Death Property and Lawyers a Behavioral Approach

Robert Horowitz

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

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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, designed to regulate the initial distribution of securities. The Securities Exchange Act was enacted the following year to control market operations after a public offering, including the actions of brokers, dealers, and national securities exchanges.

For eight years, relatively little attention was given to the broad grant of regulatory authority in section 10(b) of the Exchange Act. Then, the Securities and Exchange Commission adopted under that section a broad antifraud rule, Rule 10b-5. There was never much doubt that criminal or administrative sanctions could be imposed for breaches of the Rule. 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.

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

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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.
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.
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. 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. 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." 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.

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. A broker may, for example, incur liability for material misrepresentations or omissions in registration statements when acting as an underwriter or in an oral communication or prospectus, by offering or selling securities without the requisite registration, by extending credit in violation of margin

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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, 399 F.2d 764, 768-69 (2d Cir. 1969) (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).


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").


regulations,\textsuperscript{16} or by manipulating a security listed on a national securities exchange.\textsuperscript{17} Antifraud provisions other than 10b-5 apply to brokers acting in a brokerage capacity,\textsuperscript{18} and brokers who are registered investment advisers are also subject to special restrictions.\textsuperscript{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.\textsuperscript{20} Further, state law is superimposed on the federal securities laws, exchange rules, and NASD rules.\textsuperscript{21} A few recent cases may mark the beginning of a resurgence of state fraud law.\textsuperscript{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.\textsuperscript{23} It is uncertain what additional elements a customer suing for damages caused by the broker's 10b-5 violation must demonstrate.\textsuperscript{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,\textsuperscript{25} Securities

\begin{footnotesize}
\begin{itemize}
  \item \footnote{Exchange Act § 7, 15 U.S.C. § 77g (1970).}
  \item \footnote{Exchange Act § 9, 15 U.S.C. § 78i (1970).}
  \item \footnote{Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (1970).}
  \item \footnote{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), \textit{cert. denied\textsuperscript{,} 388 U.S. 817 (1966).}}
  \item \footnote{Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (1970).}
  \item \footnote{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), \textit{cert. denied\textsuperscript{,} 388 U.S. 817 (1966).}}
  \item \footnote{State law" includes state decisional and statutory law.}
  \item \footnote{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.}
  \item \footnote{17 C.F.R. § 240.15cl-2 (1972).}
\end{itemize}
\end{footnotesize}
Act section 17(a), 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. 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. The statutory definitions of "broker" and "dealer" codify this functional distinction. Exchange Act section 15 requires broker-dealers to register with the Commission if they use the mails or interstate commerce. Rule 10b-5, however, applies to broker-dealers

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24 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.
25 See notes 45-73 and accompanying text infra.
26 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.

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

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. 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. 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, or is a member of an exchange or the NASD.


33 E.g., Harold Grill, 41 S.E.C. 321 (1965) (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. ¶ 93,252 (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.

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. 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," 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. 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 disinterestedly 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-broker's customers nor even within the cognizance of the defendant-brokers. Consequently, no cause of action under . . . Rule 10b-5 . . . has been established.

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

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37 See notes 222-32 and accompanying text infra.


Some cases have circumvented this obstacle and have applied the securities laws. E.g., Johnson v. Espey, [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 L. 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).


40 Id. at 99,276 (emphasis added).
does not defeat other types of 10b-5 actions; 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 scalping 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. 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.

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."

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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.
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 proceeding\(^48\) 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).


\(48\) 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).

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. 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. 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.

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.” Sometimes


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, SECURIERTEG 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.\footnote{\textit{E.g.}, Harold Grill, 41 S.E.C. 321, 325 (1963) (fair dealing); N. Pinkser & Co., Inc., 40 S.E.C. 235, 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).} Professor Leavell has discussed at least three other formulations of the shingle theory.\footnote{Leavell, \textit{supra} note 57.} 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.\footnote{In addition to the fiduciary theory (see notes 70-71 and accompanying text \textit{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 \textit{infra}.}

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,\footnote{Almost all cases involve broker-customer relations, but a few have treated broker-broker questions. George J. Wunsch, \textit{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 \textit{infra}.} and applies with equal force to brokerage firms and their salesmen.\footnote{Ross Sec., Inc., 41 S.E.C. 509, 514 n.7 (1963); A. J. Caradean & Co., Inc., 41 S.E.C. 234, 235 (1962).} From its origin in cases involving implied representation of a reasonable trading price,\footnote{See notes 46-51 and accompanying text \textit{supra}.} 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,\footnote{For an explanation of a boiler room, see note 331 and accompanying text \textit{infra}.} 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.\footnote{See \textit{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 (1968).} The shingle theory in
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, 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.

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." A better view is represented by a California decision in a suit brought by a customer to recover damages from a broker who


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.


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).

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."  

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, 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.

There are many situations where the shingle and fiduciary theories are simultaneously applicable. 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.

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


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 2707; Cohen & Rabin, supra note 11, at 703-04.

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 sell 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.

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.


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 tenderees, that a tender offer is fair may be actionable if in fact the offer is unfair (cf. Mills v. Sarjen 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. Bocock, 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. 1966). 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."

There is considerable authority, in accord with this release, that broker recommendations must have a reasonable basis. 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

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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), 15cl-3, 17 C.F.R. § 240.15cl-3 (1972) (fraudulent to represent that Commission approved broker), and 15cl-5, 17 C.F.R. § 240.15cl-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.

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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.

facts concerning recommended securities. Most questions concerning representations will be discussed below, 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 statements and, although it was originally employed


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).

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


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).

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. 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, and the increase in information now included in those reports, the distinction between listed and unlisted securities is less important. Since there is now little difference among types of is-

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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(I).

Of course, not all unlisted securities are obscure and speculative, and perhaps this distinction should be recognized in the cases. In Crow, Brouman & Chatkin, 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 nonspeculative. 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.


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
Issuers 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.80

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.

80 See R. Mundheim, supra note 85, at 78 (Mr. Heller).
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 factors\(^9\) while others discuss facts which should excite suspicion and hence negate the validity of accumulated data,\(^3\) 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.\(^4\) 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."\(^5\) Although some commentators have objected to the breadth of that statement,\(^6\) 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.'"\(^7\) Whatever may in general


\(^3\) See note 106 and accompanying text infra.

\(^4\) 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 (1965).


\(^6\) R. Jennings & H. Marsh, Securities Regulation 774 (2d ed. 1968); 6 Loss 3712; R. Mundheim, supra note 85, at 78 (Mr. Heller).

\(^7\) 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." Similarly, the Commission has concluded that there can be no reasonable basis for predictions of earnings or earnings per share for such enterprises.

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).


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.

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


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 Mo. L. Rev. 189, 192 (1963). 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 basis\textsuperscript{101} may be used to determine the adequacy of the investigation as well.\textsuperscript{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.\textsuperscript{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-


\textsuperscript{102} See text following note 94 supra.

\textsuperscript{103} 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 (1969), 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, 68 (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.


\textsuperscript{105} 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.\textsuperscript{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.\textsuperscript{105} Finally, knowledge of any fact which arouses a suspicion


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 (1958). 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.” \textit{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).

\textsuperscript{105} Boiler room cases include Walker v. SEC, 383 F.2d 944, 945 (2d Cir. 1967) (do not accept blindly); Berko v. SEC, 316 F.2d 137, 142 (2d Cir. 1963), \textit{aff'd} 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 (1965); Harold Grill, 41 S.E.C. 521, 524-25 (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); \textit{see note} 343 and accompanying text \textit{infra}; cf. United States v. Ross, 321 F.2d 61, 65 (2d Cir.), \textit{cert. denied}, 375 U.S. 894 (1965) (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. \textit{E.g.,} Hanly v. SEC,

If a broker is unable after a reasonable investigation to garner sufficient information to form a reasonable basis, he must disclose this to his customers\footnote{Richard J. Buck & Co., SEC Securities Exchange Act Release No. 8482, at 8 (Dec. 31, 1968) (customer entitled to assume reasonable basis absent disclosure), \textit{aff'd sub nom.} Hauly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969) (must disclose absence of essential informa-} and, at the very least, qualify statements and caution


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 105 (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., Inc. S.E.C. 553, 561 (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. Pinski & 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,\textsuperscript{109} knew the security was speculative,\textsuperscript{110} received a prospectus,\textsuperscript{111} did not rely on the statement,\textsuperscript{112} did not believe the statement,\textsuperscript{113} understood the broker to be expressing an opinion,\textsuperscript{114} or realized a profit;\textsuperscript{115} the prediction fortuitously came true;\textsuperscript{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. \textit{Id.} at 321.

Although the cases do not limit the duty to disclose adverse information, surely a materiality concept must be implied. \textit{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). \textit{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).


\textsuperscript{111} Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 569 (1963); Ross Sec., Inc., 41 S.E.C. 509, 510 (1965).


\textsuperscript{114} Alexander Reid \& Co., 40 S.E.C. 986, 989 (Feb. 8, 1962); \textit{see note} 78 \textit{supra}.

\textsuperscript{115} Berko v. SEC, 316 F.2d 187, 143 (2d Cir. 1965).

\textsuperscript{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 Commissioner in attempting to enforce the reasonable basis rule. In two confusing opinions,^121 the federal district court for the Eastern District of Penn-


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 recommend 127 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).


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. One commentator has suggested that suitability should extend beyond recommendations by brokers and encompass almost any purchase of a security by a customer.

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, but the situa-

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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.

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bocock, 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).


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. 981, 993 (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. 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. On the other hand, reliance should be irrelevant (at least in administrative proceedings) if the shingle theory dictates the 10b-5 suitability duties.

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, has not acquiesced in this interpretation, 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).


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. 98, 928-34 (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. Since suitability apparently applies to a broader range of situations than does the reasonable basis rule, 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. 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.

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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.

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. 951, 953 (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. Rather, it should encourage the broker to compare his customer with the security prior to making any recommendation.

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. After disclosure, the broker should be allowed to execute unsolicited orders for securities he believes are inappropriate, but he may not make unsuitable recommendations.

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).

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").

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 (1955) (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.


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. 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. 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, and has applied suitability under the Rule to boiler room activities and certain other situations. Generally, however, actions may have to be more egregious to...

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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. I, 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).


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.\(^\text{149}\)

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 past\(^\text{150}\)) and to evaluate the terms of the transaction rather than the broker's conduct in effecting the trade,\(^\text{151}\) (2) impose the additional costs of defending private suits on the securities community,\(^\text{152}\) and (3) raise problems of adequately training brokerage personnel.\(^\text{153}\) The validity of these objections is open to question.\(^\text{154}\) 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.\(^\text{155}\) 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, Hamill case discussion).


\(^{151}\) 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.\(^{166}\)

**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,\(^{168}\) 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-dealers\(^{169}\) and is applicable

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\(^{157}\) 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, 319-334 (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.


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

A broker-dealer's prediction, representation, or opinion must have a reasonable basis supported by data gathered in a reasonable investigation.\textsuperscript{161} The sounder authorities indicate that a broker may also not "puff" his merchandise.\textsuperscript{162} Further, commentators have indicated that a broker's duty of disclosure is greater than that of an ordinary investor.\textsuperscript{163} In light of the basic policies underlying the Rule,\textsuperscript{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.\textsuperscript{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.\textsuperscript{166} Nevertheless, a broker can be disciplined in administrative actions if he "willfully"\textsuperscript{167} misrepresents or omits material facts, whether or not the

\textsuperscript{160} See notes 222-32 and accompanying text infra.  
\textsuperscript{161} See notes 76-122 and accompanying text supra. These duties may lack universal applicability.  
\textsuperscript{162} See note 119 and accompanying text supra.  

\textit{[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, \textit{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. \textit{See Comment, Securities and Exchange Commission Rule X-10B-5: Guided Missile or Flying Saucer?}, 32 Tex. L. Rev. 197, 200-01 (1953); Note, \textit{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.  
\textsuperscript{164} See note 9 supra.  
\textsuperscript{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). \textit{See} notes 39-44, 158 and accompanying text supra.  
\textsuperscript{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.  
customer ultimately relies. 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.

Whether a firm should bear responsibility along with its employee is essentially a question for agency law and relates to the duty to supervise. 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.

Some representations or omissions can be made by any party to a transaction. 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-

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168 See note 112 and accompanying text supra.


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;\textsuperscript{173} concealing illegal pledges;\textsuperscript{174} concealing their addresses;\textsuperscript{175} concealing their directorships or officerships in the issuer;\textsuperscript{176} concealing their financial condition;\textsuperscript{177} concealing their interest in securities purchased for a customer’s account;\textsuperscript{178} concealing any long or short position in a security; concealing their manipulation of the market;\textsuperscript{179} concealing their sales of a security they are recommending;\textsuperscript{180} concealing market maker status;\textsuperscript{181} concealing misappropriation of customer’s securities;\textsuperscript{182} concealing potential bar by regulatory authority from conducting business;\textsuperscript{183} concealing tender offers;\textsuperscript{184} concealing that a prospectus is no longer accurate;\textsuperscript{185} concealing relevant information to induce customer

\textsuperscript{173} Kenneth Leo Bauer, 26 S.E.C. 770, 775-76 (1947).
\textsuperscript{174} SEC v. Charles Plohn & Co., 433 F.2d 376, 377 (2d Cir. 1970).
\textsuperscript{175} Kenneth Leo Bauer, 26 S.E.C. 770, 775-76 (1947).
\textsuperscript{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 (1949).
\textsuperscript{177} SEC v. Charles Plohn & Co., 433 F.2d 376, 377 (2d Cir. 1979); 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).
\textsuperscript{182} Reynolds & Co., 39 S.E.C. 902, 913 (1960); see notes 475-76 and accompanying text infra (self-preferment by broker).
\textsuperscript{183} See notes 329-30 and accompanying text infra.
\textsuperscript{184} See notes 500-26 and accompanying text infra.
\textsuperscript{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).
to purchase,\textsuperscript{188} sell,\textsuperscript{189} or hold\textsuperscript{190} securities; concealing true market price;\textsuperscript{191} misrepresenting the availability of a security;\textsuperscript{192} misrepresenting that the issue has been oversubscribed;\textsuperscript{193} misrepresenting that they themselves have bought stock;\textsuperscript{194} misrepresenting that they have a research department;\textsuperscript{195} misrepresenting that they possess inside information;\textsuperscript{196} misrepresenting their age or experience;\textsuperscript{197} misrepresenting that they have sold the customer's securities;\textsuperscript{198} misrepresenting that their partners will continue to hold the issuer's stock;\textsuperscript{199} misrepresenting that their research department recommended the security;\textsuperscript{200} misrepresenting that they are members of a national securities exchange;\textsuperscript{201} misrepresenting that they will disseminate a report in the future on the issuer;\textsuperscript{202} misrepresenting that they would not buy at a certain price;\textsuperscript{203} misrepresenting that they would repurchase stock;\textsuperscript{204} misrepresenting knowledge

\textsuperscript{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).

\textsuperscript{189} M.S. Wien & Co., 23 S.E.C. 735, 746 (1946).


\textsuperscript{191} See generally notes 397-478 and accompanying text infra (broker's secret profits).


\textsuperscript{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).

\textsuperscript{196} See notes 582-83 and accompanying text infra.


\textsuperscript{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).


\textsuperscript{203} R.D. Bayly & Co., 19 S.E.C. 773, 784 (1945).

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

Any misstatement or omission by a broker-dealer is objectionable whether made orally\textsuperscript{217} or in a written document such as a market letter,\textsuperscript{212} report,\textsuperscript{217} or solicitation letter.\textsuperscript{220} Concealment of a LoB-5 offense may in and of itself constitute a violation of the Rule.\textsuperscript{221}

\textsuperscript{205} Klopp v. SEC, 427 F.2d 455, 461 (6th Cir. 1970) (SEC did not base sanction on substantial evidence).
\textsuperscript{206} See notes 381-96 and accompanying text infra.
\textsuperscript{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).
\textsuperscript{208} Batkin & Co., 38 S.E.C. 436, 449 (1958) (misrepresentation that a member of the duPont family bought security).
\textsuperscript{211} See notes 523-38 and accompanying text infra.
\textsuperscript{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).
\textsuperscript{216} See generally notes 397-478 and accompanying text infra (broker's secret profits).
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, or whether the customer pays in cash, contributes securities of other issuers, or makes a loan to a firm or one of its employees. 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. 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. Nevertheless, a number of false statements may be made, any one of which could be sufficient under the proper circumstances to constitute a


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


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 secur-


ties market. Three points should initially be noted. First, even though the majority of cases deal with stock manipulation, some decisions are concerned with debt instruments. 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. Finally, brokers must conform to a number of requirements, in addition to 10b-5, pertaining to manipulative activities.

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, who attempt to keep an orderly market by preventing

233 For a discussion of manipulation generally, see 3 Loss 1529-622; 5 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.


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).

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, 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.

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) are also prohibited by 10b-5. In one case, 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, analogous to the over-the-counter market domination cases, the Seventh Circuit found a violation of


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.


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.


242 R.J. Koeppe & 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 quotations\(^{248}\) 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.


\(^{247}\) In SEC v. Otis & Co., 106 F.2d 579, 582-83 (6th Cir. 1939), aff'd 18 F. Supp. 100, (N.D. Ohio 1938), 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 NASDAQ\textsuperscript{249} 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.\textsuperscript{250} Usually two or more firms, called market makers, regularly enter bids on a security.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.

\textsuperscript{249} NASDAQ refers to the computerized quotation system of the NASD.

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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, 582 (1947).
9(a)(2) is also a 10b-5 offense, and then proves the 9(a)(2) elements effecting "a series of transactions" 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. 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. Manipulation of one market may also affect another. Thus, manipulation of the "inside market" constitutes a manipulation of the "outside market," and manipulation of a stock

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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.
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.
exchange price while the broker is trading the same security in the over-the-counter market has also been condemned.\(^\text{263}\)

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.\(^\text{264}\) Less common is the situation in which a broker does not distribute all his shares to the public in an offering.\(^\text{265}\) 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.\(^\text{266}\) Finally, a major securities firm has been condemned for establishing and maintaining a work-out market.\(^\text{267}\)

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

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\(^{263}\) 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).


\(^{265}\) 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


\(^{269}\) 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
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; few others bid at the same time; respondent-broker accounted for a large percentage of the trading; the broker kept increasing his bid; and 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.

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 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.


der; the respondent was usually the broker raising the bids; the broker placed bids only when necessary to maintain the price; the broker could set prices arbitrarily; substantially all trades were made at prices quoted by the broker; the broker traded at or near the bid price; the broker could have purchased below the bid price but instead raised his bid; the broker increased his bid price even though he was long; 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. 176, 182 (1955) (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 (1955) (other's quotations generally lower); cf. Daniel & Co., Ltd., 38 S.E.C. 9, 11-12 (1957) (Exchange Act Rule 15cl-2 used; respondent's bid higher or equal to other bids); Barrett & Co., 9 S.E.C. 319, 327 (1941) (decision interpreting Exchange Act Rule 15cl-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 (1955) (other's quotations generally lower); cf. Daniel & Co., Ltd., 38 S.E.C. 9, 11-12 (1957) (Exchange Act Rule 15cl-2 used; respondent's bid higher or equal to other bids); Barrett & Co., 9 S.E.C. 319, 327 (1941) (Exchange Act Rule 15cl-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.


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

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 offering or obtaining a large block


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

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."

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. 819, 824 (1941) (Exchange Act Rule 15c1-2 case; float only 10% of issued stock).

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").


Id. (bought from customers and dealers).


Id.
of the security;\textsuperscript{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,\textsuperscript{298} a large block of the security,\textsuperscript{299} or a hidden source of supply such as a large stockholder or a fictitious account\textsuperscript{300}); and whether the broker liquidated his inventory quickly after the price rose.\textsuperscript{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;\textsuperscript{302} in which respondent guaranteed to purchase securities from other brokers at a profit to them if they placed bids;\textsuperscript{303} and in which

on offering circular which concealed broker's domination of market); R.L. Emadio & Co., \textsuperscript{297} 35 S.E.C. 191, 194 (1953) (10b-5 over-the-counter manipulation decision).


\textsuperscript{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 15cl-2 case); Barrett & Co., 9 S.E.C. 319, 328 (1941) (Exchange Act Rule 15cl-2 manipulation decision; manipulated to price where options could be profitably exercised).

\textsuperscript{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.


\textsuperscript{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).

\textsuperscript{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 (1965) (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. 398, 445 (1941) (Exchange Act Rule 15cl-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.

\textsuperscript{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.\textsuperscript{304}

The following factors have been successfully employed as defenses to a charge of controlling and dominating the market: an independent market existed;\textsuperscript{305} the broker dealt with informed people who had access to information about the issuer and the market;\textsuperscript{306} other brokers bid higher than respondent and he generally did not raise his bid when he was high bidder;\textsuperscript{307} the broker raised and lowered his bid;\textsuperscript{308} the broker bought and sold during the same period;\textsuperscript{309} the volume of his purchases approximated that of his sales;\textsuperscript{310} after buying and driving up the price, he permitted the market to settle before selling;\textsuperscript{311} and respondent stabilized within the meaning of Exchange Act Rule 10b-7.\textsuperscript{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;\textsuperscript{313} investors suffered no financial loss;\textsuperscript{314} the

\begin{itemize}
\item guaranteed to repurchase securities from other bidders at profit to them, \textit{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).
\item 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); \textit{see} Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967) (defendant should have known that his bids were part of scheme).
\item Norris & Hirshberg, Inc., 21 S.E.C. 865, 875 (1946), \textit{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.
\item 21 S.E.C. at 875 (informed persons “can weigh investment in the security as against investment in others”).
\item 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).
\item \textit{Id.} (of 28 days on which other brokers had higher bids, on 13 days defendant lowered bid from prior day). \textit{But see} Gob Shops of America, Inc., 29 S.E.C. 92, 99 (1959) (market dominated even though raised bids nine times and lowered them twice).
\item Bloomenthal, \textit{supra} note 252, at 213.
\item \textit{Id.} at 214.
\item 17 C.F.R. § 240.10b-7 (1972); \textit{see} Bloomenthal, \textit{supra} note 252, at 214.
\item S.T. Jackson & Co., 36 S.E.C. 631, 653 (1950) (no defense since market price not set by free market forces); \textit{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, Fornon & Anderson, 9 S.E.C. 388, 344 (1941) (Exchange Act Rule 15c1-2 construed in manipulation case; no defense since antimanipulative 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 “respondent’s assertion that the price of other stocks had also risen is . . . no defense.”
\end{itemize}
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. Whether disclosure will protect a broker who has manipulated or controlled the market is uncertain.[320]

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).

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315 See note 253 and accompanying text supra.
317 Id.
318 Bloomenthal, supra note 252, at 214.
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).
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 room\(^{331}\) persists despite efforts to curb it.\(^{332}\) Boiler room operations violate 10b-5,\(^{333}\) and persons engaged in such activities

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\(^{325}\) 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.*


\(^{331}\) 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.\textsuperscript{334} Although a sizable portion of the SEC's administrative actions have arisen in this area,\textsuperscript{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.\textsuperscript{336}


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).


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.\(^3\)

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.\(^3\)

The absence of misrepresentations and omissions and churning of customers' accounts should not exonerate a broker.\(^3\)

Similarly immaterial should be the method of communication employed in the campaign\(^4\) and the speculativeness of the security.\(^3\)

Thus, in the boiler room context,\(^8\) 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.\(^4\)

No customer has yet recovered in a reported decision under

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\(^3\) See notes 74-232 and accompanying text supra; notes 348-80 and accompanying text infra.


\(^3\) 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.

\(^4\) Of course, a means of interstate commerce or the mails must be used at some point in the scheme. See note 5 supra.

\(^8\) 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.

\(^4\) 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.

\(^4\) 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, 516 F.2d 197 (2d Cir. 1969) (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.
RULE 10b-5 AND BROKER-DEALERS

10b-5 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 relationship between his injury and the broker's acts, in addition to the elements ordinarily necessary for an SEC disciplinary proceeding.

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. Churning may result in discipline through an administrative action, a private suit for damages, and criminal prosecution.

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.
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 15cl-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...
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. A finding of indirect control is made easier by the customer's naïveté and lack of business and securities experience. 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).


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. 103, 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, since his broker exercised no control over the buy and sell determinations.

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. 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. Typically, a court or the Commission will recite a series of numbers and ratios and then decide, based on a sub-

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356 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).


358 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, 422, 423 (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.

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. A closely related test is the percentage of securities sold within a short time of purchase, 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, buying, selling, and then repurchasing the same security; and

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862 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.


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, 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).

863 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.


sells a security from one account while causing another account to purchase it. 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, or the total income of the salesman or firm, and the broker's profits gathered from other accounts. A further circumstance is the loss sustained while the investor's account was overtraded. Finally, some types of trades are sufficient on their face to prove churning without recourse to the above indicia.

The final element necessary to establish a churning offense is a


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).

Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 425 (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").


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.\textsuperscript{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.\textsuperscript{374}

If control, excessive purchases and sales, and broker motivation are shown, adequate defenses are not readily available. The investor's wealth and the broker's intent are not protection, nor is a profit in the account, whether measured against the initial balance or against the value the portfolio would have had at the end of the period had it been kept intact.\textsuperscript{375} In some investor suits for damages, courts have

\textsuperscript{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, Johnson & 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.


\textsuperscript{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.


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.\textsuperscript{379}

In private rights of action, which are permitted for overtrading,\textsuperscript{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. \textit{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.\textsuperscript{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.\textsuperscript{382} There is, however, relatively little


\textsuperscript{381} See 12 C.F.R. \textsuperscript{220.1 to .3} (1972).

authority on the question of whether a 10b-5 claim is also cognizable.\footnote{See Exchange Act Rule 10b-16, 17 C.F.R. § 240.10b-16 (1972) (disclosure of finance charges).}

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.\footnote{See generally notes 157-232 and accompanying text supra.} 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 known\footnote{H.F. Schroeder & Co., 27 S.E.C. 833, 836-37 (1948).} his statement was misleading.\footnote{See H.F. Schroeder & Co., 27 S.E.C. 833, 836, 837 (1948) (representation bank could lend only 50% whereas limit really 70%).}

The following are examples of statements falsely made: the broker can obtain margin which the customer cannot;\footnote{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).}

| 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;\footnote{See Note, Federal Margin Requirements as a Basis for Civil Liability, 66 Colum. L. Rev. 1462, 1494-95 (1966). See also Comment, supra note 390, at 620-23.} or margin is available on terms more favorable than they actually are, so the customer enters into a transaction he would not otherwise make.\footnote{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).}

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.\footnote{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. On the
other hand, a sale by a broker should be deemed a conversion, and hence actionable by the customer, if appropriate demands for additional collateral have not been made or if the broker sells more securities than is necessary to meet the statutory norm. 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.

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, 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. 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: 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. Controversy generally centers on what is "reasonable" and how the mark-up or mark-down should be computed. 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, but, due to industry pressure, it was not adopted.

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. 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. Leeby, 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.


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,\footnote{SEC v. Seaboard Sec. Corp., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,697, at 95,563 (S.D.N.Y. 1965).} except to the extent that the contemporaneous cost evidences the prevailing market.\footnote{See notes 409-22 and accompanying text infra.} The dealer should not be penalized for obtaining securities at a price less than current market price.

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, although longer intervening periods have been recognized. Second, the decisions assume the price paid for the security is the dealer’s “contemporaneous cost.” 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.” 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.

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.


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”).

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.

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.


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 dealers\textsuperscript{416} or the price which dealers were charging one another during the applicable period\textsuperscript{418} 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.\textsuperscript{417}

A market maker\textsuperscript{418} poses special problems. As the Special Study of the Securities Markets indicated,\textsuperscript{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.\textsuperscript{420} Absent proof of unusual circumstances such as these, bids and offers placed in the quotation sheets cannot supplant the contemporaneous cost standard.\textsuperscript{421} A different result should be mandated by the use


\textsuperscript{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.

\textsuperscript{419} Special Study pt. 2, at 644-68.


\textsuperscript{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.\textsuperscript{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.\textsuperscript{423} Nevertheless, the prices in the sheets are generally considered prima facie evidence of the prevailing market in the absence of contemporaneous cost.\textsuperscript{424} Since a broker \textit{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,\textsuperscript{425} and are of little value for low-priced securities with a wide spread between the bid and offer quotations.\textsuperscript{426}

\textsuperscript{422} See note 249 \textit{supra}.

\textsuperscript{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., \textit{supra}. See note 408 \textit{supra}.


\textsuperscript{425} In a case reviewing a NASD-imposed sanction, the SEC stated:

\textit{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.\(^{426}\)


\(^{429}\) 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. 788, 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(g) 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, emplo[y] a method too generous to the respondents").

\(^{430}\) Perhaps the most accurate indication of prevailing market is the mean between the low asked and the high bid quotations.

\(^{431}\) Broker-dealers can determine whether their customer prices are appropriate only if they can determine which price to use in computing the mark-up.

\(^{432}\) 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. 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.

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. 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.

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. The mark-up or mark-down permissible under Rule 10b-5 must be determined on a case-by-case basis. The NASD, to which most brokerage firms belong, has adopted its own guidelines for the percentage mark-up and mark-down allow-

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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.
437 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).
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. 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." 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.

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."

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. 7323, 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

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


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.

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

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." 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 an 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").


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. 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, or to escape discipline if the mark-up on some sales was fraudulent (even though the average mark-up was not excessive).

Other unsuccessful defenses which have been argued are: the securities were of good quality; the customer's financial position was improved; the intrinsic value of the security was higher than market; and the customers ratified the transactions.

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).

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").

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).

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. 581, 595 (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).


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-agent or as the implied agent for the customer. As an agent, the broker must obtain the best possible price for the customer, 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, but is whether any profits have been concealed from the customer. Brokers have obtained secret profits by misrepresenting the purchase or sale price.

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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 deal).

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 & Hirshberg, Inc. v. SEC, 177 F.2d 228, 231-32 (D.C. Cir. 1949), aff'd 21 S.E.C. 855 (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. 1045, 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.153. For a discussion of the implied agency theory, see notes 70-71 and accompanying text supra.


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, and billing customers too much for incidental expenses. 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. As with an over-the-counter dealer, a broker is not exonerated merely because his clients suffered no injury.

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.

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

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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 (1945) (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 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 (1942), 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).


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 marker,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

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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. 492,928 (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.


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).


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.

the customer is injured by not receiving the best price.\textsuperscript{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.\textsuperscript{473} In most cases the interposed broker garner\textsuperscript{s} 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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{477}


\textsuperscript{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).

\textsuperscript{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).


\textsuperscript{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. 1394 (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).

\textsuperscript{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.

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) (constructing Exchange Act Rules 10b-5 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.

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 rule\(^485\) 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.


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.

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

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 authority or in excess of his limited authority. The shingle theory is again the source of these prohibitions.

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 L. 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 Schruffagel 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).


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. 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. 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).


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).


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

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. Securities can be sold or pledged with-


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).


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).


out authority, transferred to another customer, or obtained by misrepresentation or concealment. 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. Customers’ monies, whether they are amounts paid for the purchase of a security, amounts held by the broker-dealer for safekeeping, and those received for a customer after a recent purchase, can likewise be converted in a variety of ways. A broker could fail to return monies when requested, spend the funds without authorization, or fail to apply funds as directed. 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).


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.


509 Calvert Sec. Corp., 25 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.\footnote{510}

Administrative penalties may be imposed and civil remedies are available when a misappropriation violation is established.\footnote{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.\footnote{512} Unauthorized transactions, themselves an infraction of the Rule, necessarily involve a misappropriation.\footnote{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.\footnote{514} More correctly, the question should be whether obtaining by false pretenses, converting, or embezzling satisfies the "in connection with" requirement.\footnote{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.\footnote{516}

\footnote{510} Cf. W. Prosser, supra note 507, at 83 (common law).
\footnote{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., 285 F. Supp. 440, 445 (N.D. Ill. 1967).
\footnote{512} See generally notes 381-96 and accompanying text supra (margin rules).
\footnote{513} See notes 490-92 and accompanying text supra.
\footnote{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.
\footnote{515} Since no distinction among these three concepts is necessary for our purposes, the words will be used interchangeably.
\footnote{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 him for the customer's account after executing a purchase order or securities delivered by the customer for sale, that sale or anticipated sale should provide the requisite nexus. Another possibility for satisfying the "in connection with" clause is the broker's subsequent pledge 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. 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.

Finding a purchase or sale on which to rely is more difficult when cash or other non-securities are converted. Little trouble should be encountered where funds are given to a stockbroker to pay for securities his customer ordered, 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).


518 Kennedy 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, 725 (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.

represent proceeds of a sale of securities.\textsuperscript{624} Then, too, if a brokerage firm uses the converted monies to purchase securities, or perhaps even to make or pay off a loan,\textsuperscript{525} the "in connection with" language would be satisfied.\textsuperscript{526} Finally, a broker representation might generally be implied that no conversion of customers' monies will be effected.\textsuperscript{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.\textsuperscript{528} That is, absent a clear understanding to the contrary,\textsuperscript{529} a stockbroker is deemed to represent at the time of the preliminary 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).


\textsuperscript{525} As to whether a loan is a security which can be purchased or sold, see 1 Loss 546.

\textsuperscript{526} See notes 519-20 and accompanying text \textit{supra} for a caveat which is equally applicable here—the subsequent use must have been contemplated at the time of conversion.

\textsuperscript{527} See note 521 and accompanying text \textit{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).


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.

\textsuperscript{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.\footnote{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.\footnote{531} Violation of the duty can give rise to civil\footnote{532} and administrative remedies. Naturally, the broker's duty to deliver promptly does not apply to property the customer desires the broker to hold,\footnote{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 executed\footnote{534} and end when delivery is made under the terms of the Uniform Commercial Code.\footnote{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,\footnote{536} when he knows the transfer agent


\footnote{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.

\footnote{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.


\footnote{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.


for the security is backed up, or when he knows the dealer from whom he purchases makes slow delivery.

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, a controlling person, or the principal of a wrongdoing agent. 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. 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


539 E.g., Gross v. SEC, 418 F.2d 103, 107 (2d Cir. 1969).


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.\textsuperscript{543}

Since this provision is a codification of the prior cases,\textsuperscript{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.\textsuperscript{545} While some courts have reached the identical result by similar reasoning,\textsuperscript{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


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.

act." 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). 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.

The duty of supervision necessitates that supervisory procedures be established, and that the responsibilities under the system be reasonably discharged. The system should cover all areas of the firm, with particular emphasis on new offices, inexperienced personnel, and geographically remote operations. A firm cannot wait for customer complaints and then implement the system. Prompt and in-depth investigation of any hint of irregularity is required. It is no defense to comply with the requirements for internal supervision as provided in section 20(a); 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).


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).

that the supervision at other firms is worse\textsuperscript{555} or that supervisors had no notice of any nonconformity.\textsuperscript{556} Indeed, the very occurrence of a fraud might be considered evidence of lack of proper supervision.\textsuperscript{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.\textsuperscript{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.\textsuperscript{559}

Brokerage firms have many antennae for inside information, but they usually\textsuperscript{560} 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.\textsuperscript{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.\textsuperscript{562} Finally, and most commonly, a broker can receive


\textsuperscript{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.\textsuperscript{557}

\textsuperscript{557} Comment, \textit{supra} note 549, at 105.

\textsuperscript{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 \textbf{TEMPLE L.Q.} 493, 495 (1966) (duty to hire competent personnel). As to the qualifications of securities personnel, see Comment, \textit{supra} note 65, at 681-700.


\textsuperscript{560} \textit{See} R.D. Bayly & Co., 19 S.E.C. 773, 784 (1945) (broker’s intent to gain control of issuer).


\textsuperscript{562} A whole series of cases arose out of inside information Merrill Lynch received when acting as lead underwriter for Douglas Aircraft. \textit{E.g.}, Smachlo v. Merrill Lynch,
a "tip" which he knows or has reason to know was obtained improperly.\footnote{563} The source of the data and whether the news was unsolicited are irrelevant.\footnote{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.\footnote{565} It is no defense that a broker-dealer reaped no monetary gain from his illegal use of the facts.\footnote{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.\footnote{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


\footnote{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.


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).

\footnote{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.

\footnote{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.
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 material 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 public 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 (1969) (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).


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).

ers,\textsuperscript{674} or selectively disclose the facts to persons who then trade on the basis of such information.\textsuperscript{675} 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.\textsuperscript{676} Any conflict of fiduciary obligations is resolved in favor of the broker-dealer's duties to the investing public and the corporate issuer.\textsuperscript{677} 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 \textit{subsequently} receives inside information indicating that the chosen course of action is correct.\textsuperscript{678}


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. This has been held to be an infraction of the Rule. 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, he must abstain from giving any further advice under these circumstances. A broker who refuses to desist and affirmatively and falsely represents he has no adverse data would also transgress the Rule.

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. 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, and the more cogently reasoned court opinions have not barred the customer from recovering despite his complicity in the use of supposedly unpublicized data. Finally, a broker with inside infor-

670 This is different from tipping in that the information is not disclosed, either directly or by innuendo.
681 See note 108 and accompanying text supra.
682 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).
684 See Daum & Phillips, supra note 163, at 951; Sandler & Conwill, supra note 578, at 269.
685 See notes 167-68, 196 and accompanying text supra.
information 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.\textsuperscript{587} A customer should have a cause of action if his broker advises him contrary to the inside information the broker possesses.\textsuperscript{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.\textsuperscript{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 point\textsuperscript{590} in prohibiting the firm from acting as a broker-agent until or unless it discloses the information.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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

\textsuperscript{587} This would satisfy the "in connection with the purchase or sale or security" language of 10b-5. \textit{See} notes 190, 212 and accompanying text \textit{supra}.


\textsuperscript{590} The customer could always go to another firm. The broker's refusal would also raise questions as to why he followed that course.


\textsuperscript{592} \textit{See} 3 \textit{Loss} 1500-08; 6 \textit{id. at} 5702-08.

\textsuperscript{593} Acting as a dealer in any capacity should be prohibited when the inside information is \textit{not} clearly good or bad, as is the case with some mergers.
executed the trade without disclosing. Whether a broker has a duty to disclose that the customer is a director, officer, or controlling stockholder of the issuer is unclear; however, in practice, no disclosure is made.

Some brokers make a market in over-the-counter securities, while others are specialists on a securities exchange. 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. 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.

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, for the Rule protects the sophisti-

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695 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.

696 In an exchange transaction disclosure would be difficult; in over-the-counter trades the information is only rarely communicated.

697 For definitions of "market maker" and "specialist," see notes 269-318 and accompanying text supra.

698 See generally notes 269-318 and accompanying text supra (broker controlling market).


600 No objection was raised when brokers brought suit in some cases. E.g., Carroll v.
cated as well as the naive. 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.

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. 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.

**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, 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.


602 The policies of equalizing bargaining position, fairness, and fostering investor confidence indicate that this should be the result.

