trading activity,³⁵³ and common-law remedies are available.³⁵⁴

Three elements comprise the offense of churning under 10b-5: control by the broker over purchases and sales in the account, excessive or objectionable trading activity, and profit motivation by the broker. The first of these requirements is clearly satisfied when an account is discretionary or when the broker has received a power of attorney from his customer.³⁵⁵ Control can also be indirect. For example, a de

to sustain. *Cf.* *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 718, 69 Cal. Rptr. 222, 241 (1968) (common law case; unsuitability of securities "colors . . . and supports" over-trading charge).

³⁵⁰ *E.g.*, *Moscarelli v. Stamm*, 288 F. Supp. 453, 457 (E.D.N.Y. 1968) (shingle theory); *J. Logan & Co.*, 41 S.E.C. 88, 98-99 (1962), *aff'd per curiam sub nom. Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964) (shingle theory); *see* RESTATEMENT (SECOND) OF AGENCY § 389 (1958) (agent acting adverse to principal's interest). The agency basis apparently applies to all situations; the shingle theory may not. *See* notes 45-73 and accompanying text *supra*.

³⁵¹ *R.H. Johnson & Co.*, 36 S.E.C. 467, 470-78 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956) (several accounts churned; some as principal, some as agent, some a mixture); *Behel, Johnsen & Co.*, 26 S.E.C. 163, 168 (1947) (dealer-principal held for churning; dictum that agent can also churn). Acting as a dealer facilitates the fraud since commissions need not be disclosed. *Id.*

³⁵² 17 C.F.R. § 240.15c1-7 (1972). In a discretionary account, the decision to buy or sell securities is lodged initially in the broker.

³⁵³ NASD Rules of Fair Practice Art. III, § 2, CCH NASD SEC. DEALERS MANUAL ¶ 2152. The same provision which governs suitability has been construed to prohibit churning. *See Samuel B. Franklin & Co.*, SEC Securities Exchange Act Release No. 7407, (Sept. 3, 1964); *First Sec. Corp.*, 40 S.E.C. 589 (1961); *Thomas Arthur Stewart*, 20 S.E.C. 196 (1945).

The New York Stock Exchange had a rule prohibiting excessive trading in discretionary accounts (Rule 435(2)), but the provision was deleted in 1968. The American Stock Exchange maintains a rule prohibiting excessive transactions in discretionary accounts. *Am. Stock Exch. Gen. Rule 422*, 2 CCH AM. STOCK EXCH. GUIDE ¶ 9442.

³⁵⁴ *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 699, 69 Cal. Rptr. 222 (1968); *Pierce v. Richard Ellis & Co.*, 62 Misc. 2d 771, 310 N.Y.S.2d 266 (N.Y.C. Civ. Ct. 1970).

³⁵⁵ *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 33

facto discretionary account is created, and the control element satisfied, when an investor evidences trust and confidence in his broker by regularly following his advice.³⁵⁶ A finding of indirect control is made easier by the customer's naïveté and lack of business and securities experience.³⁵⁷ At the other extreme is the customer who makes his own investment decisions. He cannot successfully allege churning, despite

(Nov. 12, 1965) (trading discretion given); J. Logan & Co., 41 S.E.C. 88, 97 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964) (power of attorney given); *cf.* Norris & Hirshberg, Inc., 21 S.E.C. 865, 890 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949) (Securities Act § 17(a) and Exchange Act § 15(c)(1); oral or written discretionary authority).

³⁵⁶ Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968) (broker can churn if he determines trading due to trust and confidence); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 433 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (formal vesting of discretion unnecessary); Russell L. Irish, SEC Securities Exchange Act Release No. 7687, at 3 (Aug. 27, 1965), *aff'd*, 367 F.2d 637 (9th Cir. 1966) (generally followed broker's recommendations); Looper & Co., 38 S.E.C. 294, 296 (1958) ("reposed full trust and confidence" in respondent); *cf.* Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965) (relied on broker and followed his advice); Samuel B. Franklin & Co., SEC Securities Exchange Act Release No. 7407 (Sept. 3, 1964) (NASD review); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 382 (1945) (Exchange Act Rule 15c1-2 decision; formal discretionary power not needed).

³⁵⁷ Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 838 (E.D. Va. 1968) (plaintiff and husband had no business experience; completely naive); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 30-33 (Nov. 12, 1965) (customers included editor, salesman, and teacher; none experienced investors); Reynolds & Co., 39 S.E.C. 902, 905-06 (1960) (customers were semi-retired real estate broker, veterinarian's assistant, semi-retired farmer and school teacher, and retired doctors); Walter S. Grubbs, 28 S.E.C. 323, 325 (1948) (customer had no experience in business world); *cf.* Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965) (Securities Act § 17(a) and Exchange Act Rule 15c1-7 case; plaintiff was school teacher and not skilled in securities transactions). On the other hand, some business or securities experience will not necessarily preclude a finding of trust and confidence. *See* Weiser v. Shwartz, 286 F. Supp. 389 (E.D. La. 1968) (although no securities experience, plaintiff was member of advisory boards of insurance company and bank); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 423 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970) (some prior securities dealings); Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8500, at 4 (Jan. 22, 1969), *rev'd on other grounds sub nom.* Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970) (had some business experience); Shearson, Hammill & Co., *supra* at 33 (had a prior account); Reynolds & Co., *supra* at 905 (some customers had limited securities experience). Another aid in finding control is the existence of some personal relationship between the customer and his broker.

Widows have been victims in a large number of churning cases. *E.g.*, Hecht v. Harris, Upham & Co., *supra*; First Sec. Corp., 40 S.E.C. 589, 590 (1961) (elderly widow); Reynolds & Co., *supra* at 905; R.H. Johnson & Co., 36 S.E.C. 467, 470 (1955), *aff'd*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); Behel, Johnsen & Co., 26 S.E.C. 163, 165 (1947) (two elderly widows); Norris & Hirshberg, Inc., 21 S.E.C. 865, 869 n.7 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

the volume in the account,³⁵⁸ since his broker exercised no control over the buy and sell determinations.³⁵⁹

No mathematical formula can establish a volume of trading which per se violates the Rule since an overriding subjective consideration—the customer's needs and resources—must be superimposed on the objective factors discussed below.³⁶⁰ As a consequence, an elderly widow who pays her living expenses out of income from securities should be considered to have an investment account which will support less activity by a broker under 10b-5 than will a trading account opened by a wealthy speculator.³⁶¹ Typically, a court or the Commission will recite a series of numbers and ratios and then decide, based on a sub-

³⁵⁸ But query whether a broker has an obligation, particularly to an unsophisticated customer, to warn him of the adverse effects of the customer's multiple trades. This question was left open in *Carr v. Warner*, 137 F. Supp. 611, 615 (D. Mass. 1955).

³⁵⁹ *Moscarelli v. Stamm*, 288 F. Supp. 453, 457 (E.D.N.Y. 1968) (if customer initiates, no churning "in the absence of any fiduciary relationship"); *Thomson & McKinnon*, 35 S.E.C. 451, 454-56 (1953) (customers who induced trades were relatively knowledgeable); *cf.* *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 134 (8th Cir. 1970) (commodity churning; 81 calls to broker in 45 days); *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 380 (1945) (profit drain on account responsibility of customer initiating transactions).

³⁶⁰ *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 846 (E.D. Va. 1968) (look at customer's financial condition or expressed wishes, and nature of account; regard totality of circumstances to see if churning occurred); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 432, 435 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (no formula; determine by looking at account as a whole; look at customer's needs and objectives); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 30 (Nov. 12, 1965) (judge in "the light of the nature of such accounts and the financial resources and investment needs and objectives of the customers"); *Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 890 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949) (important consideration is "the 'character' of an account"); *cf.* *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 134 (8th Cir. 1970) (commodity churning; fact question and not determined by precise rule); *First Sec. Corp.*, 40 S.E.C. 589, 591 (1961) (NASD sanction reviewed; based largely on customer's financial situation); NASD Rules of Fair Practice Art. III, § 2, CCH NASD SEC. DEALERS MANUAL ¶ 2152 (Board of Governors policy regarding churning; no specific standards available). The requirement that a broker must determine the customer's needs and objectives relates churning and suitability. *See* notes 123-56 and accompanying text *supra*.

³⁶¹ *Walter S. Grubbs*, 28 S.E.C. 323, 329 (1948) (normally greater activity in trading account than investment account); *Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 891 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949) (normally greater activity in trading account); *see* *Samuel B. Franklin & Co.*, SEC Securities Exchange Act Release No. 7407, at 7 (Sept. 3, 1964) (accounts of two widows could not be considered trading accounts under circumstances); *cf.* *First Sec. Corp.*, 40 S.E.C. 589, 591 (1961) (cannot treat as trading account where customer substantially dependent on income). Even trading accounts may be churned, however. *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 432 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1209 (9th Cir. 1970); *Paine, Webber, Jackson & Curtis*, SEC Securities Exchange Act Release No. 8500, at 5 (Jan. 22, 1969), *rev'd on other grounds sub nom.* *Klopp v. SEC*, 427 F.2d 455 (6th Cir. 1970).

jective impression of the facts, whether or not a broker is guilty of churning.

The most important statistical test in excessive trading opinions is turnover in the account, the ratio of the value of securities bought and sold to the value of the stocks and bonds in the account.³⁶² A closely related test is the percentage of securities sold within a short time of purchase,³⁶³ a higher percentage obviously suggesting excessive activity more strongly. Certain types of trading have also been used as evidence of a proscribed level of activity: purchases followed by sales and then the immediate reinvesting of the proceeds in another security;³⁶⁴ buying, selling, and then repurchasing the same security;³⁶⁵ and

³⁶² Although other definitions are used, the one which has gained the most currency in determining the turnover rate is computed

by dividing the cost of the purchases by the average investment, the latter representing the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration.

Looper & Co., 38 S.E.C. 294, 297 n.6 (1958); *accord*, Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 30 n.72 (Nov. 12, 1965); J. Logan & Co., 41 S.E.C. 88, 94 n.11 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); Reynolds & Co., 39 S.E.C. 902, 906 n.10 (1960).

The turnover rates in cases where churning has been found vary widely. In *Pierce v. Richard Ellis & Co.*, 62 Misc. 2d 771, 310 N.Y.S.2d 266 (N.Y.C. Civ. Ct. 1970), a common law case, the turnover was apparently ten times in one month. Rule 10b-5 cases with the highest turnover are Shearson, Hammill & Co., *supra* at 30-31 (average of eight and seven times per month in two different accounts), and Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8500, at 3 (Jan. 22, 1969), *rev'd on other grounds sub nom.* Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970) (2.3 times per month). A relatively low turnover rate will not necessarily insulate the broker. *See* Richard N. Cea, SEC Securities Exchange Act Release No. 8662, at 10 (Aug. 6, 1969) (3.73 times in 58 months or once every 15.5 months); J. Logan & Co., *supra*, 41 S.E.C. at 95 (3.8 times in 56 months or once every 14.7 months).

³⁶³ Among the cases citing this factor are J. Logan & Co., 41 S.E.C. 88, 94-97 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); Reynolds & Co., 39 S.E.C. 902, 906-07 (1960); Behel, Johnsen & Co., 26 S.E.C. 163, 166 (1947). These cases consider the number of transactions reversed, thereby applying a different standard than turnover which is based on transfers of dollar amounts.

³⁶⁴ Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 840, 842, 846 (E.D. Va. 1968); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 435-36 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1209 (9th Cir. 1970); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 31-33 (Nov. 12, 1965); Russell L. Irish, SEC Securities Exchange Act Release No. 7687, at 3-4 (Aug. 27, 1965), *aff'd*, 367 F.2d 637 (9th Cir. 1966), *cert. denied*, 386 U.S. 911 (1967); J. Logan & Co., 41 S.E.C. 88, 91 (1962), *aff'd per curiam sub nom.* Hersh v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); Reynolds & Co., 39 S.E.C. 902, 906 (1960); Behel, Johnsen & Co., 26 S.E.C. 163, 165 (1947). This practice is usually referred to as "in-and-out trading."

³⁶⁵ R.H. Johnson & Co., 36 S.E.C. 467, 470-71, 474, 479-80 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); Norris & Hirshberg, Inc., 21

selling a security from one account while causing another account to purchase it.³⁶⁶ Another set of mathematical criteria considers the broker's profit rather than the volume of trading. Cases compare the commissions and mark-ups generated by the allegedly churned account with the value of the investments in the account,³⁶⁷ the total income of the salesman³⁶⁸ or firm,³⁶⁹ and the broker's profits gathered from other accounts.³⁷⁰ A further circumstance is the loss sustained while the investor's account was overtraded.³⁷¹ Finally, some types of trades are sufficient on their face to prove churning without recourse to the above indicia.³⁷²

The final element necessary to establish a churning offense is a

S.E.C., 865, 891-94 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *cf.* *Pierce v. Richard Ellis & Co.*, 62 Misc. 2d 771, 310 N.Y.S.2d 266 (N.Y.C. Civ. Ct. 1970) (common-law case).

³⁶⁶ *J. Logan & Co.*, 41 S.E.C. 88, 92, 99 (1962), *aff'd per curiam sub nom. Hersh v. SEC* 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); *Looper & Co.*, 38 S.E.C. 294, 296 (1958); *Norris & Hirschberg, Inc.*, 21 S.E.C. 865, 886 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *Oxford Co., Inc.*, 21 S.E.C. 681, 688-89 (1946). This activity is often referred to as "cross-trading."

³⁶⁷ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 424-25, 435-36 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 30-33 (Nov. 12, 1965); *Reynolds & Co.*, 39 S.E.C. 902, 906-07 (1960); *Looper & Co.*, 38 S.E.C. 294, 297 (1958); *cf.* *Newkirk v. Hayden, Stone & Co.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965).

³⁶⁸ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 436 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (51%); *Samuel B. Franklin & Co.*, SEC Securities Exchange Act Release No. 7407, at 5 (Sept. 3, 1964) (30% and 46%); *Behel, Johnsen & Co.*, 26 S.E.C. 163, 166 (1947) (one-third); *cf.* *Newkirk v. Hayden, Stone & Co.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965) (17%). *See also* notes 373-74 and accompanying text *infra* (profit motive of broker as element of churning).

³⁶⁹ *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209-10 (9th Cir. 1970) (4.7% of office income although less than 0.1% of accounts in that office).

³⁷⁰ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 436 (N.D. Cal. 1968) (50 times average account), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970). It is no defense that the turnover is less than in other accounts. *Cf.* *First Sec. Corp.*, 40 S.E.C. 589, 592 (1961) (customer's account "one of the more active").

³⁷¹ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 424 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Lorenz v. Watson*, 258 F. Supp. 724, 731 (E.D. Pa. 1966); *Richard N. Cea*, SEC Securities Exchange Act Release No. 8662, at 9-10 (Aug. 6, 1969); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 30-33 (Nov. 12, 1965); *Reynolds & Co.*, 39 S.E.C. 902, 906-07 (1960); *Looper & Co.*, 38 S.E.C. 294, 297-98 (1958); *Walter S. Grubbs*, 28 S.E.C. 323, 329 (1948). A showing of no loss will not necessarily exonerate the broker. *See* notes 377-78 and accompanying text *infra*. However, it is appropriate in this situation to consider general market trends during the period of churning to protect the broker from being penalized for a general downturn in the securities markets.

³⁷² *J. Logan & Co.*, 41 S.E.C. 88 (1962), *aff'd per curiam sub nom. Hersh v. SEC*, 325 F.2d 147 (9th Cir. 1963) (*semble*), *cert. denied*, 377 U.S. 937 (1964); *cf.* *E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 382 n.52 (1945).

showing that the broker intended to reap profits at his customer's expense, or that the broker induced trading without regard for the consequences to his customer's account.³⁷³ Even though cases regularly treat this final element as a component of a churning offense, its presence seems a foregone conclusion once control and an excessive volume of trading are shown. Opinions sometimes rely on other 10b-5 violations—such as obtaining secret profits—to bolster the conclusion that the broker's intent was to make profits.³⁷⁴

If control, excessive purchases and sales, and broker motivation are shown, adequate defenses are not readily available. The investor's wealth³⁷⁵ and the broker's intent³⁷⁶ are not protection, nor is a profit in the account, whether measured against the initial balance³⁷⁷ or against the value the portfolio would have had at the end of the period had it been kept intact.³⁷⁸ In some investor suits for damages, courts have

³⁷³ *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 841-42, 845 (E.D. Va. 1968); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) ("purpose of the broker to derive profits for himself while disregarding the interests of the customer"); *Reynolds & Co.*, 39 S.E.C. 902, 907 (1960); *Looper & Co.*, 38 S.E.C. 294, 301 (1958) ("desire to produce income"); *Behel, Johnsen & Co.*, 26 S.E.C. 163, 165 (1947) (transactions "induced solely for the purpose of obtaining profits"). This is not to say that intent is a prerequisite. *See* note 376 and accompanying text *infra*.

³⁷⁴ *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965) (secret profits); *Looper & Co.*, 38 S.E.C. 294, 300 (1958) (secret profits); *R.H. Johnson & Co.*, 36 S.E.C. 467, 485 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956) (secret profits); *Norris & Hirschberg, Inc.*, 21 S.E.C. 865, 874 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949); *see Moscarelli v. Stamm*, 288 F. Supp. 453, 457 (E.D.N.Y. 1968) (must determine, *inter alia*, if any misrepresentations made); *cf. E.H. Rollins & Sons, Inc.*, 18 S.E.C. 347, 381 n.50 (1945) ("evil of overtrading" emphasized by unconscionable mark-ups); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 718, 69 Cal. Rptr. 222, 241 (1968) (common-law decision; unsuitability of securities in account "colors . . . and supports" churning). In *Walter S. Grubbs*, 28 S.E.C. 323, 329 (1948), the Commission stated that the volume and frequency of transactions alone might not be sufficient to find churning, but the taking of secret profits evidenced the respondent's desire to benefit himself.

³⁷⁵ *Richard N. Cea*, SEC Securities Exchange Act Release No. 8662, at 10 (Aug. 6, 1969).

³⁷⁶ *See Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1209 (9th Cir. 1970) (specific intent to defraud unnecessary); *cf. First Sec. Corp.*, 40 S.E.C. 589, 592 (1961) (NASD appeal). *See also* text following note 380 *infra* concerning intent in private rights of action.

³⁷⁷ *Stevens v. Abbott, Proctor & Paine*, 288 F. Supp. 836, 842, 847 (E.D. Va. 1968); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 31 (Nov. 12, 1965); *R.H. Johnson & Co.*, 36 S.E.C. 467, 475 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956); *Behel, Johnsen & Co.*, 26 S.E.C. 163, 166 (1947).

³⁷⁸ *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 32 (Nov. 12, 1965); *Samuel B. Franklin & Co.*, SEC Securities Exchange Act Release No. 7407, at 5 (Sept. 3, 1964). Query whether churning could be negated if the broker could

barred recovery if the customer received a confirmation of each trade and monthly statements in a form plainly revealing the volume of trading taking place.³⁷⁹

In private rights of action, which are permitted for overtrading,³⁸⁰ proving reliance, causation, and a form of scienter should pose little problem if churning has occurred. Reliance is a foregone conclusion in most cases because the broker controls the account. Proving that the broker's action caused the loss would merely involve establishing a loss to the customer through the transaction, and it would be a rare broker indeed who could show that he was unaware of the ill effects excessive trading would have on an account.

B. *Violation of the Margin Rules*

The Board of Governors of the Federal Reserve System has promulgated a series of regulations which restricts the right of brokers and dealers to extend credit to their customers or to arrange for the extension or maintenance of credit for them.³⁸¹ In the past, violations of these regulations have been held to give rise to private rights of action under section 7 of the Exchange Act.³⁸² There is, however, relatively little

show that the customer made at least as much as he would have made in a properly managed account. *Cf.* First Sec. Corp., 40 S.E.C. 589, 592 (1961) (customer's good income from investments held not determinative).

³⁷⁹ Carr v. Warner, 137 F. Supp. 611, 614-15 (D. Mass. 1955). The principle may have been accepted in other cases but is certainly rejected on the facts. Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 431, 434 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202, 1209 (9th Cir. 1970) (confirmations misleading and plaintiff could not tell account churned); *accord*, Weiser v. Schwartz, 286 F. Supp. 389, 393 (E.D. La. 1968); Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965); *see* Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 842 (E.D. Va. 1968) (customer not alerted by incomplete confirmations). The Commission has not wholeheartedly embraced this defense. *See* Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 31-32 (Nov. 12, 1965); Looper & Co., 38 S.E.C. 294, 297 (1958) (questions raised by some customers); R.H. Johnson & Co., 36 S.E.C. 467, 470, 479 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), *cert. denied*, 352 U.S. 844 (1956) (broker reassured customers after complaint); Norris & Hirshberg, Inc., 21 S.E.C. 865, 893 (1946), *aff'd*, 177 F.2d 228 (D.C. Cir. 1949).

³⁸⁰ Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1209 (9th Cir. 1970); Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 845 (E.D. Va. 1968); Moscarelli v. Stamm, 288 F. Supp. 453, 457-58 (E.D.N.Y. 1968); Leonard v. Colton, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,284 (E.D.N.Y. 1968) (may be actionable); Lorenz v. Watson, 258 F. Supp. 724, 730 (E.D. Pa. 1966); *cf.* Newkirk v. Hayden, Stone & Co., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,621 (S.D. Cal. 1965).

³⁸¹ See 12 C.F.R. §§ 220.1 to .8 (1972).

³⁸² *See, e.g.*, Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd per curiam*, 409 F.2d 1360 (2d Cir.), *cert. denied*, 396 U.S. 904 (1969); Remar v. Clayton Sec. Corp., 81 F. Supp. 1014 (D. Mass. 1949). *But see* Exchange Act § 7(f), 15 U.S.C. § 78g(f) (1970).

authority on the question of whether a 10b-5 claim is also cognizable.³⁸³

Under the margin rules, a customer must, within a reasonably short time after purchase, either pay for a security he buys or contribute adequate collateral to secure a loan. Should he fail to do so, or neglect to provide additional collateral when necessary, the broker must sell that part of the customer's securities which will bring him into conformity with the margin regulations. Both the customer's initial purchase and the broker's sale pursuant to the margin regulations are events which can trigger 10b-5 liability.³⁸⁴ In the initial purchase, any misrepresentation or omission of a material fact by the broker which is relied on by his customer is grounds for a private right of action if the broker knew or should have known³⁸⁵ his statement was misleading.³⁸⁶ The following are examples of statements falsely made: the broker can obtain margin which the customer cannot;³⁸⁷ the method of financing suggested is usual and involves no greater risk than normal;³⁸⁸ margin is not available at all, or less can be borrowed than is actually available, with the result that the broker obtains more money from his customer;³⁸⁹ or margin is available on terms more favorable than they actually are, so the customer enters into a transaction he would not otherwise make.³⁹⁰ A broker's concealment that a transaction breached the margin rules would also be a 10b-5 infraction if the illegality were a material fact.³⁹¹

A customer who has failed to comply with legitimate demands for additional margin or to pay for his securities within the requisite time period may not sue under the Rule if he is sold out in conformity with law, even though his broker may have promised not to sell.³⁹² On the

³⁸³ See Exchange Act Rule 10b-16, 17 C.F.R. § 240.10b-16 (1972) (disclosure of finance charges).

³⁸⁴ In *H.F. Schroeder & Co.*, 27 S.E.C. 833, 836-37 (1948), a broker was held to have violated 10b-5 because he asked his customer for additional margin when none was really necessary.

³⁸⁵ A broker has a duty to know the securities laws. *Carter H. Corbrey & Co.*, 29 S.E.C. 283, 288 (1949).

³⁸⁶ See generally notes 157-232 and accompanying text *supra*.

³⁸⁷ *H.F. Schroeder & Co.*, 27 S.E.C. 833, 835, 837 (1948).

³⁸⁸ *Glickman v. Schweickart & Co.*, 242 F. Supp. 670, 673-74 (S.D.N.Y. 1965).

³⁸⁹ *H.F. Schroeder & Co.*, 27 S.E.C. 833, 835, 837 (1948) (representation bank could lend only 50% whereas limit really 70%).

³⁹⁰ *Smith v. Bear*, 237 F.2d 79, 88 (2d Cir. 1956) (dictum); cf. Comment, *Credit Regulation in the Securities Market: An Analysis of Regulation T*, 62 Nw. U.L. Rev. 587, 620 (1967).

³⁹¹ See Note, *Federal Margin Requirements as a Basis for Civil Liability*, 66 COLUM. L. REV. 1462, 1484-85 (1966). See also Comment, *supra* note 390, at 620-23.

³⁹² *Shemtob v. Shearson, Hammill & Co., Inc.*, 448 F.2d 442, 445 (2d Cir. 1971) (without allegation of fraud or scienter, suit nothing more than breach of contract action).

other hand, a sale by a broker should be deemed a conversion, and hence actionable by the customer,³⁹³ if appropriate demands for additional collateral have not been made³⁹⁴ or if the broker sells more securities than is necessary to meet the statutory norm.³⁹⁵ A customer should also have a right to damages if his broker sells him out in the mistaken belief that the customer did not pay on time or did not have adequate collateral on deposit.³⁹⁶

C. *Brokers' Secret Profits and Other Illegal Compensation*

A brokerage firm acting as agent is allowed to charge a reasonable commission. When the firm acts as a dealer—selling securities to or buying them from its customer for its own account—it is entitled to reasonable compensation in the form of a mark-up (sales price above market) or mark-down (purchase price below market). The temptation to increase their compensation beyond permissible bounds, considering the likelihood that such an increase will go undetected,³⁹⁷ has led brokers to develop a variety of practices violative of 10b-5. These artifices include a dealer exacting unreasonable mark-ups or mark-downs, a broker charging excessive commissions, an underwriter obtaining larger compensation than is disclosed, a brokerage house positioning another firm between it and the security's primary source, self-preference by a broker-dealer, and payment of secret rebates by a broker.

The majority of cases in this area concern brokers' undisclosed commissions or dealers' unreasonable mark-ups or mark-downs in the over-the-counter market. The first and most difficult question involves the compensation of an over-the-counter dealer. The dealer is entitled to a reasonable mark-up when he sells to his customers, and a reasonable mark-down when he buys from them.³⁹⁸ This rule is usually expressed

³⁹³ See notes 500-27 and accompanying text *infra* (broker converting customer's property).

³⁹⁴ This should be true regardless of whether sufficient collateral is actually held by the broker. *But cf.* *Shemtob v. Shearson, Hammill & Co., Inc.*, 448 F.2d 442, 445 (2d Cir. 1971) (contract action not available if customer is adequately informed; no discussion of proceeding under a tort or conversion approach. The customer could, of course, waive the requirement of notice in his margin agreement.

³⁹⁵ This is equivalent to a conversion by the broker, and intent to misappropriate is therefore unnecessary. See note 510 and accompanying text *infra*.

³⁹⁶ See note 395 *supra*.

³⁹⁷ Many customers are too unsophisticated to detect these frauds; even knowledgeable clients may not realize they are paying illegally increased brokerage fees.

³⁹⁸ In the case of a customer exchanging one security for another, the market value of the securities surrendered by the customer is presumed to be reasonably related to the market value of those received. *Walter S. Grubbs*, 28 S.E.C. 323, 326 (1948) (switches of securities within 10b-5); *cf.* *Jack Goldberg*, 10 S.E.C. 975, 978, 980-81 (1942) (representation

in terms of the shingle theory:³⁹⁹ a statement by a dealer with respect to the price of a security carries with it the implied representation that such price bears a reasonable relationship to the prevailing market price.⁴⁰⁰ Controversy generally centers on what is "reasonable" and how the mark-up or mark-down should be computed.⁴⁰¹ The Commission once proposed a rule which would have required every dealer executing an over-the-counter transaction to reveal to his customer the best independent bid or asked price,⁴⁰² but, due to industry pressure, it was not adopted.⁴⁰³

Mark-up (and mark-down) must be distinguished from the dealer's profit. The latter is defined as the difference between what the dealer pays for a security and the price at which he later sells it to the customer. This profit is not the concern of the securities laws.⁴⁰⁴ Rather, Rule 10b-5 regulates the difference between the price charged to the customer and the security's market value on the date of sale. Consequently, a dealer would violate 10b-5 if he bought a security at \$10 and thereafter sold it to a customer for \$7 when the prevailing market price

by implication); NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154 (NASD rules, which are analogous to 10b-5-imposed limitations, have been interpreted by the Association's Board of Governors so that exchanges of securities are treated as cash purchases. See also SPECIAL STUDY pt. 2, at 6-7. Thill Sec. Corp., SEC Securities Exchange Act Release No. 7342, at 8 n.1 (June 11, 1964) (for NASD purposes, in an exchange include mark-up on sale in determining fairness of purchase mark-up).

³⁹⁹ See notes 45-69 and accompanying text *supra*. Not all dealers, however, are subject to the shingle theory.

⁴⁰⁰ *E.g.*, William Harrison Keller, Jr., 38 S.E.C. 900, 905 (1959); Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 830-31 (1948); *cf.* Lawrence R. Leebby, 13 S.E.C. 499, 505 (1943); Scott McIntyre & Co., 11 S.E.C. 442, 446 (1942); Jack Goldberg, 10 S.E.C. 975, 980-81 (1942); Allender Co., 9 S.E.C. 1043, 1057 (1941). As a wrinkle on the usual formulation, the quoted price must bear a reasonable relationship to the price in a *free, unmanipulated* market. See Comment, *supra* note 65, at 735.

⁴⁰¹ A dealer has no duty to disclose the mark-up or mark-down; rather, he need only ensure that the amount is reasonable. Arleen W. Hughes, 27 S.E.C. 629, 637 n.11 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949); Knauss, *supra* note 11, at 638-39. In *Chasins v. Smith, Barney & Co., Inc.*, 305 F. Supp. 489, 495 (S.D.N.Y.), *motion to amend denied*, 306 F. Supp. 177 (S.D.N.Y. 1969), *aff'd*, 438 F.2d 1167 (2d Cir. 1971), the court held that a dealer was under no duty to disclose the price he received on resale of the subject bonds because, under the circumstances, the disclosure would not have affected the customer's decision to sell.

⁴⁰² The proposed rule would have made compensation disclosure requirements consistent in the trade since disclosure of compensation is required of over-the-counter brokers and in exchange transactions, but the over-the-counter dealer is immune from revealing his compensation. See Knauss, *supra* note 11, at 637-38.

⁴⁰³ See SEC Securities Exchange Act Release No. 3940 (April 2, 1947).

⁴⁰⁴ *Cf.* Maryland Sec. Co., 40 S.E.C. 443, 446 (1960) (appeal from NASD sanction; price paid weeks prior to sale cannot be used as contemporaneous cost); G. Alex Hope, 7 S.E.C. 1082, 1084 (1940) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; do not condemn profit from market rise).

was \$2, even though the broker would have sustained a \$3 loss. Similarly irrelevant is a dealer's spread—the price the customer is charged less the amount the dealer paid for the security on the same day,⁴⁰⁵ except to the extent that the contemporaneous cost evidences the prevailing market.⁴⁰⁶ The dealer should not be penalized for obtaining securities at a price less than current market price.

Mark-up equals cost to customer minus prevailing market price,⁴⁰⁷ with the customer's cost equal to the fair market value of all consideration surrendered which is proximately related to the transaction. Determination of the prevailing market price has been a constant battle. It is generally considered appropriate to use the inside or wholesale price.⁴⁰⁸ Various measures of such price have been suggested, but the SEC has continuously held "that, absent countervailing evidence, a dealer's *contemporaneous cost* is the best evidence of the market price for the purpose of computing mark-ups."⁴⁰⁹ Such a standard raises a host of prob-

⁴⁰⁵ SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,697, at 95,563 (S.D.N.Y. 1966).

⁴⁰⁶ See notes 409-22 and accompanying text *infra*.

⁴⁰⁷ E.g., SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,697, at 94,563 (S.D.N.Y. 1966). Mark-downs are measured by the difference between the prevailing market price and the amount the selling customer receives.

⁴⁰⁸ The wholesale or inside price is the one at which dealers trade among themselves; dealer-customer transactions are consummated at the outside or retail price. Cf. Merritt, Vickers, Inc., SEC Securities Exchange Act Release No. 7409, at 5 (Sept. 2, 1964), *aff'd*, 353 F.2d 293 (2d Cir. 1965) (appeal from NASD sanction; mark-up measured over "current wholesale, not retail, market price").

⁴⁰⁹ Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 n.57 (Nov. 12, 1965) (emphasis added); *accord*, Barnett v. United States, 319 F.2d 340, 344 (8th Cir. 1963) (affirming SEC order); Associated Sec. Corp. v. SEC, 293 F.2d 738, 741 (10th Cir. 1961); Century Sec. Co., SEC Securities Exchange Act Release No. 8123, at 7 (July 14, 1967), *aff'd sub nom.* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969); J.A. Winston & Co., Inc., SEC Securities Exchange Act Release No. 7337, at 9 (June 8, 1964); Paul Carroll Ferguson, 39 S.E.C. 260, 263 (1959); William Harrison Keller, Jr., 38 S.E.C. 900, 905 (1959); cf. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (contemporaneous cost and quotation sheets in absence of evidence to the contrary). The same rule for ascertaining prevailing market price pertains in NASD proceedings as well. See, e.g., Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 3 (Dec. 8, 1966); J.A. Winston & Co., Inc., SEC Securities Exchange Act Release No. 7334, at 8-9 (June 5, 1964); General Investing Corp., SEC Securities Exchange Act Release No. 7316, at 3 (May 15, 1964) (discussing the "market maker" exception); Naftalin & Co., Inc., 41 S.E.C. 823, 826-27 (1964); Maryland Sec. Co., 40 S.E.C. 443, 446 (1960); Boren & Co., 40 S.E.C. 217, 220 (1960); Samuel B. Franklin & Co., 38 S.E.C. 908, 910 (1959), *aff'd*, 290 F.2d 719, 725 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961); Managed Inv. Programs, 37 S.E.C. 783, 786 (1957).

This measure of prevailing market price applies whether the dealer sells from his inventory (a trade in which he has risk) or sells a security he purchases in response to the receipt of the customer's order (a riskless transaction). Cf. Naftalin & Co., Inc., *supra* at 826-27; NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154.

lems. First, the maximum time between the dealer's purchase and sale to his customer permissible to qualify under the "contemporaneous cost" concept is unclear; cases generally refer to same-day purchases,⁴¹⁰ although longer intervening periods have been recognized.⁴¹¹ Second, the decisions assume the price paid for the security is the dealer's "contemporaneous cost."⁴¹² Any related internal expenses are excluded and are to be recouped, if at all, in the mark-up upon the sale of the security. Third, when a dealer makes more than one purchase near the time of the sale, the purchase nearest in time to the sale is used. In the absence of evidence as to which is closest, "fairness [to the dealer] requires that the highest cost of purchase be used."⁴¹³ The Commission rejected its staff's recommendation that the average of the contemporaneous costs be employed, reasoning that a declining market could cause a mark-up which seemed reasonable in the morning to become unreasonable in the afternoon.⁴¹⁴

A number of dealers have overcome the presumption that con-

In J.A. Winston & Co., Inc., SEC Securities Exchange Act Release No. 7337 (June 8, 1964), the SEC decided a 10b-5 case arising out of the same transactions which gave rise to an appeal from an NASD sanction which the Commission had decided three days earlier. The Commission dismissed an argument that the issue of current market price must be determined differently for NASD appeals and 10b-5 cases. *Id.* at 9 NASD cases on the issue of prevailing market price are therefore sound authority for the antifraud provisions.

A salesman not knowing of his firm's contemporaneous cost is not held for violation of 10b-5 on the basis of those costs. *Cf.* Langley-Howard, Inc., SEC Securities Exchange Act Release No. 7986, at 7 (Oct. 26, 1966). *Compare* Mark E. O'Leary, SEC Securities Exchange Act Release No. 8361, at 7 (July 25, 1968).

⁴¹⁰ *E.g.*, Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965) (reject claim that should average contemporaneous costs over entire day); *cf.* General Investing Corp., SEC Securities Exchange Act Release No. 7316, at 3 (May 15, 1964) (NASD appeal; disciplined firm successfully argued against same day contemporaneous costs since it was market maker); Maryland Sec. Co., 40 S.E.C. 443, 446 (1960) (appeal from NASD sanction; same day cost price); Samuel B. Franklin & Co., 38 S.E.C. 908, 910 (1959), *aff'd*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961) (NASD review; use same-day sales for mark-downs); Managed Inv. Programs, 37 S.E.C. 783, 786 (1957) (NASD appeal; "price paid for a security on the same day").

⁴¹¹ SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,697, at 95,563 (S.D.N.Y. 1966) (same day, day before, or day after); William Harrison Keller, Jr., 38 S.E.C. 900, 904 (1959) (some purchases and sales one day apart but use cost anyway); *cf.* Scott McIntyre & Co., 11 S.E.C. 442, 444-45 (1942) (comparison of costs within one or two days of sale). *See also* note 404 and accompanying text *supra*.

⁴¹² Any brokerage commission the dealer incurs, as when he purchases securities on an exchange and thereafter sells them in the over-the-counter market, should be part of his contemporaneous cost.

⁴¹³ Century Sec. Co., SEC Securities Exchange Act Release No. 8123, at 7 (July 14, 1967), *aff'd sub nom.* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969); *accord*, Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965).

⁴¹⁴ *See* cases cited in note 413 *supra*.

temporaneous cost is the best evidence of market value. In a few cases, the price at which respondent sold to other dealers⁴¹⁵ or the price which dealers were charging one another during the applicable period⁴¹⁶ has been deemed controlling. A dealer can also rebut the presumption by proving he acquired his securities at a discount, as, for example, when he purchases a large block having a relatively thin market.⁴¹⁷

A market maker⁴¹⁸ poses special problems. As the *Special Study of the Securities Markets* indicated,⁴¹⁹ use of a market maker's contemporaneous cost might discourage his activity since the spread allowable might be insufficient to justify the risk of maintaining a position.⁴²⁰ Absent proof of unusual circumstances such as these, bids and offers placed in the quotation sheets cannot supplant the contemporaneous cost standard.⁴²¹ A different result should be mandated by the use

⁴¹⁵ See Mark E. O'Leary, SEC Securities Exchange Act Release No. 8361, at 7-8 (July 25, 1968) (contemporaneous sales to other brokers preferred over contemporaneous cost); Century Sec. Co., SEC Securities Exchange Act Release No. 8123, at 7 (July 14, 1967), *aff'd sub nom.* Nees v. SEC, 414 F.2d 211 (9th Cir. 1969) (use contemporaneous prices in sales to other dealers if higher than contemporaneous cost); cf. Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 4 (Dec. 8, 1966) (NASD appeal; use member's contemporaneous price to other dealers). See also Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965).

⁴¹⁶ Cf. Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 4 (Dec. 8, 1966) ("other inter-dealer sales"); Langley-Howard, Inc., SEC Securities Exchange Act Release No. 7986, at 6 (Oct. 26, 1966) (NASD appeal; "transactions between other dealers" taken into consideration).

⁴¹⁷ Cf. Langley-Howard, Inc., SEC Securities Exchange Act Release No. 7986, at 7 (Oct. 26, 1966) (NASD appeal; to prevent block from being dumped, member bought at low price to protect its customers); Strathmore Sec., Inc., SEC Securities Exchange Act Release No. 7864, at 3 (April 18, 1966), *aff'd*, 407 F.2d 722 (D.C. Cir. 1969) (NASD case; third party tried for over two weeks to sell block but no one would buy); Boren & Co., 40 S.E.C. 217, 220-21 (1960) (obtained block at special concession). The burden of proving the concession is on the dealer. Cf. Kenneth B. Strucker Inv. Sec., SEC Securities Exchange Act Release No. 7823, at 3 (Feb. 15, 1966) (NASD appeal).

⁴¹⁸ A market maker is a dealer who holds himself out as willing to buy or sell an over-the-counter security on a continuous basis.

⁴¹⁹ SPECIAL STUDY pt. 2, at 645-68.

⁴²⁰ When the SEC faced this issue it utilized other dealers' offers to determine the market price. Cf. General Investing Corp., SEC Securities Exchange Act Release No. 7316, at 3 (May 15, 1964) (appeal from an NASD sanction).

⁴²¹ Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965) (do not use quotations where there are substantial sales to dealers); cf. Gateway Stock & Bond Inc., SEC Securities Exchange Act Release No. 8003, at 3 (Dec. 8, 1966) (appeal from NASD sanction; low priced speculative securities with wide spreads); Naftalin & Co., 41 S.E.C. 823, 826-28 (1964) (NASD proceeding appeal; extent of use of quotations in sheets depends on number of circumstances and not overcome by speculative securities). But in Thill Sec. Corp., SEC Securities Exchange Act Release No. 7342, at 6-8 (June 11, 1964), the SEC held that the NASD was wrong to use contemporaneous sales prices of other dealers and, in their absence, bids in the sheets, to measure mark-downs where the respondent obtained oral bids from other dealers in an active market, the securities were

of the automated NASDAQ system, since within that system a broker is required to trade at the price he inserts.⁴²²

Another measure of prevailing market price must be utilized in the absence of contemporaneous cost. A number of organizations, among them the National Quotation Bureau, Inc., publish sheets in which dealers place their bid and asked quotations. Quotations for securities of issuers which meet certain standards are also reported on the automated NASDAQ system. Because usually more than one firm is interested in a security, the sheets and NASDAQ system often reflect a range of bid and asked quotations. The figures in the sheets do not represent actual transactions or even firm offers in the legal sense; rather, they are in the nature of feelers among dealers as to the price at which a sale might be made.⁴²³ Nevertheless, the prices in the sheets are generally considered prima facie evidence of the prevailing market in the absence of contemporaneous cost.⁴²⁴ Since a broker *must* trade at his NASDAQ prices, these perhaps offer more accurate indices of market. The sheets' and NASDAQ's quotations, however, are not controlling when factors so indicate,⁴²⁵ and are of little value for low-priced securities with a wide spread between the bid and offer quotations.⁴²⁶

nonspeculative, most had more than one market maker, and the spread between the bid and offer was narrow.

⁴²² See note 249 *supra*.

⁴²³ *Merritt, Vickers, Inc. v. SEC*, 353 F.2d 293, 296-97 (2d Cir. 1965) (not firm offers and subject to change); *Allender Co.*, 9 S.E.C. 1043, 1058 (1941) (not actual transactions or firm bids).

The quotations in the sheets represent the wholesale or inside market, but do furnish some indication of the retail price. *Allender Co.*, *supra*. See note 408 *supra*.

⁴²⁴ *Weber v. SEC*, 222 F.2d 822, 823 (2d Cir. 1955), *cert. denied*, 350 U.S. 947 (1956) (sheets used as evidence); *Franklin Nat'l Bank v. L.B. Meadows & Co., Inc.*, 318 F. Supp. 1339, 1345-46 (E.D.N.Y. 1970) (lender can rely); *SEC v. Seaboard Sec. Corp.*, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,697, at 95,563 (S.D.N.Y. 1966) (sufficient proof in absence of contrary evidence); *SPECIAL STUDY* pt. 2, at 650 (use quotations in sheets if no contemporaneous cost); *cf. Merritt, Vickers, Inc. v. SEC*, 353 F.2d 293, 296-97 (2d Cir. 1965) (burden on broker to prove special circumstances), *aff'g SEC Securities Exchange Act Release No. 7409*, at 4-5 (Sept. 2, 1964) (permissible to use sheets); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 438 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (Securities Act § 17(a) and Exchange Act § 15(c)(1); concurrent prices and sheets permissible in absence of contrary evidence); *Samuel B. Franklin & Co.*, 38 S.E.C. 908, 910 (1959), *aff'd*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961) (appeal from NASD sanction; use quotations in sheets if no contemporaneous cost); *Mitchell Sec., Inc.*, 37 S.E.C. 178, 182 (1956) (NASD appeal; quotations in sheets prima facie proof); *Scott McIntyre & Co.*, 11 S.E.C. 442, 445 n.1 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; quotations in sheets some indication); *Allender Co.*, 9 S.E.C. 1043, 1054, 1057-58 (1941) (other general antifraud provisions invoked; persuasive indication although not conclusive).

⁴²⁵ In a case reviewing a NASD-imposed sanction, the SEC stated:

It seems clear that the propriety of using quotations as evidence of prevailing market price must be tested in the light of all relevant circumstances, e.g., the

Even when reference is made to the sheets or NASDAQ, the proper quotation must be chosen. Some cases refer simply to the asked quotations.⁴²⁷ When more than one asked figure appears, the rule seems to be that the higher asked governs.⁴²⁸ Although the respondent dealer would have been held to have violated the Rule in most reported cases regardless of which quotation was used,⁴²⁹ these distinctions do make a difference in planning future mark-ups.⁴³⁰

Some exceptions have developed to the high-asked-price rule, as, for example, when amounts paid for the security indicate that the high asked quotation is not reliable.⁴³¹ Also, when the high quote is placed by the dealer, it may not be controlling, since any charge to customers could be justified by raising the asked price to an arbitrary

nature of the security, the breadth of the market and whether it is independent of the dealer relying upon the quotations, the spread in the quotations, and the functions of the dealer.

Naftalin & Co., 41 S.E.C. 823, 828 (1964); see Gateway Stock & Bond, Inc., SEC Securities Exchange Act Release No. 8003, at 3 (Dec. 8, 1966) (quotation not generally tested by interdealer sales not reliable guide).

The converse occurs when salesmen of a firm do not realize that the quotations in the sheets are not an accurate reflection of the market. In that situation, the salesmen do not violate 10b-5. Cf. Langley-Howard, Inc., SEC Securities Exchange Act Release No. 7986, at 7 (Oct. 26, 1966) (NASD sanction appeal). Compare Mark E. O'Leary, SEC Securities Exchange Act Release No. 8361, at 7-9 (July 25, 1968).

⁴²⁶ Cf. Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 4 (Oct. 22, 1965) (appeal from NASD disciplinary action; quotations "likely to be subject to negotiation"); Naftalin & Co., 41 S.E.C. 823, 828 (1964) (review of NASD disciplinary proceedings; quotations subject to negotiation).

⁴²⁷ SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,697, at 95,563 (S.D.N.Y. 1966); cf. General Investing Corp., SEC Securities Exchange Act Release No. 7316, at 2 (May 15, 1964) (appeal from NASD decision; use representative quotations); Boren & Co., 40 S.E.C. 217, 220-21 (1960) (NASD review); United Sec. Corp., 15 S.E.C. 719, 725, 728 (1944).

⁴²⁸ This is the price most favorable to the dealer. Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965) (if respondent made no sales to other dealers on date of sale to customer, use highest sales price to other dealers on closest day or lowest inside asked price at time of sale to customer, whichever is less); cf. Managed Inv. Programs, 37 S.E.C. 783, 786 (1957) (NASD appeal); Mitchell Sec., Inc., 37 S.E.C. 178, 182 (1956); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 355 n.15 (1945) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; high exchange price for the day used in determining market price but SEC said that it "undoubtedly, for the most part, employ[es] a method too generous to the respondents").

⁴²⁹ Perhaps the most accurate indication of prevailing market is the mean between the low asked and the high bid quotations.

⁴³⁰ Broker-dealers can determine whether their customer prices are appropriate only if they can determine which price to use in computing the mark-up.

⁴³¹ Cf. Merritt, Vickers, Inc., SEC Securities Exchange Act Release No. 7409, at 5 (Sept. 2, 1964), *aff'd*, 352 F.2d 293 (2d Cir. 1965) (review of NASD proceeding; permissible to use "low ask" quotation because member's quotation was at most times only higher entry and purchase price showed it to be unreliable).

level.⁴³² Still another exception is recognized when the bulk of the quotations are on the asked side; a buyers' market then exists, and the quotes are merely for the purpose of negotiation.⁴³³

In addition to the issue of which price to use, the problem of which quotation sheet to employ has been discussed in two cases. In one involving a firm based in California, the SEC relied on the West Coast section of the National Quotation Bureau's sheets.⁴³⁴ In the second case, the proper sheets were held to be those dated the day of the dealer's sale to his customer, not those published on that date.⁴³⁵

When there is neither contemporaneous cost nor any quotation in the sheets or NASDAQ, the price of interdealer trades should be used to establish the prevailing market price. Without at least this minimal evidence, the SEC or a private party would find it extremely difficult to prove that a dealer's price was not reasonably related to the prevailing market.

Contemporaneous cost, or in its absence the high asked quotation in the sheets or on NASDAQ, is presumed to be the prevailing market price. This price is a prerequisite to ascertaining whether the mark-up charged by the dealer was fair.⁴³⁶ The mark-up or mark-down permissible under Rule 10b-5 must be determined on a case-by-case basis.⁴³⁷ The NASD, to which most brokerage firms belong, has adopted its own guidelines for the percentage mark-up and mark-down allow-

⁴³² Cf. Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 3-4 (Oct. 22, 1965).

⁴³³ Cf. J.A. Winston & Co., Inc., SEC Securities Exchange Act Release No. 7334, at 8 (June 5, 1964) (appeal from NASD sanction; purchase always made at or below the high, and usually the low, asked quotation).

⁴³⁴ Boren & Co., 40 S.E.C. 217, 220-21 (1960) (NASD appeal).

⁴³⁵ Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 3 (Oct. 22, 1965). The National Quotation Bureau receives quotations on Day 1 and publishes sheets containing those quotations on Day 2. However, the sheets published on Day 2 bear the date of Day 1, so sheets dated a particular day reflect quotations submitted on that day. It is reasonable to assume that quotations given early in the day are representative of the market for the rest of the day. *Id.*

⁴³⁶ Mark-ups are expressed in terms of a percentage. A dollar amount is not used. Although use of a percentage can be misleading when applied to a small dollar volume (*see* Samuel B. Franklin & Co., 38 S.E.C. 908 (1959), *aff'd*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961)), the percentages permitted may be higher.

The percentage is obtained by dividing the price charged the customer, less the prevailing market price, by the prevailing market price. *See* Mitchell Sec., Inc., 37 S.E.C. 178, 181 (1956). For example, a sale to a customer at \$11 when the prevailing market was \$10 would result in a 10% mark-up. Mark-downs are computed by dividing the prevailing market price, less the price the dealer paid the customer, by the price paid to the customer. *See* Clarence Earl Thornton, SEC Securities Exchange Act Release No. 7693, at 2 (Aug. 31, 1965).

⁴³⁷ Cf. Duker & Duker, 6 S.E.C. 386, 389 (1939).

able.⁴³⁸ While the NASD rules do not, of course, establish the limits of 10b-5, they do furnish a useful comparative scheme. The NASD's Rules of Fair Practice provide that a member acting as a dealer must trade at a fair price taking into account market conditions, expenses involved, and a reasonable profit for the dealer.⁴³⁹ The NASD's Board of Governors has interpreted this provision to mean that "[u]nder certain circumstances a mark-up in excess of 5 percent may be justified, but on the other hand, 5 percent or even a lower rate is by no means always justified."⁴⁴⁰ The Board also noted that the five percent figure is only a guideline, not a rule, and cannot be used to justify excessive expenses. It observed that a number of factors are relevant in determining the size of a permissible mark-up: common stock may justify a greater percentage than a bond; an inactive security may allow for a higher mark-up; the mark-up generally increases as the security's price decreases; a larger percentage may be permissible when the dollar volume of the transaction is small; disclosure of the mark-up bears on its reasonableness; and the nature of the dealer's business and costs may justify greater mark-ups.⁴⁴¹ The five percent NASD guide

⁴³⁸ See note 20 and accompanying text *supra* (private rights of action implied under the NASD rules).

Firms which are not members of the NASD are under similar restrictions by virtue of Exchange Act Rule 15b10-2, 17 C.F.R. § 240.15b10-2 (1972), which requires that they "observe high standards of commercial honor and just and equitable principles of trade."

⁴³⁹ NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154.

⁴⁴⁰ *Id.*

⁴⁴¹ *Id.* The Board further construed the Association's rules to be applicable to trades where the dealer is at risk, to riskless purchases and sales, and to exchanges of securities, but not to sales under a prospectus or offering circular. *Id.*

Generally speaking, expenses out of the ordinary in connection with the sale should justify a somewhat larger mark-up. However, respondents have been singularly unsuccessful in arguing this point. See Paul Carroll Ferguson, 39 S.E.C. 260, 263 (1959) (no special services shown); William Harrison Keller, Jr., 38 S.E.C. 900, 906 (1959) (no showing of unusual expenses or services); cf. Kenneth B. Stucker Inv. Sec., SEC Securities Exchange Act Release No. 7823, at 3-4 (Feb. 15, 1966) (review of NASD disciplinary action; rejecting services primarily related to promotion and sale of issuer's stock); Thill Sec. Corp., SEC Securities Exchange Act Release No. 7342, at 9-11 (June 11, 1964) (NASD appeal; conferences to develop business, driving to and from customers' homes, and research on actively traded securities not sufficient; abnormal analysis time spent should have been the subject of a separate contract); General Investing Corp., SEC Securities Exchange Act Release No. 7316, at 5 (May 15, 1964) (rejecting argument that expenses of large inventory and expenses incurred in extensive solicitation efforts justify mark-ups where same securities generally available from other brokers); Midland Sec., Inc., 40 S.E.C. 333, 335, 338 (1960) (review of NASD sanction; expenses cannot justify excessive mark-up; SEC classified the following services as not "unusual": maintaining a ready market, not charging customers a commission for selling stock used in payment for purchases, accepting collect long-distance telephone charges, and, without cost to customers, keeping certificates and

does not apply to 10b-5 proceedings, and may in fact be a stricter standard than any requirement imposed by the Rule;⁴⁴² yet, ten percent mark-ups are clearly beyond the Rule's permissible limits.⁴⁴³

Dealers caught violating the implied representation that their prices are reasonably related to the prevailing market have interposed a number of defenses. The representation may, according to the Commission, "be obviated either by the independent knowledge of the customer or by full and complete disclosure of facts and circumstances which will permit the customer to decide whether or not the transaction should be completed."⁴⁴⁴ Mere constructive knowledge of the

breaking certificates into smaller numbers of shares at actual cost); Samuel B. Franklin & Co., 38 S.E.C. 908, 912 (1959), *aff'd*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961) (NASD appeal; no evidence of special circumstances to justify greater mark-up "such as unusual expenses in connection with particular transactions [or] extraordinary services rendered to customers"); SPECIAL STUDY pt. 2, at 648 (in NASD proceedings involving riskless transactions, can take into account "expenses of checking markets, solicitation of order and research or other advisory services," but these expenses cannot be excessive).

⁴⁴² In a NASD appeal, the Commission held that "an undisclosed mark-up which is not so excessive as to constitute fraud [under the Rule] might nevertheless violate business ethics [and hence the NASD Rules]." Herrick, Waddell & Co., Inc., 25 S.E.C. 437, 446 (1947).

⁴⁴³ Arnold Sec. Corp., SEC Securities Exchange Act Release No. 7813, at 5 n.9 (Feb. 7, 1966) ("mark-ups of more than 10% are unfair even in the sale of low-priced securities").

Mark-downs in the securities industry are traditionally less than mark-ups. See generally Costello, Russotto & Co., SEC Securities Exchange Act Release No. 7729, at 5 n.15 (Oct. 22, 1965); Thill Sec. Corp., SEC Securities Exchange Act Release No. 7342, at 8 n.1 (June 11, 1964); SPECIAL STUDY pt. 2, at 626-27. The permissible percentage for mark-downs may therefore be less than that allowed for mark-ups, all other factors being equal.

The SEC's view that mark-ups of 5.2% to 7.7% were illegal was not contested in one case. See Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 24 (Nov. 12, 1965) (workout market). Other relatively low mark-ups which have been condemned include: 8.5% to 78.9% (E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 357-58 (1945)) and 5.4% to 22.7% (Shearson, Hammill & Co., *supra* at 24). The spread between other dealers' bid and asked quotations on the day in issue are not evidence of a reasonable mark-up. Cf. Samuel B. Franklin & Co., 38 S.E.C. 908, 911-12 (1959), *aff'd*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961).

⁴⁴⁴ Alexander Smith, 22 S.E.C. 13, 17 (1946). See generally Paul Carroll Ferguson, 39 S.E.C. 260, 263 (1959) (fraud to charge unreasonable price without disclosure); William Harrison Keller, Jr., 38 S.E.C. 900, 905 (1959) (implied representation arises in absence of disclosure); cf. William J. Stelmack Corp., 11 S.E.C. 601, 622 (1942) (cure by charging correct price or disclosing); Jack Goldberg, 10 S.E.C. 975, 980 (1942) (cure by reasonable price or disclosure); Duker & Duker, 6 S.E.C. 386, 389 (1939) (avoid fraud by disclosure or reasonable price).

In Arleen W. Hughes, 27 S.E.C. 629, 639-40 (1948), an investment adviser was disciplined for selling securities to her clients without disclosing either the best price obtainable or the cost of the securities. The Commission rejected the argument that a clause in a contract was sufficient and held that disclosure must be "clear enough so that a client is fully apprised of the facts and is in a position to give his informed consent." The Court of Appeals agreed. 174 F.2d 969, 976 (D.C. Cir. 1949).

In contrast to the federal securities antifraud provisions (Securities Act § 17(a), 15

prices, e.g., when they are published in newspapers, or mere access to market information is insufficient to overcome the implied representation.⁴⁴⁵ Nor has the SEC permitted dealers to increase their mark-up on sales for the purpose of recouping losses sustained in purchases from their customers,⁴⁴⁶ or to escape discipline if the mark-up on some sales was fraudulent (even though the average mark-up was not excessive).⁴⁴⁷ Other unsuccessful defenses which have been argued⁴⁴⁸ are: the securities were of good quality,⁴⁴⁹ the customer's financial position was improved,⁴⁵⁰ the intrinsic value of the security was higher than market,⁴⁵¹ and the customers ratified the transactions.⁴⁵²

U.S.C. § 77q(a) (1970), and Exchange Act Rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1972)), under the NASD rules disclosure is only one element to be considered when a matter of business ethics is concerned. See note 441 and accompanying text *supra*. See also Herrick, Waddell & Co., Inc., 25 S.E.C. 437, 446 (1947) (NASD proceeding in which mark-up disclosed); Thill Sec. Corp., SEC Securities Exchange Act Release No. 7342, at 10 (June 11, 1964) (appeal from NASD sanction; disclosure made).

⁴⁴⁵ See William Harrison Keller, Jr., 38 S.E.C. 900, 906 (1959) (customer entitled to rely on implied representation even if he has access to market information); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 362 (1945) (construing Securities Act § 17(a) and Exchange Act Rule 15c1-2; customers could have ascertained true spread since most bonds listed on New York Stock Exchange and prices reported in newspapers, but mere access to information does not overcome implied representation); United Sec. Corp., 15 S.E.C. 719, 727 (1944) ("any person, regardless of his knowledge of the market or his access to market information, is entitled to rely on the implied representation . . . that customers will be treated fairly").

⁴⁴⁶ Cf. E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 363-64 (1945) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; invalidates part of scheme to maintain customer's confidence); Trost & Co., Inc., 12 S.E.C. 531, 534-35 (1942) (violation when unreasonable prices charged in individual transactions).

⁴⁴⁷ William Harrison Keller, Jr., 38 S.E.C. 900, 906 (1959) (inappropriate to determine mark-up on average basis); cf. E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 370 (1945) (must look at each transaction individually); United Sec. Corp., 15 S.E.C. 719, 728 (1944) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; do not average since dealer should act fairly at all times); Trost & Co., Inc., 12 S.E.C. 531, 535 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2); William J. Stelmack Corp., 11 S.E.C. 601, 622 (1942) (do not use average mark-up since can conceal excessive mark-ups in average).

⁴⁴⁸ A purported justification based upon a dealer's risk-taking was rejected as insubstantial in SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,597, at 95,564 (S.D.N.Y. 1964). Although a firm's right to a profit is one factor to be considered under the NASD rules (see Boren & Co., 40 S.E.C. 217, 220 (1960)), a firm's losses cannot justify unreasonable mark-ups under 10b-5. See Arnold Sec. Corp., SEC Securities Exchange Act Release No. 7813, at 5-6 (Feb. 7, 1966). It is no defense that other dealers are charging excessive mark-ups. Cf. Amsbury, Allen & Morton, Inc., SEC Securities Exchange Act Release No. 7834, at 4 (March 7, 1966) (NASD appeal).

⁴⁴⁹ Cf. William J. Stelmack Corp., 11 S.E.C. 601, 622 (1942).

⁴⁵⁰ See E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 373 (1945) ("yields and profits to the funds do not provide a defense"); cf. William J. Stelmack Corp., 11 S.E.C. 601, 622 (1942).

⁴⁵¹ Mitchell Sec., Inc., 37 S.E.C. 178, 181-82 (1956).

⁴⁵² Cf. Trost & Co., Inc., 12 S.E.C. 531, 538 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; not understood by them).

A brokerage firm can violate 10b-5 not only as a dealer in the over-the-counter market, but also when acting as an over-the-counter agent. The firm bears the same responsibilities whether acting as a broker-agent⁴⁵³ or as the implied agent for the customer.⁴⁵⁴ As an agent, the broker must obtain the best possible price for the customer,⁴⁵⁵ and cannot receive any remuneration beyond that agreed to by his principal, the customer.

The issue is not the reasonableness of a broker's compensation, as was the case with an over-the-counter dealer,⁴⁵⁶ but is whether any profits have been concealed from the customer.⁴⁵⁷ Brokers have obtained secret profits by misrepresenting the purchase or sale price,⁴⁵⁸

⁴⁵³ When acting as a broker, the firm stands in the classic principal-agent relationship with its customers. Harry Marks, 25 S.E.C. 208, 215 (1947); *cf.* NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154 (applies to broker-dealer acting as agent or dealer).

⁴⁵⁴ Although buying or selling for its own account, the firm is deemed an agent if it has its customer's trust and confidence. *Norris & Hirschberg, Inc. v. SEC*, 177 F.2d 228, 231-32 (D.C. Cir. 1949), *aff'g* 21 S.E.C. 865 (1946) (implied agency); *Herbert R. May & Russell H. Phinney*, 27 S.E.C. 814, 830 (1948) (implied agency due to trust); *cf.* *Trost & Co., Inc.*, 12 S.E.C. 531, 536 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; firm instructed to act as agent but acts as principal); *Allender Co.*, 9 S.E.C. 1043, 1054 (1941). A riskless transaction—where the broker does not sell from inventory—does not involve an implied agency relationship. *Knauss*, *supra* note 11, at 639 n.133. For a discussion of the implied agency theory, see notes 70-71 and accompanying text *supra*.

⁴⁵⁵ *Sinclair v. SEC*, 444 F.2d 399, 400 (2d Cir. 1971); *Thompson & McKinnon*, SEC Securities Exchange Act Release No. 8310 (May 8, 1968); *Herbert R. May & Russell H. Phinney*, 27 S.E.C. 814, 830 (1948); *Oxford Co.*, 21 S.E.C. 681, 690 (1946); *cf.* *R.D. Bayly & Co.*, 19 S.E.C. 773, 786-87 (1945)

⁴⁵⁶ Excessive compensation would, however, raise problems under the NASD rules even if disclosed. NASD Rules of Fair Practice Art. III, § 4, CCH NASD SEC. DEALERS MANUAL ¶ 2154.

⁴⁵⁷ *Moore & Co.*, 32 S.E.C. 191, 195 (1951); *Arleen W. Hughes*, 27 S.E.C. 629, 637 n.11 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949) (any profit, in the absence of disclosure, is secret profit); *Harry Marks*, 25 S.E.C. 208, 215 (1947) (had to divulge all profit except commission unless customer informed; self-preferment case); *Oxford Co.*, 21 S.E.C. 681, 688-93 (1946); *cf.* *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) (Securities Act § 17(a) and Exchange Act § 15(c)(1); all undisclosed profits forfeited). Therefore, a broker cannot defend an absence of disclosure by proving that the price charged the customer was reasonably related to the market. *Arleen W. Hughes*, *supra* at 637 n.11.

⁴⁵⁸ *Investment Registry of America, Inc.*, 21 S.E.C. 745, 755-56 (1946); *cf.* *Scott McIntyre & Co.*, 11 S.E.C. 422, 444 (1942) (lies in 70% of agency transactions).

A number of dealer cases have held that the price quoted by a broker or a dealer carries with it an implied representation that such a price is reasonably related to the prevailing market. *See William J. Stelmack Corp.*, 11 S.E.C. 601, 621-22 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2); *Jack Goldberg*, 10 S.E.C. 975, 980 (1942). This certainly has less effect in the case of a broker where any compensation will previously have been disclosed and agreed upon. *Cf.* notes 401-03 *supra*.

overcharging commissions,⁴⁵⁹ and billing customers too much for incidental expenses.⁴⁶⁰ A broker is insulated from liability for generating secret profits, however, if prior to the transaction there is full disclosure to the customer, in a clear and understandable manner, of the nature and extent of the broker's compensation.⁴⁶¹ As with an over-the-counter dealer, a broker is not exonerated merely because his clients suffered no injury.⁴⁶²

Securities exchanges usually handle trading not done in the over-the-counter market. A customer desiring to purchase or sell on an exchange engages a broker to act as his agent. There is little authority relating to brokers' secret profits derived from trading on an exchange, but the rules pertaining to over-the-counter brokers arguably should apply with equal force.⁴⁶³

When firms act as underwriters, rather than as brokers or dealers, they can also violate the Rule by selling shares at an offering price⁴⁶⁴ not reasonably related to the actual market price or by substituting their own shares for the securities to be underwritten.⁴⁶⁵ These activi-

⁴⁵⁹ Cf. Scott McIntyre & Co., 11 S.E.C. 442, 444 (1942) (overcharges on commissions). On the other hand, occasional mistakes (*see* General Sec. Corp., 18 S.E.C. 635, 636 (1945) (ten instances in four years aggregating less than \$15)) or commissions equal to less than the comparable rate on an exchange (*cf.* Boren & Co., 40 S.E.C. 217, 221 (1960) (NASD sanction reviewed)) will not form the basis of a disciplinary action.

⁴⁶⁰ Investment Registry of America, Inc., 21 S.E.C. 745, 755-56 (1946) (deducting excess charges for interest, brokerage commission, taxes, and postage); *cf.* Scott McIntyre & Co., 11 S.E.C. 442, 444 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; overstated charges).

⁴⁶¹ Arleen W. Hughes, 27 S.E.C. 629, 639 (1948) (clear disclosure before completion of transaction), *aff'd*, 174 F.2d 969, 976 (D.C. Cir. 1949) (disclosure not sufficient where clients did not understand); Moore & Co., 32 S.E.C. 191, 196 (1951) (need customer's "informed consent based upon a full disclosure of every vital particular touching the transaction"). Accordingly, partial disclosure is insufficient. *Cf.* Allender Co., 9 S.E.C. 1043, 1054 (1941) (Securities Act § 17(a) and Exchange Act Rule 15c1-2; customer's knowledge that some profits were made not enough). Concerning the minimum disclosure of compensation, *see* William J. Stelmack Corp., 11 S.E.C. 601, 619-20 (1942).

Exchange Act Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1972), requires an over-the-counter broker to disclose, at or before the completion of any transaction, the source and amount of his commission or other remuneration.

⁴⁶² Hughes v. SEC, 174 F.2d 969, 974 (D.C. Cir. 1949) (broker-dealer disciplined even though no client injured and majority of clients filed brief with court stating that they understood arrangement).

⁴⁶³ In E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 355-75 (1945), the SEC treated over-the-counter bonds and listed bonds similarly and used the high exchange price for the day to compute mark-ups although noting that this was undoubtedly too generous to respondent. *Id.* at 355 n.15; *accord*, United Sec. Corp., 15 S.E.C. 719, 726-28 (1944) (over-the-counter and exchange treated together; high sale or high offer price used).

⁴⁶⁴ Indiana State Sec. Corp., 38 S.E.C. 118, 120-21 (1957) (implied representation that offering price reasonably related to market).

⁴⁶⁵ *Cf.* David Joel Benjamin, 38 S.E.C. 614, 618 (1958) (Securities Act § 17(a) and Exchange Act § 15(c)(1)).

ties give the appearance more of misrepresentation than implied representation.⁴⁶⁶

Another method broker-dealers have used to gain illegal compensation is "interpositioning," whereby a broker acting for a customer buys from or sells to another firm which is not a major source of the security, and which nets out the transaction by selling to or buying from the primary source.⁴⁶⁷ If interpositioning is proved, both the initiating and the interposed firms may be disciplined.⁴⁶⁸ Although interpositioning usually involves over-the-counter transactions with a firm which is not a market maker,⁴⁶⁹ the doctrine also applies to sales of listed securities to an over-the-counter firm in the third market.⁴⁷⁰ Generally, if not invariably, the initiating firm receives a benefit from either the interposed firm or a third party.⁴⁷¹ Proof of the benefit should not be necessary to make out a 10b-5 violation if

⁴⁶⁶ See generally notes 157-232 and accompanying text *supra* (broker misrepresentation).

In *SEC v. Guaranty Bond & Sec. Corp.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,928 (M.D. Tenn. 1971), an underwriter was enjoined from concealing from his customers that he was pocketing the difference between the sums left with him by the customers and the 5% interest he paid.

⁴⁶⁷ The interposed firm can act either as an agent or a principal, but in either case any charge is absorbed by the original customer. SPECIAL STUDY pt. 2, at 620.

⁴⁶⁸ *Sinclair v. SEC*, 444 F.2d 399, 401 (2d Cir. 1971) (employee of initiating broker); *Hoit, Rose & Co.*, SEC Securities Exchange Act Release No. 8563, at 2 (April 7, 1969) (interposed firm disciplined); *Folger, Nolan, Fleming & Co., Inc.*, SEC Securities Exchange Act Release No. 8489 (Jan. 8, 1969) (initiating firm violates the Rule); *Thompson & McKinnon*, SEC Securities Exchange Act Release No. 8310, at 3-4 (May 8, 1968) (initiating firm disciplined); *Delaware Management Co.*, SEC Securities Exchange Act Release No. 8128 (July 19, 1967) (initiating firm violates Rule); cf. *W.K. Archer & Co.*, 11 S.E.C. 635, 642-43 (1942), *aff'd*, 133 F.2d 795, 800 (8th Cir.), *cert. denied*, 319 U.S. 767 (1943) (interposed dealer).

In *George A. Brown*, SEC Securities Exchange Act Release No. 8160, at 4-5 (Sept. 19, 1967), a broker was exonerated from an interpositioning charge when it was shown that the interposed firm often turned down the offer to act as intermediary, the initiating firm frequently checked the primary source of the security (in this case, an exchange) to see if it was getting the best price, most covering transactions took place after the interposed dealer bought the security, and the interposed firm had losses on many trades. Compare *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971) (no proof shown of due diligence to ascertain best price).

⁴⁶⁹ *Folger, Nolan, Fleming & Co., Inc.*, SEC Securities Exchange Act Release No. 8489 (Jan. 8, 1969); *Thompson & McKinnon*, SEC Securities Exchange Act Release No. 8310, at 3-4 (May 8, 1968).

⁴⁷⁰ *George A. Brown*, SEC Securities Exchange Act Release No. 8160, at 4-5 (Sept. 19, 1967) (charges dismissed). The interposed firm then covers its activities by selling or buying on the exchange. In the third market, listed securities are sold off the exchange much like their over-the-counter counterparts.

⁴⁷¹ The benefit can take any number of forms. See, e.g., *Hoit, Rose & Co.*, SEC Securities Exchange Act Release No. 8563, at 2 (April 7, 1969) (cash payment by interposed firm and referral of its business); *Folger, Nolan, Fleming & Co., Inc.*, SEC Securities Exchange Act Release No. 8489 (Jan. 8, 1969) (reciprocal interposing agreement; kick-back

the customer is injured by not receiving the best price.⁴⁷² The mere presence of any such undisclosed benefit, however, should suffice to render the interpositioning illegal, without a showing of harm to the customer.⁴⁷³ In most cases the interposed broker garners a profit, but this need not be a prerequisite to a violation if either the customer is harmed or the initiating broker receives a benefit.⁴⁷⁴

Still another 10b-5 violation occurs when a broker receives a customer's order to sell a security but, sensing an imminent decline in the market, delays the sale and instead dumps his own stock.⁴⁷⁵ The same rationale should apply in a rising market where the broker puts aside purchases for customers in order to increase his own inventory. It is also illegal for a broker to induce his customers to purchase a security while he is unloading his own interest in that stock.⁴⁷⁶

A firm may realize illegal compensation when it ostensibly acts as agent for a customer, but deals with another party who is in fact one of its partners or employees, or a dummy representing their interests.⁴⁷⁷

to initiating firm's employee); Thompson & McKinnon, SEC Securities Exchange Act Release No. 8310, at 3-4 (May 8, 1968) (to reciprocate for listed business referred to it by interposed firms, to reward such firms for furnishing services to respondent, and to get business of mutual fund); Delaware Management Co., SEC Securities Exchange Act Release No. 8128 (July 19, 1967) (incentive to mutual fund salesmen to sell more).

⁴⁷² Thompson & McKinnon, SEC Securities Exchange Act Release No. 8310, at 4 (May 8, 1968) (prima facie violation of 10b-5 if interposes another broker-dealer; burden on respondent to show he obtained best price for the customer).

⁴⁷³ In Thompson & McKinnon, SEC Securities Exchange Act Release No. 8310, at 4 n.7 (May 8, 1968), the Commission suggested that concealment of interpositioning may be an independent violation of the Rule. The Second Circuit found it could avoid the issue of whether interpositioning is illegal per se in the absence of harm to customers. *Sinclair v. SEC*, 444 F.2d 399, 401 (2d Cir. 1971).

⁴⁷⁴ An interposed broker's losses are, however, an indication that the customer is receiving the best price. See George A. Brown, SEC Securities Exchange Act Release No. 8160, at 4 (Sept. 19, 1967).

⁴⁷⁵ *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 670-76 (S.D.N.Y.), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966) (securities of firm sold and private right of action sustained); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 11-15 (Nov. 12, 1965) (sales of shares of firm and those of employees). Delaying execution of an order is itself a 10b-5 violation. See notes 493-95 and accompanying text *infra*.

⁴⁷⁶ *Reynolds & Co.*, 39 S.E.C. 902, 913 (1960). The Rule should also be considered breached if it were the firm's stock instead. This activity, though, again shades into the misrepresentation area. See *Silverman v. Bear, Stearns & Co.*, 331 F. Supp. 1334 (E.D. Pa. 1971) (plaintiff's claim that broker did not sell plaintiff out in order to avoid depressing market and injuring broker's holdings, when combined with representation to sell plaintiff's securities in a declining market, stated a cause of action); *Butcher & Sherrerd*, Summary of Order for Public Proceeding, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,466 (Nov. 24, 1971).

⁴⁷⁷ *Alm & Co.*, 36 S.E.C. 279, 280-81 (1955) (partner as executor sells securities of estate indirectly to respondent firm which sells to customers; partner buys from the

Finally, the obverse of such cases will also constitute a violation; a broker may not pay a rebate to an employee of a customer.⁴⁷⁸

The remedies of a customer whose broker-dealer has engaged in the practices just discussed are not yet clearly defined. There should be little doubt, however, as to a customer's right to recover any damages suffered by him arising out of the broker's conduct.

estate for himself, sells to respondent which sells to customers); Henry Marks, 25 S.E.C. 208, 214 (1947) (sales from account in broker's wife's name and fictitious name to customers); Burley & Co., 23 S.E.C. 461, 463-66 (1946) (sales from partner's account through another brokerage firm to broker for customers; purchases by customers from and sales by them to account established for the two firms); General Sec. Corp., 18 S.E.C. 635, 636 (1945) (sales by customers to broker's wife without disclosure to customer); cf. R.D. Bayly & Co., 19 S.E.C. 773 (1945) (Exchange Act Rule 15c1-2; partner buys from clients and sells to third party). See also notes 467-74 and accompanying text *supra* (interpositioning and rebates).

In George J. Wunsch, SEC Securities Exchange Act Release No. 8714 (Oct. 7, 1969), a group of enterprising brokerage firm employees set up a series of elaborate schemes to defraud their employers: (1) Wunsch had his firm sell securities at or near the low price on a day to his secret account which then, in turn, sold them to an associate's firm at or near the day's high price, and his associates did the same; (2) he caused his firm to trade with a dealer so that the dealer made substantial profits, part of which were rebated to Wunsch; and (3) he caused his employer to sell securities to another broker-dealer, who sold them to Wunsch's account, bought them back at a profit, and finally resold them to the employer or another brokerage firm.

In Bethel, Johnsen & Co., 26 S.E.C. 163, 165 (1947), a brokerage firm was held to have violated the Rule when it sold stock from customers' accounts, used the proceeds to buy securities for its own account, and then resold those securities to its customers at a profit.

See generally Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 443 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202, 1210-11 (9th Cir. 1970) (salesman's offer personally to buy back shares from customer at her cost without disclosing three-fold increase sufficient to permit damage action).

⁴⁷⁸ Junger, Anderson & Co., 31 S.E.C. 747, 750 (1950) (one-half of investment company's commissions funneled through dummy account to one of its employees); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 382-86 (1945) (rebates sent to brother of broker who worked for customer; brother requested that broker increase price of securities and this should have alerted broker); cf. Herbert L. Honohan, 13 S.E.C. 754, 759-60 (1943) (construing Exchange Act Rules 10b-3 and 15c1-2; payments to traders in other firms for diverting business to respondent or selling to respondent at price so low that respondent could make large profit on resale). See also cases involving interpositioning discussed in notes 467-74 and accompanying text *supra*.

This borders on the area of give-ups, where, for example, a mutual fund directs the executing broker to give part of his commission on the trade to another broker. The give-up ultimately rebounds to the benefit of the fund's officers or adviser in violation of 10b-5. See Winfield & Co., Inc., SEC Securities Exchange Act Release No. 9478 (Feb. 9, 1972) (broker is aider and abettor); Provident Management Corp., SEC Securities Exchange Act Release No. 9028 (Dec. 1, 1970) (broker aided violation); Arthur Lipper Corp., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,126 (June 11, 1971) (initial decision of hearing examiner). See generally Bernard Cornfeld, SEC Securities Exchange Act Release No. 9094 (March 1, 1971) (directing fund's give-ups to underwriter violation of 10b-5).

D. Other Actions In Connection With a Customer's Order

A broker-dealer, by virtue of the shingle theory,⁴⁷⁹ impliedly represents that he is solvent whenever he confirms trades, or solicits or accepts purchase or sale orders. Engaging in business while insolvent therefore violates 10b-5.⁴⁸⁰ Cases sometimes refer to insolvency only as an inability to meet debts as they become due,⁴⁸¹ or in the sense that assets are less than liabilities,⁴⁸² but the majority of opinions rely on both definitions.⁴⁸³ The SEC has occasionally indicated that transacting business while in violation of the New York Stock Exchange's net capital requirements also constitutes a breach of the Rule.⁴⁸⁴ By analogy, a broker engaging in business while not conforming to the SEC's own net capital rule⁴⁸⁵ should run afoul of 10b-5. The Commission has also held that a broker-dealer contravened 10b-5 by effecting transactions while his books and records were confused.

⁴⁷⁹ See notes 45-69 and accompanying text *supra*. The implied agency theory of liability would also seem to be applicable in at least some of the situations discussed herein. See notes 70-71 and accompanying text *supra*.

⁴⁸⁰ *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Fliederbaum, Mooradian & Co.*, SEC Securities Exchange Act Release No. 7176, at 1 (Nov. 29, 1963); *D. Earle Hensley Co.*, 40 S.E.C. 849, 852 n.1 (1961); *Thompson & Sloan, Inc.*, 40 S.E.C. 451, 454 (1961); *Earl L. Robbins*, 39 S.E.C. 847, 849 (1960); *Harvey H. Shields, Jr.*, 39 S.E.C. 608, 609 (1959); *Joseph J. Wilensky & Co.*, 39 S.E.C. 327, 329 (1959); *Abraham Rosen*, 39 S.E.C. 268, 270 (1959); *John D. Ferris*, 39 S.E.C. 116, 119 (1959); *Gill-Harkness & Co.*, 38 S.E.C. 646, 651 (1958); *Batkin & Co.*, 38 S.E.C. 436, 446 (1958).

⁴⁸¹ *Brennan v. Midwestern United Life Ins. Co.*, 286 F. Supp. 702, 705, 707 (N.D. Ind. 1968), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *W.F. Coley & Co.*, 31 S.E.C. 722, 726, 728 (1950); *Harold G. Wise*, 29 S.E.C. 542, 543-44 (1949).

⁴⁸² *Acmerge Sec. Co.*, SEC Securities Exchange Act Release No. 7962, at 1 (Sept. 26, 1966); *Joseph J. Wilensky & Co.*, 39 S.E.C. 327, 329 (1959); *cf. R.G. Williams & Co., Inc.*, 39 S.E.C. 928, 929-30 (1960).

⁴⁸³ *SEC v. Raymond, Bliss, Inc.*, 4 SEC Jud. Dec. 834 (D. Mass. 1946); *SEC v. Financial Serv., Inc.*, 4 SEC Jud. Dec. 480 (S.D. Ind. 1945); *Fliederbaum, Mooradian & Co.*, SEC Securities Exchange Act Release No. 7176, at 1 (Nov. 29, 1963); *Thompson & Sloan, Inc.*, 40 S.E.C. 451, 454 (1961); *Harvey H. Shields, Jr.*, 39 S.E.C. 608, 609 (1959); *Abraham Rosen*, 39 S.E.C. 268, 270 (1959); *Batkin & Co.*, 38 S.E.C. 436, 446 (1958); *Cobb & Co.*, 38 S.E.C. 166, 167 (1958); *Strousse, Thomas & Whelan, Inc.*, 29 S.E.C. 297, 298 (1949).

⁴⁸⁴ *Joseph V. Shields, Jr.*, SEC Securities Exchange Act Release No. 8484, at 2 (Jan. 3, 1969); *see SEC v. Charles Plohn & Co.*, 433 F.2d 376, 379 (2d Cir. 1970); *Pickard & Co., Inc.*, SEC Securities Exchange Act Release No. 8447, at 2 (Nov. 14, 1968) (violation of 10b-5 and other rules for, *inter alia*, noncompliance with NYSE financial requirements).

⁴⁸⁵ Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1972).

A broker selling securities of his own enterprise must disclose violations of the Commission's net capital rule. *See* note 229 and accompanying text *supra*.

⁴⁸⁶ *Joseph V. Shields, Jr.*, SEC Securities Exchange Act Release No. 8484, at 2 (Jan. 3, 1969); *Acmerge Sec. Co.*, SEC Securities Exchange Act Release No. 7962, at 1 (Sept. 26, 1966); *see Pickard & Co., Inc.*, SEC Securities Exchange Act Release No. 8447, at 2 (Nov.

The Rule also prohibits misleading confirmations.⁴⁸⁷ Accordingly, a confirmation must accurately state the amount to which the customer is entitled and the transaction to which it relates must be authorized.⁴⁸⁸ Failing to deliver a confirmation or delivering it when no trade was made is also a transgression of the Rule.⁴⁸⁹

Distinct from but related to confirmation violations are instances of unauthorized trading. A stockbroker breaches the Rule if he executes a trade for a customer's account either without any authority⁴⁹⁰ or in excess of his limited authority.⁴⁹¹ The shingle theory is again the source of these prohibitions.⁴⁹²

14, 1968) (books not current, and this and other acts constituted violations of 10b-5 and other provisions).

⁴⁸⁷ A confirmation is a document delivered by a broker-dealer to a customer disclosing the terms of a completed transaction. Exchange Act Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1972), also governs confirmations. It requires a broker or dealer, at or before the completion of a transaction, to give the customer a written confirmation.

⁴⁸⁸ L.B. Sec. Corp., SEC Securities Exchange Act Release No. 7806, at 3 n.4 (Jan. 28, 1966) (dictum) (confirmation to initiate order, commonly called "wooden order," violates 10b-5); Shelley, Roberts & Co., 38 S.E.C. 744, 751 (1958) (confirmations of unauthorized sales false since confirmation is representation of effective orders or authority); First Anchorage Corp., 34 S.E.C. 299, 303-04 (1952) (confirmation false since secret profit not reflected; also false since transactions unauthorized and confirmation impliedly represents existence of antecedent orders); D.S. Waddy & Co., 30 S.E.C. 367, 369 (1949) (falsely stating amount realized on sale). *See also* William I. Hay, 19 S.E.C. 397, 409, 410 (1945) (confirmation "carried with it the implication that the purchase had been made in full adherence to brokerage principles" and "that a security in actual existence, received or receivable in due course, has been purchased"); R.D. Bayly & Co., 19 S.E.C. 773, 785, 787 (1945) (Exchange Act Rule 15c1-2; failure to disclose secret profit). *But see* Schraufuagel v. Broadwall Sec., Inc., [1966-67 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,827 (S.D.N.Y. 1966) (no recovery for damages suffered when confirmation sent out on unauthorized transaction because plaintiff did not rely); General Sec. Corp., 18 S.E.C. 635, 636 (1945) (two understatements of proceeds received from sales during four-year period and amounting to less than \$15 held inadvertent errors).

⁴⁸⁹ W.F. Coley & Co., 31 S.E.C. 722, 724 (1950); D.S. Waddy & Co., 30 S.E.C. 367, 368 (1949) (confirming when no transaction took place); H.F. Schroeder & Co., 27 S.E.C. 833, 835, 838 (1948) (failure to confirm); *cf.* Goodman v. H. Hentz & Co., 265 F. Supp. 440, 444 (N.D. Ill. 1967) (false representation that purchase made); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 375, 378 (1945) (Exchange Act Rule 15c1-2; absence of confirmation).

⁴⁹⁰ Kavitt v. A.L. Stamm & Co., [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,915 (S.D.N.Y. 1967) (do not dismiss allegation of unauthorized short sale); Amalgamated Inv., Inc., SEC Securities Exchange Act Release No. 8253, at 1 (Feb. 9, 1968) (sales without authority and other securities substituted); L.B. Sec. Corp., SEC Securities Exchange Act Release No. 7806, at 3 (Jan. 28, 1966) (dictum); R.A. Holman & Co., Inc., SEC Securities Exchange Act Release No. 7770, at 10 (Dec. 15, 1965), *aff'd*, 366 F.2d 446 (2d Cir. 1966), *modified on other grounds*, 377 F.2d 665 (2d Cir.), *cert. denied*, 389 U.S. 991 (1967); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 30 (Nov. 12, 1965); J. Logan & Co., 41 S.E.C. 88, 98 (1962), *aff'd per curiam sub nom.* Hersli v. SEC, 325 F.2d 147 (9th Cir. 1963), *cert. denied*, 377 U.S. 937 (1964); Thompson & Sloan, Inc., 40 S.E.C. 451, 454 (1961); Reynolds & Co., 39 S.E.C. 902, 909 (1960); Shelley, Roberts & Co., 38 S.E.C. 744, 751 (1958); Looper & Co., 38 S.E.C. 294, 297, 301 (1958) (together with churning

Still another broker practice condemned under the shingle theory is the failure of a broker to execute his customer's order promptly in accordance with trade custom.⁴⁹³ An insight into the speed with which a broker must usually act can be gleaned from a case in which the SEC concluded, on rather atypical facts, that a three-day delay was permissible.⁴⁹⁴ The acceptable time delay is flexible. An hour or even a matter of minutes might be inexcusable for a small block of an actively traded, volatile security if communications facilities were readily available. Conversely, a week or two would not seem unreasonable for a very large block of a little-known and only sporadically traded security. With the added element of interference by the broker with the customer's property, a delayed execution becomes a misappropriation by the broker of his customer's funds (in the case of a buy order) or securities (in the case of a sell order).⁴⁹⁵

and secret profits); First Anchorage Corp., 34 S.E.C. 299, 301-04 (1952); D.S. Waddy & Co., 30 S.E.C. 367, 368 (1949). See generally *Armstrong, Jones & Co. v. SEC*, 421 F.2d 359, 363-64 (6th Cir.), cert. denied, 398 U.S. 958 (1970) (underwriter cannot confirm purchases without at least true indication of interest from customer); Stephen Goldberg, SEC Securities Exchange Act Release No. 9430 (Nov. 20, 1971) (confirmations mailed to issuer's customers). A high percentage of cancelled orders is acceptable evidence that customers did not agree to buy securities.

⁴⁹¹ Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 31 (Nov. 12, 1965) (discretion limited to when customer on trips); Shelley, Roberts & Co., 38 S.E.C. 744, 751 (1958) (confirming for twice the number of shares); First Anchorage Corp., 34 S.E.C. 299, 303 (1952) (stock powers given with instructions to sell particular stock; instead, other securities bought and sold).

⁴⁹² First Anchorage Corp., 34 S.E.C. 299, 304 (1952).

⁴⁹³ *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 443-44 (N.D. Ill. 1967) (representation that sales made when in fact never executed); *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 670-73 (S.D.N.Y.), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966) (delaying execution of sale order while unloading broker's own securities of same class); see Leo G. MacLaughlin Sec. Co., SEC Securities Exchange Act Release No. 7783, at 1 (Jan. 5, 1966) (shingle theory requires execution); *Reynolds & Co.*, 39 S.E.C. 902, 913 (1960) (withholding buy orders until stock price manipulated upward); *William Rex Cromwell*, 38 S.E.C. 913, 915 (1959) (purchase orders); *Batkin & Co.*, 38 S.E.C. 436, 446 (1958); *W.F. Coley & Co.*, 31 S.E.C. 722, 726 (1950); *Silverman v. Bear, Stearns & Co.*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,065 (E.D. Pa. 1971) (in discretionary account where broker-dealer represented would sell out at small loss, cause of action stated where customer alleges reason for delaying sale was that firm did not want to lower market price of security which firm also held); cf. *Carl J. Bliedung*, 38 S.E.C. 518, 521 (1958) (construing Exchange Act Rule 15c1-2; purchase orders). See also *Sills & Co.*, 38 S.E.C. 931, 933 (1959) (broker converted funds obtained on false representation that would purchase securities); note 536 and accompanying text *infra* (absence of adequate facilities to consummate transaction).

⁴⁹⁴ *Van Alstyne, Noel & Co.*, 33 S.E.C. 311, 335 (1952) (order given on Sunday to partner in Cuba, next day holiday, following day had trouble getting through to New York, and order made next day).

⁴⁹⁵ Failure to execute promptly is equivalent to forcing the customer to make an unsecured loan to the broker. See *Warning to Broker-Dealers on Bucketing*, SEC Securities

Finally, selling securities which are fictitious⁴⁹⁶ or which are subject to a lien placed on them by the broker,⁴⁹⁷ violates the Rule. Failure to ascertain whether securities a customer is selling must be registered under the 1933 Act⁴⁹⁸ may also violate the Rule.⁴⁹⁹

IV

BROKER ACTIONS SUBSEQUENT TO EXECUTION OF A CUSTOMER'S ORDER

The Rule prohibits a stockbroker, upon completion of a transaction, from misappropriating his customer's funds or securities, or delaying delivery of the customer's property. A broker can misappropriate his customer's property by any number of methods, all of which violate the Rule.⁵⁰⁰ Securities can be sold⁵⁰¹ or pledged⁵⁰² with-

Exchange Act Release No. 9459 (Jan. 14, 1972). A broker may, however, without liability orally refuse to execute an order at the time it is placed. *See* Courtland v. Walston & Co., Inc., [Current Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,378, at 91,945 (S.D.N.Y. 1972). *See also* notes 500-27 and accompanying text *infra* (misappropriation treated). Failure to deliver securities after purchase, and withholding proceeds of a sale, are discussed at notes 528-38 and accompanying text *infra*.

⁴⁹⁶ *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 443-44 (N.D. Ill. 1967); *D.S. Waddy & Co.*, 30 S.E.G. 367, 368 (1949).

⁴⁹⁷ *Richard A. Sebastian*, 38 S.E.C. 865, 868-69 (1959) (implied representation that customer will have clear title); *cf.* *Morrison Bond Co.*, 11 S.E.C. 125, 133 (1942) (Securities Act § 17(a) and Exchange Act Rule 15c1-2 case). *See generally* note 502 and accompanying text *infra* (broker pledging customer's securities without authority).

⁴⁹⁸ In its earlier releases, when the Commission discussed exemptions from registration under the 1933 Act and violations of the antifraud rules, it was careful to keep the two concepts separate. *See* SEC Securities Exchange Act Release Nos. 6721 (Feb. 2, 1962) & 8638 (July 2, 1969). The line between the two was less clear in a 1971 release. *See* SEC Securities Exchange Act Release No. 9239 (July 1, 1971).

⁴⁹⁹ A broker who negligently sells stolen securities while acting in his usual capacity is not liable under the Rule to the true owner. *Aetna Cas. & Sur. Co. v. Paine, Webber, Jackson & Curtis*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,748 (N.D. Ill. 1970).

⁵⁰⁰ Conversion of customer's property is also prohibited under common law. 1 W. BLACK, *THE LAW OF STOCK EXCHANGES, STOCKBROKERS AND CUSTOMERS* § 531, at 372-73 (1940).

⁵⁰¹ *See e.g.*, *American Canadian Enterprises, Ltd.*, 39 S.E.C. 606, 607 (1949); *D.S. Waddy & Co.*, 30 S.E.C. 367, 368 (1949); *H.F. Schroeder & Co.*, 27 S.E.C. 833, 834, 836 (1948). *See also* notes 490-92 and accompanying text *supra* (unauthorized trading by broker).

⁵⁰² *SEC v. Raymond, Bliss, Inc.*, 4 SEC Jud. Dec. 834, 835 (D. Mass. 1946) (pledge to secure broker's own loan); *John D. Ferris*, 39 S.E.C. 116, 118 (1959) (to secure broker's personal bank loan); *William Rex Cromwell*, 38 S.E.C. 913, 915 (1959) (collateral for personal loan); *W.F. Coley & Co.*, 31 S.E.C. 722, 724-26 (1950) (pledges for debts of firm and individual in firm); *Investment Registry of America, Inc.*, 21 S.E.C. 745 (1946) (pledge for respondent's borrowings); *see SEC v. Charles Plohn & Co.*, 433 F.2d 376, 377 (2d Cir. 1970)

out authority, transferred to another customer,⁵⁰³ or obtained by misrepresentation or concealment.⁵⁰⁴ Except where securities are obtained by ruse, these means can be employed to convert those securities delivered to a broker-dealer in anticipation of a sale, those held by him for safekeeping, and those he receives for a customer after a recent purchase.⁵⁰⁵ Customers' monies, whether they are amounts paid for the purchase of a security, amounts held by the broker-dealer for safekeeping, or amounts received from a sale of a security,⁵⁰⁶ can likewise be converted in a variety of ways. A broker could fail to return monies when requested,⁵⁰⁷ spend the funds without authorization,⁵⁰⁸ or fail to apply funds as directed.⁵⁰⁹ Although negligent action by the broker

(allegation by Commission that 10b-5 violated by illegally pledging securities); Bernard & Co., SEC Securities Exchange Act Release No. 8273, at 1 (March 15, 1968) (false representations to induce customer to furnish securities as collateral for broker's bank loan); H.F. Schroeder & Co., 27 S.E.C. 833, 834 (1948) (using bonds as collateral for other security trading). See generally Exchange Act Rule 8c-1, 17 C.F.R. § 240.8c-1 (1972).

⁵⁰³ William Rex Cromwell, 38 S.E.C. 913, 915 (1959); Shaver & Co., 36 S.E.C. 92, 94 (1954).

⁵⁰⁴ E.g., Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 442-43 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970) (obtained without customer's understanding of what was taking place); Tadashi Yamamoto, SEC Securities Exchange Act Release No. 8536, at 1 (Feb. 25, 1969) (representation that needed to buy seat on exchange); Bernard & Co., SEC Securities Exchange Act Release No. 8273, at 1 (March 15, 1968); Amalgamated Inv., Inc., SEC Securities Exchange Act Release No. 8253, at 1 (Feb. 9, 1968) (misrepresentation that issuer would make changes); W.F. Coley & Co., 31 S.E.C. 722, 724 (1950) (needed for litigation).

⁵⁰⁵ E.g., Thompson & Sloan, Inc., 40 S.E.C. 451, 454 (1961) (misappropriated securities held for safekeeping); William Rex Cromwell, 38 S.E.C. 913, 915 (1959) (shares delivered after purchase); W.F. Coley & Co., 31 S.E.C. 722, 725-26 (1950) (shares delivered to be broken into smaller denominations; bonds obtained for customer's account after sale; stock held for safekeeping which broker did not sell when instructed to do so); Kenneth Leo Bauer, 26 S.E.C. 770, 773 (1947) (misappropriation of securities delivered for sale); cf. Carl J. Bliedung, 38 S.E.C. 518, 521 (1958) (took shares received for customer after purchase). Consequently, misappropriation can actually take place before, at the time of, or after a transaction.

⁵⁰⁶ See cases cited in notes 523-24 *infra* (conversion of funds for purchase of securities or proceeds from sale); cf. *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D.N.Y. 1966) (broker converted monies from securities account presumably to offset commodity losses); H.F. Schroeder & Co., 27 S.E.C. 833, 834 (1948) (misappropriation of funds from margin account).

⁵⁰⁷ Joseph Garofalo, SEC Securities Exchange Act Release No. 9429 (Nov. 22, 1971); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 15, at 89 (4th ed. 1971) (common law).

⁵⁰⁸ E.g., *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135, 144 (7th Cir.), cert. denied, 396 U.S. 838 (1969); William Rex Cromwell, 38 S.E.C. 913, 915 (1959); Cobb & Co., 38 S.E.C. 166, 167 (1958); Frank S. Kelly, 32 S.E.C. 636, 637 (1951) (broker loaned customer's money to partnership engaged in steel business); W.F. Coley & Co., 31 S.E.C. 722, 724 (1950); D.S. Waddy & Co., 30 S.E.C. 367, 368 (1949); Jesse S. Lockaby, & Co., 29 S.E.C. 271, 273 (1949).

⁵⁰⁹ Calvert Sec. Corp., 35 S.E.C. 141, 143 (1953) (did not apply to purchase price of other properties as was agreed upon).

will not suffice to make out a 10b-5 misappropriation, conscious wrongdoing need not be proven; all that is necessary is intent to exercise dominion over the property.⁵¹⁰

Administrative penalties may be imposed and civil remedies are available when a misappropriation violation is established.⁵¹¹ Of course, when a customer's property is subject to the broker's lien or is held in a margin account as necessary collateral there can be no 10b-5 violation. A customer must satisfy the lien or conform to the margin requirements before he may reclaim his goods.⁵¹² Unauthorized transactions, themselves an infraction of the Rule, necessarily involve a misappropriation.⁵¹³

The final clause of 10b-5 stipulates that claims must arise "in connection with the purchase or sale of a security." Actions by a broker occurring prior to or in connection with the execution of an order clearly satisfy this requirement; the same is not necessarily true in the case of misappropriation. There is some indication that acquiring property by misrepresentation is a 10b-5 offense, while converting or embezzling it may not be, unless the broker planned his actions from the time he obtained possession.⁵¹⁴ More correctly, the question should be whether obtaining by false pretenses, converting, or embezzling satisfies the "in connection with" requirement.⁵¹⁵

Several alternatives are available to satisfy the "in connection with" aspect of the Rule, whether the broker obtains property by ruse, conversion, or embezzlement. When securities rather than cash are taken, the act of conversion may constitute a sale by the customer.⁵¹⁶

⁵¹⁰ Cf. W. PROSSER, *supra* note 507, at 83 (common law).

⁵¹¹ Civil recoveries were permitted in *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 442-43 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970), and *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 445 (N.D. Ill. 1967).

⁵¹² See generally notes 381-96 and accompanying text *supra* (margin rules).

⁵¹³ See notes 490-92 and accompanying text *supra*.

⁵¹⁴ 103 CONG. REC. 11,638 (1957) (SEC's legislative program); *Hearings on S. 1178-82 Before Subcomm. of the Senate Comm. on Banking and Currency*, 86th Cong., 1st Sess. 369 (1959); 3 Loss 1429 n.21. Under common law, the tort of conversion requires no intent to take the property, just intent to exercise dominion. W. PROSSER, *supra* note 507, at 83.

⁵¹⁵ Since no distinction among these three concepts is necessary for our purposes, the words will be used interchangeably.

⁵¹⁶ This is the only way to explain the holding of some cases. In *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 442-43 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970), a broker was held liable for damages for obtaining shares by ruse. There was no mention of any purchase or sale to which the conversion could be related. In *Kenneth Leo Bauer*, 26 S.E.C. 770, 773 (1947), the Commission held that a broker violated the Rule when he obtained a stock certificate by false representations and then did not return it. *Accord*, *W.F. Coley & Co.*, 31 S.E.C. 722, 724 (1950) (obtaining securities by misrepresentation and pledging ten months later). In *Thompson & Sloan*,

In addition, if the broker misappropriates securities received by the him for the customer's account after executing a purchase order⁵¹⁷ or securities delivered by the customer for sale,⁵¹⁸ that sale or anticipated sale should provide the requisite nexus. Another possibility for satisfying the "in connection with" clause is the broker's subsequent pledge⁵¹⁹ or sale of the appropriated securities, provided the conversion and pledge or sale are related. A rebuttable presumption that, at the time of the conversion, the broker intended to make the subsequent sale or pledge would establish this relationship, although such a presumption seems contrived.⁵²⁰ Finally, it could be argued that the broker impliedly represents that securities delivered to him for sale or upon execution of a purchase order will not be converted.⁵²¹

Finding a purchase or sale on which to rely is more difficult when cash or other non-securities⁵²² are converted. Little trouble should be encountered where funds are given to a stockbroker to pay for securities his customer ordered,⁵²³ or where the funds given the stockbroker

Inc., 40 S.E.C. 451, 454 (1961), the respondent retained customers' securities for safekeeping and was held to have violated 10b-5 by thereafter appropriating the securities. The result can be explained under either the conversion theory or an implied representation concept (*see* note 521 and accompanying text *infra*). Under common law, a converter is forced to buy the item in question. W. PROSSER, *supra* note 507, at 80. The statutory definition of sale is not very helpful in this context. *See* Exchange Act §§ 3(a)(13), (14), 15 U.S.C. §§ 78c(a)(13), (14) (1970).

⁵¹⁷ William Rex Cromwell, 38 S.E.C. 913, 915 (1959); *cf.* Carl J. Bleidung, 38 S.E.C. 518, 521 (1958).

⁵¹⁸ Kenneth Leo Bauer, 26 S.E.C. 770, 773 (1947).

⁵¹⁹ SEC v. Raymond, Bliss, Inc., 4 SEC Jud. Dec. 834, 835 (D. Mass. 1946), involved an injunction against violations of 10b-5. The broker was accepting customers' securities for safekeeping and then pledging them to secure his own loans. Unless the broker's conversion or pledging can supply the "purchase or sale" required by the Rule, it is difficult to see any other source. *Accord*, W.F. Coley & Co., 31 S.E.C. 722, 726 (1950) (almost five months after purchased shares for customer, pledged without authority).

⁵²⁰ The broker could rebut the presumption by pointing to the lapse of time between the conversion and his pledging or sale, or to the intervening adverse change of circumstances which would drive him to such an act. This is quite similar to the investment intent in private placements applied prior to the adoption of Securities Act Rule 144, SEC Securities Act Release No. 5223 (Jan. 11, 1972).

⁵²¹ The representation can arise from the broker being in business or from his soliciting, accepting, or executing the customer's order. But it is broader than the usual shingle theory concept which implies a representation at an instant in time. The representation in the text continues from the time a customer buys securities or delivers them to the broker until the broker converts them. Of course, it should be no defense if a broker obtains custody of the certificates, disavows this implied representation, and then converts.

⁵²² An example of a non-security might be a commodity future. A conversion by a broker of securities and non-securities as part of the same scheme would all be within 10b-5.

⁵²³ *E.g.*, Goodman v. H. Hentz & Co., 265 F. Supp. 440, 444 (N.D. Ill. 1967); SEC v. Kelly, [1948-1952 Transfer Binder] CCH FED. SEC. L. REP. ¶ 90,497 (N.D. Ill. 1951) (pre-

represent proceeds of a sale of securities.⁵²⁴ Then, too, if a brokerage firm uses the converted monies to purchase securities, or perhaps even to make or pay off a loan,⁵²⁵ the "in connection with" language would be satisfied.⁵²⁶ Finally, a broker representation might generally be implied that no conversion of customers' monies will be effected.⁵²⁷

Late delivery to a customer of purchased securities or of funds obtained from a sale is another activity occurring after a trade which may be proscribed. Under the shingle theory, a broker impliedly represents that he will consummate a transaction promptly in accordance with trade practice.⁵²⁸ That is, absent a clear understanding to the contrary,⁵²⁹ a stockbroker is deemed to represent at the time of the

liminary injunction granted); Joseph J. Wilensky, 39 S.E.C. 327, 328-29 (1959); Cobb & Co., 38 S.E.C. 166, 168 (1958); Shaver & Co., 36 S.E.C. 92, 94 (1954).

⁵²⁴ D. Earle Hensley Co., Inc., 40 S.E.C. 849, 852 (1961); Sils & Co., 38 S.E.C. 931, 933 (1959); William Rex Cromwell, 38 S.E.C. 913, 915 (1959); Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949).

⁵²⁵ As to whether a loan is a security which can be purchased or sold, see 1 Loss 546.

⁵²⁶ See notes 519-20 and accompanying text *supra* for a caveat which is equally applicable here—the subsequent use must have been contemplated at the time of conversion.

⁵²⁷ See note 521 and accompanying text *supra*.

None of the above, however, can explain the result in *Sinva, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 361, 367 (S.D.N.Y. 1966) (misappropriation to cover losses in non-securities account).

⁵²⁸ SEC Securities Exchange Act Release No. 8363, at 1 (July 29, 1968); Leo G. MacLaughlin Sec. Co., SEC Securities Exchange Act Release No. 7783, at 1 (Jan. 5, 1966); D. Earle Hensley Co., 40 S.E.C. 849, 852 n.1 (1961); Ned J. Bowman Co., 39 S.E.C. 879, 883 (1960); Joseph J. Wilensky & Co., 39 S.E.C. 327, 329 (1959); John D. Ferris, 39 S.E.C. 116, 119 (1959); Harold G. Wise, 29 S.E.C. 542, 544 (1949); Lewis H. Ankeny, 29 S.E.C. 514, 516-17 (1949); *cf.* Carl J. Bliedung, 38 S.E.C. 518, 521 (1953) (Exchange Act Rule 15c1-2 decision; two to five month delay). Late delivery or nondelivery has also been held to be a 10b-5 violation without reference to the shingle theory. *E.g.*, Richard A. Sebastian, 38 S.E.C. 865, 868-69 (1959); Shaver & Co., 36 S.E.C. 92, 94 (1954); W.F. Coley & Co., 31 S.E.C. 722, 726 (1950); Jesse S. Lockaby & Co., 29 S.E.C. 271, 273 (1949).

This concept is broad enough to require an underwriter to make delivery of certificates promptly after the closing with the issuer or selling stockholders. There are instances, however, where this is not done. Since the representation is implied at the time of a trade or a solicitation for a trade, the "in connection with" part of the Rule is satisfied.

⁵²⁹ SEC Securities Exchange Act Release No. 6778, at 1 (April 16, 1962); Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949); *cf.* Carl J. Bliedung, 38 S.E.C. 518, 521 (1958) (construing Exchange Act Rule 15c1-2). A broker-dealer should not be penalized for a delay in delivery caused by events occurring after the trade is made which were unforeseeable at the time of the trade and beyond the control of the broker-dealer. Thus, a dealer should not be criticized if he confirms a trade, having gone short to do so in anticipation that he will be able to cover by purchasing the required shares in the actively traded market, and then finds that trading in the security is suspended immediately thereafter by the SEC for a reason which the broker neither knew nor should have known. On the other hand, suspension of trading is generally not an excuse for failure to complete a transaction when a broker is long. SEC Securities Exchange Act Release No. 7920 (July 19, 1966).

trade that he will deliver to his customer with reasonable promptness the securities purchased or the proceeds from the sale.⁵³⁰ A customer's demand for possession of property which his broker is holding for safekeeping should also be protected by the implied representation of speedy delivery.⁵³¹ Violation of the duty can give rise to civil⁵³² and administrative remedies. Naturally, the broker's duty to deliver promptly does not apply to property the customer desires the broker to hold,⁵³³ or that which is subject to a broker's lien or is required collateral in a margin account. The time period in which delivery must be made should begin when the transaction is executed⁵³⁴ and end when delivery is made under the terms of the Uniform Commercial Code.⁵³⁵ When so computed, the reasonable time for delivery is relatively short. Additionally, the SEC has opined that a broker violates the Rule when he does not have adequate facilities to consummate the trade by prompt delivery,⁵³⁶ when he knows the transfer agent

⁵³⁰ Particularly in the early cases, the SEC emphasized the question of whether at or before the transaction the broker intended to make prompt delivery. *See* SEC Securities Exchange Act Release No. 8363, at 1 (July 29, 1968); SEC Securities Exchange Act Release No. 6778 (April 16, 1962); Ned J. Bowman Co., 39 S.E.C. 879, 883 (1960); Lewis H. Ankeny, 29 S.E.C. 514, 516-17 (1949); Jesse S. Lockaby & Co., 29 S.E.C. 271, 273 (1949); Kenneth Leo Bauer, 26 S.E.C. 770, 775 (1947).

⁵³¹ Once again the problem of what constitutes "in connection with the purchase or sale of a security" arises, but the difficulty can be resolved by reliance upon one of the theories outlined above with regard to misappropriation. *See* notes 516-27 and accompanying text *supra*.

⁵³² Examples of damages include loss of interest on monies or loss of dividends, interest, or other distributions on a security. Similarly, if a customer is unable to sell a security because of his broker's slow delivery, damages (if provable) flowing from the broker's act should be recoverable. In *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 442-43 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970), a registered representative who failed to deliver 20 shares to his customer and who later fraudulently obtained the other 100 shares which he did deliver, was held liable for the value of all 120 shares.

⁵³³ *But see* Exchange Act Proposed Rules 15c3-3 and 15c3-4, SEC Securities Exchange Act Release No. 9388 (Nov. 12, 1971) (segregation of customers' property).

⁵³⁴ Measurement from the time a transaction *should have* been executed would penalize the broker twice—once for delaying execution (*see* notes 493-95 and accompanying text *supra*) and a second time for delaying delivery.

⁵³⁵ UNIFORM COMMERCIAL CODE § 8-313. The New York State version of this provision was construed in the first (now superseded) opinion in *Shaw v. Dreyfus & Co.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,608 (N.Y. Civ. Ct. 1969) (sending purchase confirmation when broker has not yet acquired security not delivery to customer).

⁵³⁶ *Joseph V. Shields, Jr.*, SEC Securities Exchange Act Release No. 8484, at 2 (Jan. 3, 1969); *Pickard & Co., Inc.*, SEC Securities Exchange Act Release No. 8447, at 2 (Nov. 14, 1968).

for the security is backed up,⁵³⁷ or when he knows the dealer from whom he purchases makes slow delivery.⁵³⁸

V

OTHER ACTIONS OF BROKER-DEALERS

A. *Broker's Duty to Supervise and Train Employees*

A brokerage firm may be subject to administrative sanctions, civil remedies, and criminal penalties under a variety of theories when one or more persons associated with it violate 10b-5. The firm could, for example, be held liable as an aider-and-abettor,⁵³⁹ a controlling person,⁵⁴⁰ or the principal of a wrongdoing agent.⁵⁴¹ These doctrines are applicable in all areas governed by the Rule. However, two other concepts—absence of adequate supervision and lack of sufficient training—are unique to the broker-dealer field.

SEC decisions prior to 1964 generally held that firms and supervisors failing adequately to supervise employees who breached the Rule were subject to the imposition of administrative sanctions as participants in the fraud.⁵⁴² In 1964, Congress adopted comprehensive amendments to the 1934 Act, including section 15(b)(5)(E) which provides an independent statutory basis for disciplining a broker, dealer, or supervisor in the public interest if he

has failed reasonably to supervise, with a view to preventing violations of [the 1933 Act, the 1934 Act, the Investment Advisers Act of 1940, or the rules or regulations thereunder], another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this clause (E) no person shall be deemed to have failed reasonably to supervise any person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected

⁵³⁷ SEC Securities Exchange Act Release No. 8363, at 1 (July 29, 1968); see Exchange Act Proposed Rule 10b-14, SEC Securities Exchange Act Release No. 8413 (Sept. 25, 1968) (issuer must provide adequate transfer facilities).

⁵³⁸ SEC Securities Exchange Act Release No. 8363, at 1 (July 29, 1968). Also, the broker-dealer who does not make prompt delivery to another broker violates 10b-5. John D. Ferris, 39 S.E.C. 116, 118-19 (1959).

⁵³⁹ *E.g.*, Gross v. SEC, 418 F.2d 103, 107 (2d Cir. 1969).

⁵⁴⁰ *E.g.*, Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 710 (D. Minn. 1968).

⁵⁴¹ *E.g.*, Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 840, 845 (E.D. Va. 1968).

⁵⁴² See cases cited in note 545 *infra*.

to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.⁵⁴³

Since this provision is a codification of the prior cases,⁵⁴⁴ no distinction will be made between decisions construing it and those enunciating the pre-1964 law.

In the Commission's view, failure to supervise provides an independent basis for charging a firm or supervisor with a 10b-5 infringement.⁵⁴⁵ While some courts have reached the identical result by similar reasoning,⁵⁴⁶ others have imposed 10b-5 liability by intertwining supervision with the controlling person provision of section 20(a) of the 1934 Act which renders a controlling person responsible to the same extent as the controlled person "unless the controlling person acted in good faith and did not directly or indirectly induce the

⁵⁴³ 15 U.S.C. § 78o(b)(5)(E) (1970).

⁵⁴⁴ Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8500, at 6 n.9 (Jan. 22, 1969), *rev'd on other grounds sub nom.* Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970).

⁵⁴⁵ F.S. Johns & Co., Inc., SEC Securities Exchange Act Release No. 7972, at 13 (Oct. 10, 1966), *aff'd sub nom.* Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967) & Winkler v. SEC, 377 F.2d 517 (2d Cir. 1967); Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743, at 25-30 (Nov. 12, 1965); Victor R. Redstone, SEC Securities Exchange Act Release No. 7516, at 4 (Jan. 22, 1965); Sutro Bros. & Co., 41 S.E.C. 470, 480-81 & n.34 (1963); Reynolds & Co., 39 S.E.C. 902, 916-17 (1960); Van Alstyne, Noel & Co., 33 S.E.C. 311, 339-40 (1952); *see* Midland Sec., Inc., 40 S.E.C. 635, 639-40 (1961); Best Sec., Inc., 39 S.E.C. 931, 934 (1960); *cf.* Kidder Peabody & Co., 18 S.E.C. 559, 573 (1945); E.H. Rollins & Sons, Inc., 18 S.E.C. 347, 391 (1945). The SEC on occasion has confused supervision and controlling person liability. *See, e.g.,* Bond & Goodwin, Inc., 15 S.E.C. 584, 601 (1944).

The post-1964 SEC cases have not been models of clarity either. In *Armstrong, Jones & Co.*, SEC Securities Exchange Act Release No. 8420, at 12 n.27 (Oct. 3, 1968), *aff'd*, 421 F.2d 359 (6th Cir.), *cert. denied*, 398 U.S. 958 (1970), the Commission held that Exchange Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970), had to be alleged in the order for the proceedings, and that failure to supervise could not be made into a violation without reliance on that section. Therefore § 15(b)(5)(E) in a sense preempted the case law upon which it was based. This imposes no hardship concerning administrative proceedings since the SEC's Division need only add another paragraph to its order. But where does it leave the private litigant? He can, of course, rely on Exchange Act § 20(a), 15 U.S.C. § 78t (1970), in combination with failure to supervise (*see* notes 546-49 and accompanying text *infra*). Alternatively, he can allege violations of 10b-5 and 15(b)(5)(E) in his complaint (*see* note 546 *infra*). Such tactics may enable the private litigant to survive a motion to dismiss.

⁵⁴⁶ In *Goodman v. H. Hentz & Co.*, 265 F. Supp. 440, 445 (N.D. Ill. 1967), the court held, relying on Exchange Act § 15(b)(5)(E), 15 U.S.C. § 78o(b)(5)(E) (1970), that a failure to supervise renders the supervisor liable. In *R.H. Johnson & Co. v. SEC*, 198 F.2d 690, 696-97 (2d Cir.), *cert. denied*, 352 U.S. 844 (1952), the court affirmed a sanction which had been based on lack of supervision.

act."⁵⁴⁷ The latter group of cases imposes on the firm the burden of proving adequate supervision to satisfy the "good faith" requirement of section 20(a).⁵⁴⁸ The SEC and judicial approaches seem to reach the same result, although differing from a respondeat superior theory which would permit the firm to escape 10b-5 liability if its employee's misfeasance was not within the scope of his employment.⁵⁴⁹

The duty of supervision necessitates that supervisory procedures be established, and that the responsibilities under the system be reasonably discharged.⁵⁵⁰ The system should cover all areas of the firm,⁵⁵¹ with particular emphasis on new offices, inexperienced personnel, and geographically remote operations.⁵⁵² A firm cannot wait for customer complaints and then implement the system.⁵⁵³ Prompt and in-depth investigation of any hint of irregularity is required.⁵⁵⁴ It is no defense

⁵⁴⁷ 15 U.S.C. § 78t (1970).

⁵⁴⁸ *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438-39, 443 (N.D. Cal. 1968), *modified on other grounds*, 430 F.2d 1202 (9th Cir. 1970) (churning and two separate transactions; as to the latter, liable on dual ground of respondeat superior and failure "to comply with the requirement for internal supervision as provided in section 20(a)"); *Lorenz v. Watson*, 258 F. Supp. 724, 732-33 (E.D. Pa. 1966) (reference to Exchange Act § 20 (a) and to view that lack of supervision is itself a violation); *cf. Moscarelli v. Stamm*, 288 F. Supp. 453, 460 & n.5 (E.D.N.Y. 1968) (margin violations).

⁵⁴⁹ Comment, *Brokerage Firm's Liability for Salesman's Fraudulent Practices*, 36 *FORDHAM L. REV.* 95, 97 (1967).

⁵⁵⁰ Breach of either part of this obligation is a 10b-5 offense. For example, only the duty to apply supervisory procedures seems to have been violated in *Richard J. Buck*, SEC Securities Exchange Act Release No. 8482, at 11-12 (Dec. 31, 1968), *aff'd sub nom. Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969).

⁵⁵¹ *F.S. Johns & Co., Inc.*, SEC Securities Exchange Act Release No. 7972, at 13 (Oct. 10, 1966), *aff'd sub nom. Dlugash v. SEC*, 373 F.2d 107 (2d Cir. 1967) & *Winkler v. SEC*, 377 F.2d 517 (2d Cir. 1967).

⁵⁵² *Richard J. Buck*, SEC Securities Exchange Act Release No. 8482, at 11-12 (Dec. 31, 1968), *aff'd sub nom. Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969) (close supervision over new officers and personnel; large organizations require utmost vigilance); *Shearson, Hammill & Co.*, SEC Securities Exchange Act Release No. 7743, at 29-30 (Nov. 12, 1965) (executive committee cannot rely on regional personnel; branch offices require more supervision); *Sutro Bros. & Co.*, 41 S.E.C. 443, 463-64 (1963) (large organizations and new offices require more supervision; expanding facilities, inexperienced personnel, and increased business pressure require more vigorous effort); *Reynolds & Co.*, 39 S.E.C. 902, 916-17 (1960) (good system "especially imperative" in large organizations; no defense that firm growing, personnel inexperienced, or pressured by new business). Some of the checks which should be built into the system are described in *Michael Shaub*, SEC Securities Exchange Act Release No. 8113, at 4 (June 30, 1967); *Sutro Bros. & Co.*, *supra* at 462; Comment, *supra* note 549, at 102-04; *cf. Exchange Act Rule 15b10-4(c)*, 17 C.F.R. § 240.15b10-4(c) (1972).

⁵⁵³ *Reynolds & Co.*, 39 S.E.C. 902, 917 (1960).

⁵⁵⁴ *Richard J. Buck*, SEC Securities Exchange Act Release No. 8482, at 12 (Dec. 31, 1968), *aff'd sub nom. Hanly v. SEC*, 415 F.2d 589 (2d Cir. 1969) (slightest indication of irregularity mandates utmost vigilance); *Sutro Bros. & Co.*, 41 S.E.C. 443, 463 (1963); *Reynolds & Co.*, 39 S.E.C. 902, 916 (1960).

that the supervision at other firms is worse⁵⁵⁵ or that supervisors had no notice of any nonconformity.⁵⁵⁶ Indeed, the very occurrence of a fraud might be considered evidence of lack of proper supervision.⁵⁵⁷

A firm's failure to train adequately employees whose acts breach the Rule may also be a violation of 10b-5. Because violations by insufficiently trained personnel can be expected, the broker-employer is accountable for such violations when they occur.⁵⁵⁸

B. *Broker With Inside Information*

A broker-dealer inherits myriad problems when he possesses what is commonly called "inside information"—information he knows or should know has been obtained improperly and has not been disseminated to and absorbed by the investing public.⁵⁵⁹

Brokerage firms have many antennae for inside information, but they usually⁵⁶⁰ obtain their knowledge in one of three ways. First, the information might come from a person associated with them who acts as a director, officer, employee, or controlling stockholder of the corporate issuer.⁵⁶¹ Second, information might be received in a business capacity, as when the firm acts as an underwriter or evaluates the fairness of a merger.⁵⁶² Finally, and most commonly, a broker can receive

⁵⁵⁵ Paine, Webber, Jackson & Curtis, SEC Securities Exchange Act Release No. 8500, at 8 (Jan. 22, 1969), *rev'd on other grounds sub nom.* Klopp v. SEC, 427 F.2d 455 (6th Cir. 1970); F.S. Johns & Co., Inc., SEC Securities Exchange Act Release No. 7972, at 13 (Oct. 10, 1966), *aff'd sub nom.* Dlugash v. SEC, 373 F.2d 107 (2d Cir. 1967) & Winkler v. SEC, 377 F.2d 517 (2d Cir. 1967). As to prior industry standards, see SPECIAL STUDY pt. 2, at 557-58 (supervision over traders).

⁵⁵⁶ To rule otherwise would place a premium on a firm remaining ignorant concerning employee misdeeds, a result contrary to the goal of the supervisory requirement.

⁵⁵⁷ Comment, *supra* note 549, at 105.

⁵⁵⁸ SEC v. Rapp, 304 F.2d 786, 790 (2d Cir. 1962) (inadequately trained salesmen making false representations); Triangle Inv. Corp., SEC Securities Exchange Act Release No. 7902 (June 20, 1966) (officers and registrant violated 10b-5 in that they "employed salesmen whom they failed to provide with suitable training."); cf. 39 TEMPLE L.Q. 493, 495 (1966) (duty to hire competent personnel). As to the qualifications of securities personnel, see Comment, *supra* note 65, at 681-700.

⁵⁵⁹ See Note, *Rule 10b-5: The Effect of Insider Trading Decisions on the Security Analyst*, 54 MINN. L. REV. 147, 161-69 (1969) (definition of "inside information").

⁵⁶⁰ See R.D. Bayly & Co., 19 S.E.C. 773, 784 (1945) (broker's intent to gain control of issuer).

⁵⁶¹ Pennaluna & Co., SEC Securities Exchange Act Release No. 8063, at 10-12 (April 27, 1967), *aff'd*, 410 F.2d 861 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (partner of broker held directorship of issuer); Cady, Roberts & Co., 40 S.E.C. 907 (1961) (registered representative a director); Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (partner of firm a director of issuer).

⁵⁶² A whole series of cases arose out of inside information Merrill Lynch received when acting as lead underwriter for Douglas Aircraft. *E.g.*, Smachlo v. Merrill Lynch,

a "tip" which he knows or has reason to know was obtained improperly.⁵⁶³ The source of the data and whether the news was unsolicited are irrelevant.⁵⁶⁴ Nor does it matter that the recipient did not know the information was not yet publicly released if he should have known it was not.⁵⁶⁵ It is no defense that a broker-dealer reaped no monetary gain from his illegal use of the facts.⁵⁶⁶

The difficult problem of when information actually known by one of a firm's partners, officers, directors, employees, or agents will be imputed to the firm should be a matter of common-law agency.⁵⁶⁷ Constructive notice should be imputed to individuals lacking actual knowledge who work for a firm where the news is known if a typical brokerage employee with comparable experience would have been

Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,148 (S.D.N.Y. 1971); Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,147 (S.D.N.Y. 1971); Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971); City Associates, SEC Securities Exchange Act Release No. 8509 (Jan. 31, 1969); Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968). *See generally* Lewis v. Spiral Metal Co., 317 F. Supp. 905, 907 (S.D.N.Y. 1970) (defendant broker was issuer's underwriter and adviser); Van Alstyne, Noel & Co., SEC Securities Exchange Act Release No. 8511 (Jan. 31, 1969) (broker was underwriter); M.S. Wien & Co., 23 S.E.C. 735 (1946). Information about the stockbroker's client as well as about his merger partner would be considered inside information.

⁵⁶³ Mates Fin. Servs., SEC Securities Exchange Act Release No. 8836 (March 9, 1970) (from director of issuer); George J. Wunsch, SEC Securities Exchange Act Release No. 8713 (Oct. 7, 1969); Blyth & Co., Inc., SEC Securities Exchange Act Release No. 8499 (Jan. 17, 1969) (from employee of Federal Reserve; government securities involved); Herbert L. Honohan, 13 S.E.C. 754 (1943), *modified*, 16 S.E.C. 297 (1944).

⁵⁶⁴ Cf. Investors Management Co., SEC Securities Exchange Act Release No. 9267, at 9 n.18, 12 n.25 (July 29, 1971) (broker tipping customers; customers disciplined). The inside information was unsolicited in Cady, Roberts & Co., 40 S.E.C. 907 (1961), and yet a violation was found.

⁵⁶⁵ Investors Management Co., SEC Securities Exchange Act Release No. 9267, at 12 (July 29, 1971).

Although the issue had been left open in *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 n.5 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), the SEC did indicate that a broker who knew or should have known of inside information violated 10b-5. *See also* SEC v. Aldred Investment Trust, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,349 (S.D.N.Y. 1963).

⁵⁶⁶ *See* notes 575-99 and accompanying text *infra* (violation for broker to tip, trade for discretionary accounts, recommend, and, perhaps, act as an order clerk, market maker, or specialist). A tipper, although violating 10b-5, makes no pecuniary profit.

⁵⁶⁷ Cf. *Schoenbaum v. Firstbrook*, 405 F.2d 200, 211-12 (2d Cir.), *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968) (agency rules used to impute information to corporation). As to the common law, *see* RESTATEMENT (SECOND) OF AGENCY §§ 272-82 (1958). Although limiting the number of persons within the firm who receive inside information is no defense if the firm is held to violate the Rule, it may mitigate any sanction the Commission imposes and would decrease the number of persons who could breach 10b-5.

aware of the nature of the data.⁵⁶⁸ When a stockbroker is acting as a broker-agent, and a fortiori when he is a dealer-principal, his inside information should not be imputed to his customer because the firm is precluded from disclosing it.⁵⁶⁹

The Second Circuit established a rule of expected conduct for a person with material⁵⁷⁰ inside information in the landmark *Texas Gulf Sulphur* decision:

[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must *abstain from trading in or recommending* the securities concerned while such inside information remains undisclosed.⁵⁷¹

From both practical and legal standpoints, a stockbroker usually cannot effectively disseminate inside information,⁵⁷² so he must forego "trading in or recommending" the security. Since *Texas Gulf Sulphur* dealt with corporate insiders, not broker-dealers, the literal language may not apply in all situations. The Court of Appeals' directive clearly applies in some circumstances, however. Neither a firm nor any of its employees having actual or constructive knowledge of material inside information may engage in transactions with the public⁵⁷³ or custom-

⁵⁶⁸ Cf. note 171 and accompanying text *supra* (impute knowledge of misrepresentation to employee).

⁵⁶⁹ A similar question was left unanswered in *List v. Fashion Park, Inc.*, 340 F.2d 456, 464 n.4 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965) (knowledge that insiders were bidding). See generally *Black v. Shearson, Hammill & Co.*, 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (common law construed; misrepresentation by partner of firm to plaintiff's securities salesman employed by him equivalent to misrepresentation to customer). In a recent case, however, Judge Pollack has indicated that knowledge of a broker *should* be imputed to his principal-customer. *Radiation Dynamics, Inc. v. Goldmuntz*, 323 F. Supp. 1097, 1099 (S.D.N.Y. 1971) (*dictum*).

⁵⁷⁰ For the court's definition of the term "material," see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-53 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

⁵⁷¹ 401 F.2d at 848 (emphasis added).

⁵⁷² As a practical matter, most brokers do not have the facilities to handle press releases and rarely could they exert sufficient influence on the corporation to have it promulgate a statement. From a legal aspect, even a fully-publicized broker announcement may not be sufficient to render data "public" and the stockbroker may incur some liability to the corporation if he releases the news. See *Van Alstyne, Noel & Co.*, 33 S.E.C. 311, 321 (1952) (not sufficient disclosure by asking issuer to make information available to stockholders).

⁵⁷³ *George J. Wunsch*, SEC Securities Exchange Act Release No. 8713 (Oct. 7, 1969); *Van Alstyne, Noel & Co.*, SEC Securities Exchange Act Release No. 8511 (Jan. 31, 1969); *Blyth & Co., Inc.*, SEC Securities Exchange Act Release No. 8499 (Jan. 17, 1969) (employee trading for employer's account without knowledge); *Pennaluna & Co.*, SEC Securities Exchange Act Release No. 8063, at 9-10 (April 27, 1967), *aff'd*, 410 F.2d 861, 869-70 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (director of issuer who was partner of broker

ers,⁵⁷⁴ or selectively disclose the facts to persons who then trade on the basis of such information.⁵⁷⁵ In these respects, brokers and non-brokers are treated alike. Yet firms perform other functions unique to their status. For example, a stockbroker owes a fiduciary duty to a customer who gives him discretionary authority to buy or sell securities for his account. The customer cannot expect a firm to violate the law by basing trades for the discretionary account on the firm's material inside information.⁵⁷⁶ Any conflict of fiduciary obligations is resolved in favor of the broker-dealer's duties to the investing public and the corporate issuer.⁵⁷⁷ The law does not, however, prohibit implementation of a decision to trade for the broker's own account or a discretionary account, if the broker *subsequently* receives inside information indicating that the chosen course of action is correct.⁵⁷⁸

sold using inside information); Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); see Herbert L. Honohan, 13 S.E.C. 754 (1943), *modified on other grounds*, 16 S.E.C. 297 (1944) (Securities Act § 17(a) and Exchange Act Rules 10b-3 and 15c1-2; trading with trustee). See also Lewis v. Spiral Metal Co., 317 F. Supp. 905, 907-08 (S.D.N.Y. 1970) (issuer has no cause of action for such activity).

⁵⁷⁴ Van Alstyne, Noel & Co., SEC Securities Exchange Act Release No. 8511 (Jan. 31, 1969). Common law agency and shingle theory concepts should also prohibit such activities. In Lewis v. Spiral Metal Co., 317 F. Supp. 905, 907-09 (S.D.N.Y. 1970), the court held that an issuer whose board of directors was fully informed had no cause of action against the investment banking firm which advised the issuer to privately place stock at an allegedly inadequate price and then took a major portion for its subsidiary.

A broker who acquired an option to purchase a corporation's security and then obtained favorable inside information should be permitted to exercise the option. Cf. Ryan v. J. Walter Thompson Co., 453 F.2d 444, 447 (2d Cir. 1971), *cert. denied*, 92 S. Ct. 1611 (1972).

⁵⁷⁵ Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459, at 3-5 (Nov. 25, 1968); Mates Fin. Servs., SEC Securities Exchange Act Release No. 8836, at 12 (March 9, 1970). Customers of the broker who were not tipped would have no cause of action against the broker. Smachlo v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,148 (S.D.N.Y. 1971); Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,147 (S.D.N.Y. 1971). Tipping all customers is not a solution. See Merrill Lynch, Pierce, Fenner & Smith, Inc., *supra*, at 5 n.8.

⁵⁷⁶ Van Alstyne, Noel & Co., SEC Securities Exchange Act Release No. 8511 (Jan. 31, 1969) (dictum); Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

⁵⁷⁷ Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961); cf. Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (common law recovery where broker was director of issuer and indirectly misrepresented to plaintiff-customer; conflicting duties should be avoided in advance).

⁵⁷⁸ This concept was approved in Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961), but rejected on the facts. *Accord*, Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971) (Commissioner Smith, concurring); Daum & Phillips, *supra* note 163, at 957-58; Sandler & Conwill, *Texas Gulf Sulphur; Reform in the Securities Marketplace*, 30 OHIO ST. L.J. 225, 269 (1969) (extraordinary actions indicative of influence of non-public information).

A broker who acquires material inside information faces significant difficulties concerning previous or subsequent recommendations of securities to his customers. Five fact patterns illustrate these difficulties. First, a broker may use inside information to formulate a new recommendation without disclosing the nonpublic data.⁵⁷⁹ This has been held to be an infraction of the Rule.⁵⁸⁰ Second, the newly gained facts may indicate that the broker's previously formed recommendation to buy or sell is incorrect. Since he must disclose any fact not in conformity with his recommendation under the reasonable basis rule,⁵⁸¹ he must abstain from giving any further advice under these circumstances.⁵⁸² A broker who refuses to desist and affirmatively and falsely represents he has no adverse data would also transgress the Rule.⁵⁸³ The third difficult situation arises when a stockbroker's data reinforces an already-conceived recommendation to trade. It could be argued that since the recommendation was determined independently and since the reasonable basis rule does not require disclosure, a broker should be able to continue making his recommendation.⁵⁸⁴ On the other hand, the potential for abuse under this rule, in addition to the possibility that the broker might use the inside knowledge to determine when to change his advice, suggest the conclusion that recommendations cannot be made after inside information is acquired. The fourth fact pattern involves a broker who falsely informs his customer that he has material inside information and urges a purchase or sale of a security. This misrepresentation of a material fact is grounds for a disciplinary proceeding,⁵⁸⁵ and the more cogently reasoned court opinions have not barred the customer from recovering despite his complicity in the use of supposedly unpublicized data.⁵⁸⁶ Finally, a broker with inside infor-

⁵⁷⁹ This is different from tipping in that the information is not disclosed, either directly or by innuendo.

⁵⁸⁰ Van Alstyne, Noel & Co., SEC Securities Exchange Act Release No. 8511 (Jan. 31, 1969). In Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961), the SEC said that the 10b-5 prohibitions extended to "soliciting and executing" orders, but did not elaborate.

⁵⁸¹ See note 108 and accompanying text *supra*.

⁵⁸² Cf. Van Alstyne, Noel & Co., 33 S.E.C. 311, 321 (1952) (also supersedes duty to issuer to keep secret); M.S. Wien & Co., 23 S.E.C. 735, 752-54 (1946) (misrepresentation and concealment).

⁵⁸³ Cf. Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1968) (common law opinion). But see Smachlo v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,148 (S.D.N.Y. 1971); Shulof v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,147 (S.D.N.Y. 1971).

⁵⁸⁴ See Daum & Phillips, *supra* note 163, at 951; Sandler & Conwill, *supra* note 578, at 269.

⁵⁸⁵ See notes 167-68, 196 and accompanying text *supra*.

⁵⁸⁶ Compare Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 57-58 (S.D.N.Y.

mation could dissuade his customer from trading. This should be grounds for an administrative sanction whether or not the broker indicates the existence of the undisclosed facts to the customer.⁵⁸⁷ A customer should have a cause of action if his broker advises him contrary to the inside information the broker possesses.⁵⁸⁸ On the other hand, a customer who was convinced to change a previously erroneous decision by advice based on inside information will suffer no harm. This recommendation is then actionable, if at all, only by persons trading at about the same time.⁵⁸⁹

No counterpart exists in other areas covered by the Rule to the broker with undisclosed facts who receives an unsolicited buy or sell order from a customer. There is little point⁵⁹⁰ in prohibiting the firm from acting as a broker-agent until or unless it discloses the information.⁵⁹¹ The question is more difficult when it acts as a dealer-principal in the over-the-counter market. No objection should be posed if it buys from or sells to its customer when inside information suggests a contrary course. If anyone is injured, it will be the broker-dealer. But considering the discretion vested in a stockbroker in deciding whether to act as agent or principal,⁵⁹² he should not be permitted to profit by selling instead of buying or buying instead of selling in such a case, even though the inside information may play no part in soliciting the trade.⁵⁹³ The converse factual pattern exists when a broker receives an unsolicited order from a customer he knows or should know has material inside information. The broker would be a party to the fraud if he

1971) (*in pari delicto* rejected in part because defendant was broker), *with* Kuehnert v. Texstar Corp., 412 F.2d 700 (5th Cir. 1969) (reaching opposite result in 2-1 decision; defendant-tipper was corporate officer); *see* Wohl v. Blair & Co., 50 F.R.D. 89, 92 (S.D.N.Y. 1970) (cannot distinguish typical tippee case from situation where tipper is broker; do not accept *in pari delicto* defense without further exploration).

⁵⁸⁷ This would satisfy the "in connection with the purchase or sale or security" language of 10b-5. *See* notes 190, 212 and accompanying text *supra*.

⁵⁸⁸ *Cf.* Stockwell v. Reynolds & Co., 252 F. Supp. 215, 219 (S.D.N.Y. 1965) (false representations to induce customer to hold actionable).

⁵⁸⁹ Daum & Phillips, *supra* note 163, at 952; Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1388 (1965); *cf.* note 575 *supra*.

⁵⁹⁰ The customer could always go to another firm. The broker's refusal would also raise questions as to why he followed that course.

⁵⁹¹ Phillips v. Reynolds & Co., 297 F. Supp. 736, 737 (E.D. Pa. 1969) (*dictum*); Painter, *supra* note 589, at 1388. The broker should incur no liability for executing the trade without disclosure. McDowell, *Director's Liabilities in Securities Transactions*, 22 BUS. LAW. 76, 86 n.36 (1966); *cf.* notes 576-77 and accompanying text *supra*.

⁵⁹² *See* 3 Loss 1500-08; 6 *id.* at 3702-08.

⁵⁹³ Acting as a dealer in any capacity should be prohibited when the inside information is *not* clearly good or bad, as is the case with some mergers.

executed the trade without disclosing.⁵⁹⁴ Whether a broker has a duty to disclose that the customer is a director, officer, or controlling stockholder of the issuer is unclear;⁵⁹⁵ however, in practice, no disclosure is made.⁵⁹⁶

Some brokers make a market in over-the-counter securities, while others are specialists on a securities exchange.⁵⁹⁷ The potential for abuse is abundantly present when a market maker or specialist has material inside information. Because of the broad discretion lodged in market makers and specialists, the misuse of inside information cannot be controlled by periodic references to the trading methods of some fictional "reasonably prudent" market maker or specialist who is presumed not to have the nonpublic data.⁵⁹⁸ The alternative is to force the stockbroker to suspend all activity. In the over-the-counter market, this might start rumors, and, if there were only one market maker, would stop trading entirely. Similarly, there could be no buying or selling on the exchange if a specialist were prohibited from trading. Since this would have the effect of inducing the corporation to disclose the inside information as early as possible—a result consonant with the purposes of 10b-5—it is the preferable alternative.⁵⁹⁹

C. *Broker as a Plaintiff*

Much attention has been given the liabilities 10b-5 imposes on broker-dealers. A stockbroker may also enjoy the benefits of the Rule. He can sue to vindicate violations,⁶⁰⁰ for the Rule protects the sophisti-

⁵⁹⁴ *List v. Fashion Park, Inc.*, 340 F.2d 457, 461 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (dictum); *Hughes & Treat*, 22 S.E.C. 623, 626 (1946) (dictum); *see SEC v. Aldred Inv. Trust*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,349 (S.D.N.Y. 1963) (SEC alleged broker violated 10b-5).

⁵⁹⁵ This "novel question" was left open in *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 n.4 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), but the Commission has indicated that it believes nondisclosure constitutes a violation. *SEC v. Aldred Inv. Trust*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,349 (S.D.N.Y. 1963). If there is a duty to disclose the name, the broker may arguably have a further obligation to elicit from the insider whether he possesses any inside information.

⁵⁹⁶ In an exchange transaction disclosure would be difficult; in over-the-counter trades the information is only rarely communicated.

⁵⁹⁷ For definitions of "market maker" and "specialist," see notes 327, 248-51 and accompanying text *supra*.

⁵⁹⁸ *See generally* notes 269-318 and accompanying text *supra* (broker controlling market).

⁵⁹⁹ *SEC v. Aldred Inv. Trust*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,349 (S.D.N.Y. 1963) (SEC complaint alleged violation where broker with inside information placed bids); Note, *supra* note 163, 42 N.Y.U.L. REV. at 712. *But see* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121, 157 n.161 (1962).

⁶⁰⁰ No objection was raised when brokers brought suit in some cases. *E.g.*, *Carroll v.*

cated as well as the naive.⁶⁰¹ However, some policies underlying the Rule suggest that a broker's case must be stronger than that of other plaintiffs if he is to recover.⁶⁰²

One type of fraud is practiced solely on brokers. A broker can recover damages from a customer who places an order to buy a security with the concealed intention of making payment on the settlement date only if the market price rises in the interim.⁶⁰³ Should a broker-dealer be unable to prove that the customer's intent existed at the time of the order, no 10b-5 claim would arise and a common-law contract remedy would be the only available mode of recovery.⁶⁰⁴

CONCLUSION

This article has attempted to delineate the extent of broker-dealer liability under Rule 10b-5. The areas of liability discussed may not be exhaustive; future decisions may proscribe other practices,⁶⁰⁵ even practices which are now customary in the financial community. A primary value of 10b-5 is its breadth, and the flexibility such breadth allows the courts and the Commission in their efforts to safeguard investor interests and to preserve the integrity of the securities markets.

First Nat'l Bank, 413 F.2d 353 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970) (misrepresentation case); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967) (manipulation); Globus, Inc. v. Jaroff, 271 F. Supp. 378 (S.D.N.Y. 1967) (stockholder derivative suit); cases cited in note 603 *infra*.

⁶⁰¹ Carroll v. First Nat'l Bank, 413 F.2d 353, 357 (7th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970); Lehigh Valley Trust Co. v. Central Nat'l Bank, 409 F.2d 989, 992 (5th Cir. 1969), *cert. denied*, 396 U.S. 1003 (1970).

⁶⁰² The policies of equalizing bargaining position, fairness, and fostering investor confidence indicate that this should be the result.

⁶⁰³ A.T. Brod & Co. v. Perlow, 375 F.2d 393, 395-98 (2d Cir. 1967); SEC Litigation Release No. 499 (Feb. 4, 1949) (defendant enjoined from engaging in this practice); *cf.* United States v. Bialkin, 331 F.2d 956, 957 (2d Cir. 1964) (criminal case).

⁶⁰⁴ A.T. Brod & Co. v. Perlow, 375 F.2d 393, 398 (2d Cir. 1967); Patton, *The "Purchase or Sale" Restriction of SEC Rule 10b-5—Judicial Extension of a Federal Remedy*, 18 CATHOLIC U.L. REV. 463, 474 n.56 (1969).

⁶⁰⁵ *Cf.* Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167, 1171 (2d Cir. 1971) (permissible to outlaw a violation in first litigation on the issue); *accord*, Opper v. Hancock Sec. Corp., 250 F. Supp. 668, 675 (S.D.N.Y.), *aff'd per curiam*, 367 F.2d 157 (2d Cir. 1966).