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THE SEC AND THE BROKER-DEALER *

LOUIS LOSS **

A couple of weeks ago the Commission handed down an opinion in a broker-dealer revocation proceeding which is the latest in a series of cases over the past few years that have gradually blocked out the duties of a broker-dealer to his customer. That case gives me my theme today.

It happens that most of what I am about to say relates primarily to the over-the-counter market. I was a little disturbed about the propriety of talking about over-the-counter problems under the auspices of this organization. However, we are all interested, I take it, in the problems of the securities industry as a whole, and I was anxious, if possible, to give you something newsworthy. What I shall try to do today, therefore, is to trace briefly the history of the several doctrines which the Commission has developed with reference to the duties of a broker-dealer and summarize their present status. I want to emphasize that I am not here to preach or moralize, but only to expound. I realize that it may be just as hard to tell the difference between preaching and expounding as it sometimes is to determine whether a firm is acting as a broker or as a dealer, but I honestly want to limit myself to putting the mosaic together for you.

The story has a double importance. It is not merely a matter of a firm's so conducting its business that it will not fall afoul of the SEC and risk possible revocation or injunction or criminal proceedings. If that were the only problem, a great majority of the members of the investment fraternity could put their minds at ease. For, as the late Judge Healy¹ once said, people can be pretty sure they will not get into trouble with the Commission so long as they do what most of them know and agree is the decent and honorable thing to do. The more serious problem from the point of view of the respectable and sound members of the industry is that a violation of one of these doctrines may give rise to a lawsuit by a customer seeking either rescission of his contract or damages. Within the past couple of years there have been a number of court decisions to the effect that a violation of the Securities Exchange Act or some rule thereunder creates a civil liability in favor of the injured person even though there is no specific provision for a private lawsuit under the particular section or rule which has been violated.² So it is well to know these principles and to remember them.

* This article is a reprint (with annotations) of an address delivered at the Chicago Stock Exchange under the auspices of the Exchange and the Stock Brokers' Associates of Chicago on March 16, 1948.

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1. Commissioner, SEC, 1934-46.

2. *Geismar v. Bond & Goodwin, Inc.*, 40 F. Supp. 876 (S.D.N.Y. 1941); *Baird v. Franklin*, 141 F. 2d 238 (C.C.A. 2d 1944), *cert. denied*, 323 U.S. 737 (1944); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), *appeal pending*; *Slavin v. German-*

I think it is worth stressing at the start that most of the doctrine that I am going to try to relate is not particularly new or radical. In great measure it very likely would have been developed in time by the courts even if there had never been an SEC. The fact is that much of the doctrine is nothing more than good old-fashioned agency law. I say this because occasionally members of the securities industry seem surprised to find that, when the common law says that an agent owes certain duties to his principal, it applies no less to securities than it does to houses or cans of beans—or, shall I say, commodities. I suppose this is because the securities industry does not rely to too great an extent on formal contracts with all the attendant caveats and “whereases” which are the badges of the legal fraternity. When brokers or dealers trade with each other, they necessarily rely to a great extent on a mutual trust and confidence developed by the financial community over many years. Commitments by word of mouth are by no means rare, and in most instances they are strictly honored, as they should be.

The fact is, however, that the law of agency does not and cannot make any exceptions in favor of the securities business. Quite the contrary, the law recognizes that the securities business is not quite like the business of selling groceries or automobiles—although I suppose at the moment many of you here would prefer a resemblance to the latter. The courts have made it plain that when federal and state securities laws speak of fraud they are not necessarily limited to action which would be considered fraudulent at common law. The very fact that the Congress and the legislatures of 47 states, as well as all the foreign countries of any importance in the financial world, have deemed it necessary to pass special laws in the securities field demonstrates in itself that the securities business is something of a unique animal.³ The Supreme Court of the United States recognized this as early as 1917 in sustaining the constitutionality of one of the first state blue sky laws,⁴ and the Court of Appeals of the State of New York specifically held 22 years ago that the term “fraud” as used in that state’s Martin Act was not limited to common law concepts but “includes all deceitful practices contrary to the plain rules of common honesty.”⁵

town Fire Insurance Co., 74 F. Supp. 876 (E.D. Pa. 1946), *appeal pending*; Fifth-Third Union Trust Co. v. Block, Civil Action No. 1507, S.D. Ohio, Dec. 11, 1946; Speed v. Transamerica Corp., 71 F. Supp. 457 (D. Del. 1947); Acker v. Schulte, 74 F. Supp. 683 (S.D.N.Y. 1947); cf. Goldstein v. Groesbeck, 142 F. 2d 422 (C.C.A. 2d 1944), *cert. denied*, 323 U.S. 727 (1944); Phillips v. United Corp., No. 40-497, S.D.N.Y., July 30, 1947. *But cf.* Downing v. Howard, 162 F. 2d 654 (C.C.A. 3d 1947), *cert. denied*, 332 U.S. 818 (1947); Weinberger v. Semenenko, 36 N.Y.S. 2d 396 (Sup. Ct. 1942). See Note, *New Civil Liabilities under Securities and Exchange Act Rules*, 14 U. OF CHI. L. REV. 471 (1947).

3. In the course of enacting the Securities Act of 1933, securities were referred to as “intricate merchandise.” H. R. REP. NO. 85, 73d Cong., 3d Sess. (1933) 8.

4. Hall v. Geiger-Jones Co., 242 U.S. 539, 552 (1917), 17 COL. L. REV. 244 (1917); see also Archer v. SEC, 133 F. 2d 795, 803 (C.C.A. 8th 1943), *cert. denied*, 319 U.S. 767 (1943).

5. People v. Federated Radio Corp., 224 N.Y. 33, 154 N.E. 655, 657-8 (1926);

I mentioned at the beginning the fact that the Commission had handed down its most recent opinion in this general field a few weeks ago. The firm involved was Arleen W. Hughes, doing business as E. W. Hughes & Co., out in Colorado Springs.⁶ This case should not be confused with the earlier case involving Charles Hughes & Co., Inc., which was decided by the Commission in 1943 and affirmed by the Circuit Court of Appeals in New York.⁷ It is one of those strange coincidences that two of the leading cases in this field should involve firms of the same name. It is even an odder coincidence, in view of the relatively few representatives of the fair sex in this business, that both these firms were run by ladies. I hasten to add that we have no prejudice against the family name Hughes and certainly no prejudice against ladies in the securities business. We just don't show them any special favors. The common surname, however, will probably not help to resolve the inevitable confusion between the twin doctrines represented by these two cases. It is essentially the purpose of my talk to try to forestall that confusion.

The first *Hughes* case had its genesis in 1939, when the Commission for the first time held in the course of a broker-dealer revocation proceeding that it was a fraud under the securities laws for a dealer to sell securities to a customer at a price not reasonably related to the current market. This has nothing to do with any agency obligation. The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public. It is an element of that implied representation, the theory goes, that his prices will bear some reasonable relation to the current market unless he discloses to the contrary. Therefore, charging a price that does not bear such a relation is a breach of the dealer's implied representation and works a fraud on the customer. Just as that doctrine has nothing to do with agency or brokerage law, it likewise has nothing to do with limiting the amount of the dealer's profit, except of course where his own purchase is substantially contemporaneous with his sale. If a dealer buys a security at \$10 and holds on to it until the market hits \$20, he is perfectly free to take his profit of 100 per cent or somewhat more. Conversely, if he buys a security at \$10 and is unlucky enough to stay with it until the market falls to \$5, it is fraudulent for him without disclosure to sell it at a price not reasonably related to the current market of \$5 notwithstanding that he will suffer a loss.

Some of you will recall this as the *Duker* doctrine, since the first case in which the Commission applied it back in 1939 related to a firm called Duker & Duker.⁸ The doctrine was then repeated by the Commission and elaborated

Charles Hughes & Co., Inc. v. SEC, 139 F. 2d 434, 437 (C.C.A. 2d 1943), *cert. denied*, 321 U.S. 786 (1944); William J. Stelmack Corp., 11 SEC 601, 621 (1942); Trost & Co., Inc., 12 SEC 531, 535 (1942); *cf.* SEC v. Chenery Corp., 318 U.S. 80 (1942).

6. Arleen W. Hughes, SEC Securities Exchange Act Releases Nos. 4048, 4073 (1948), *appeal pending*, App. D.C.

7. Charles Hughes & Co., Inc., 15 SEC 676 (1943), *aff'd*, 139 F. 2d 434 (C.C.A. 2d 1943), *cert. denied*, 321 U.S. 786 (1944), 18 ST. JOHN'S L. REV. 134 (1944).

8. 6 SEC 386 (1939).

in a substantial number of cases⁹ and finally affirmed on judicial review, as I have already stated, in the *Charles Hughes & Co.* case five years ago. That case went all the way to the Supreme Court of the United States, which refused to review the opinion of the Circuit Court of Appeals. In that case the mark-ups over the current market ranged from 16 to 50 per cent, averaging about 25 per cent, and the Circuit Court of Appeals unanimously held that the failure to reveal those mark-ups was "both an omission to state a material fact and a fraudulent device." "When nothing was said about market price," the court stated, "the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. The law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other." And again: "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities."¹⁰

The first *Hughes* case thus recognized the obvious importance of market price in the securities field. A stock certificate has no intrinsic value. Unlike the produce from a grocery store it cannot be eaten. Its value rests mainly on the fact that it can produce income or be converted into money—that it has market value. A hungry man is willing to pay a vendor at a football stadium two or three times what they both know a "hot dog" is worth because the buyer wants to eat it at the moment. Or, because of immediate use value, you or I might decide to pay several hundred dollars more than list price for a car which is euphemistically called second-hand. But a security has no use value. The buyer of a security is interested only in two things. How much income will it produce and what will it bring in the market on resale? And the income-producing feature is important in large measure because it affects the market price.¹¹ If the securities dealer ignores the market price in a transaction with a customer, the transaction is condemned as fraudulent. And this presumably applies both ways—to purchases by dealers as well as sales—although in practice, as we all know, spreads are usually far smaller on the purchase side.

This first *Hughes* case was a milestone in broker-dealer law, and the

9. See 10 SEC ANN. REP. 74, n. 56, H. Doc. No. 158, 79th Cong., 1st Sess. (1945).

10. *Charles Hughes & Co., Inc. v. SEC*, 139 F. 2d 434, 437 (C.C.A. 2d 1943), *cert. denied*, 321 U.S. 786 (1944).

11. The Supreme Court has referred to securities as "the equivalent of money." *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 598 (1921); *Venner v. Southern Pacific Co.*, 279 Fed. 832, 843 (C.C.A. 2d 1922); see BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1934) 287, 306-7. Moreover, it is the vital importance of market price which is the basis for holding that manipulation of the market is a fraud. *Otis & Co. v. SEC*, 106 F. 2d 579, 583 (C.C.A. 6th 1939); *United States v. Brown*, 79 F.2d 312, 325 (C.C.A. 2d 1935); *Kopald-Quinn & Co. v. United States*, 101 F. 2d 628, 631-2 (C.C.A. 5th 1939), *cert. denied*, 307 U.S. 628 (1939); *Rex v. DeBerenger*, 3 Maule & S. 67, 105 Eng. Reprint 536 (K.B. 814); see Moore and Wiseman, *Market Manipulation and the Exchange Act*, 2 U. OF CHI. L. REV. 46 (1934).

doctrine is now so well settled that we have actually obtained criminal convictions of dealers in a number of cases on that theory.¹² But like many great cases the first *Hughes* case left a number of questions unanswered.

The first question which obviously comes to mind is how to ascertain the market which the Commission and the court held to be so important in the pricing of a transaction. The over-the-counter market knows no ticker tape. In the first *Hughes* case itself the Commission and the court relied on the quotations in the National Daily Quotation Sheets and the prices paid concurrently by the firm as sufficiently indicating prevailing market price in the absence of evidence to the contrary. But suppose there are no quotations in the Sheets. Or suppose there is no offer but only a "sleeper bid"; someone is hunting for a bargain. The Sheets are not necessarily the last word, although they are very important. As long as the dealer is sure that there were *bona fide* independent offers at a price reasonably near the dealer's sale price, the dealer is in the clear so far as the first *Hughes* case is concerned.

Now suppose it is impossible to find any independent quotes of any kind. Here there is precedent, both in the Commission and in the courts, for assuming that the dealer's own cost is a fair indication of the current market if the dealer's purchase is substantially contemporaneous with his sale.¹³ Of course, if there is no market and the dealer has held the security for some time before selling it, there is nothing for the theory to operate on. I should emphasize that I am still talking of the dealer who is effecting an ordinary principal transaction; there are other doctrines applicable, even where there is no market, to a dealer occupying a special fiduciary position, and I shall come to them a little later.

Another question which in the nature of things was left unanswered in the first *Hughes* case—and which the Commission, I would guess, is not likely to attempt to answer—is precisely what spread is reasonable in relation to the current market in all cases. The Commission has revoked the registration of a succession of firms whose average mark-ups were clearly out of line, but there is no arbitrary standard. Obviously we must consider the overall business conduct of a particular firm and not one or a half-dozen isolated transactions. Percentages are particularly unreliable, it goes without saying, when the gross dollar amount of the transactions is relatively small. Nevertheless, the Commission's application of the first *Hughes* doctrine tended to reduce substantially some of the more shocking mark-ups.

12. *United States v. Dagg*, No. 15460, W.D. Wash. 1943; *United States v. Guaranty Underwriters, Inc.*, No. 7155, S.D. Fla. 1944; *United States v. Florida Bond & Share, Inc.*, No. 533, S.D. Fla. 1946.

13. *Lawrence R. Leiby*, 13 SEC 499 (1943); *Bernard J. Johnson*, SEC Securities Exchange Act Release No. 3729 (1945); *Scott McIntyre & Co.*, 11 SEC 442, 445, n. 1 (1942); *Sherman Gleason*, SEC Securities Exchange Act Release No. 3550 (1944) 14; *Pandolfo v. United States*, 128 F. 2d 917 (C.C.A. 10th 1942), *cert. denied*, 317 U.S. 651 (1942).

At this point the Commission's work was soon supplemented by the NASD, as I believe Congress intended it should be.¹⁴ As you all know, whereas the Commission operates for the most part under rules phrased in terms of "fraud," the NASD is in a position to attack the problem of unreasonable spreads under the broader and more flexible "high standards of commercial honor and just and equitable principles of trade."¹⁵ As a result of a 1943 survey of its members' over-the-counter transactions which indicated that about half the transactions were effected at mark-ups of three per cent or less and most of the transactions at mark-ups of less than five per cent, the NASD instructed its District Business Conduct Committees to bear those statistics in mind in determining whether prices were reasonably related to the market for the purposes of its own rules.¹⁶

I have no wish here to elaborate on this "5 per cent philosophy" of the NASD. I mention it only to round out the picture of the first *Hughes* doctrine. The Commission, in an opinion last year in which it reversed disciplinary action taken by an evenly divided Board of Governors of the NASD against the firm of Herrick, Waddell & Co., agreed with the NASD that its rules against unethical conduct went beyond fraud. Fraud, the Commission said, is normally obviated by disclosure, whereas conduct may be unethical regardless of disclosure. Nevertheless, the Commission held that the NASD's action had been based on the fallacious theory that mark-ups in excess of those customarily charged are in themselves conclusive proof of violation of the NASD's rules. While disclosure will not always obviate a violation of the rules against unethical conduct, the degree of disclosure made must be considered along with all other pertinent circumstances in judging the reasonableness of the mark-ups and the ethics of the transactions.¹⁷

In any event, the NASD's application of its "5 per cent philosophy" has considerably minimized the enforcement problems under the Commission's fraud rules. Consequently, while the first *Hughes* doctrine is still in full effect and there are occasions even today calling for its application, it is perhaps appropriate now to concentrate our attention primarily on the second of the

14. The National Association of Securities Dealers, Inc., is a nation-wide association of over-the-counter brokers and dealers registered with the Securities and Exchange Commission as a "national securities association" under Section 15A of the Securities Exchange Act of 1934. That section was added to the Act as part of the so-called Maloney Act amendment in 1938. 52 STAT. 1070 (1938), 15 U.S.C. § 78o-3 (1940). See 10 SEC ANN. REP. 76-9, H. Doc. No. 158, 79th Cong., 1st Sess. (1945); National Association of Securities Dealers, Inc., 5 SEC 627 (1939); Grant, *The National Association of Securities Dealers: Its Origin and Operation* [1942] WIS. L. REV. 597; Comment, *Over-the-Counter Trading and the Maloney Act*, 48 YALE L.J. 633 (1939).

15. SECURITIES EXCHANGE ACT OF 1934 §. 15A(b)(7), 52 STAT. 1071 (1938), 15 U.S.C. § 78o-3(b)(7) (1940); NASD RULES OF FAIR PRACTICE, art. III, § 1, NASD MANUAL C-7.

16. National Association of Securities Dealers, Inc., SEC Securities Exchange Act Release No. 3623 (1944).

17. Herrick, Waddell & Co., Inc., SEC Securities Exchange Act Release No. 3935 (1947).

two doctrines, which finds its latest expression in the more recent *Hughes* case—the *Arleen W. Hughes* case decided by the Commission on February 18 of this year.¹⁸ The doctrine of that case, in a nutshell, is that a firm which is acting as agent or fiduciary for a customer, rather than as a principal in an ordinary dealer transaction, is under a much stricter obligation than merely to refrain from taking excessive mark-ups over the current market. Its duty as an agent or fiduciary selling its own property to its principal is to make a scrupulously full disclosure of every element of its adverse interest in the transaction.

In other words, when one is engaged as agent to act on behalf of another, the law requires him to do just that. He must not bring his own interests into conflict with his client's. If he does, he must explain in detail what his own self-interest in the transaction is in order to give his client an opportunity to make up his own mind whether to employ an agent who is riding two horses. This requirement has nothing to do with good or bad motive. In this kind of situation the law does not require proof of actual abuse. The law guards against the potentiality of abuse which is inherent in a situation presenting conflicts between self-interest and loyalty to principal or client. As the Supreme Court said a hundred years ago, the law "acts not on the possibility, that, in some cases the sense of duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty."¹⁹ Or, as an eloquent Tennessee jurist put it before the Civil War, the doctrine "has its foundation, not so much in the commission of actual fraud, but in that profound knowledge of the human heart which dictated that hallowed petition, 'Lead us not into temptation, but deliver us from evil,' and that caused the announcement of the infallible truth, that 'a man cannot serve two masters.'"²⁰

This time-honored dogma applies equally to any person who is in a fiduciary relation toward another, whether he be a trustee, an executor or administrator of an estate, a lawyer acting on behalf of a client, an employee acting on behalf of an employer, an officer or director acting on behalf of a corporation, an investment adviser or any sort of business adviser for that matter, or a broker. The law has always looked with such suspicion upon a fiduciary's dealing for his own account with his client or beneficiary that it permits the client or beneficiary at any time to set aside the transaction without proving any actual abuse or damage.²¹ What the recent *Hughes* case does

18. *Arleen W. Hughes*, SEC Securities Exchange Act Releases Nos. 4048, 4073 (1948), *appeal pending*, App. D.C.

19. *Michoud v. Girod*, 4 How. 503, 554 (U.S. 1846); *United States v. Carter*, 217 U.S. 286, 306 (1910).

20. *Tisdale v. Tisdale*, 2 Sneed 596, 64 Am. Dec. 775, 783 (Tenn. 1855).

21. *Robertson v. Chapman*, 152 U.S. 673, 681 (1894).

is to say that such conduct, in addition to laying the basis for a private lawsuit, amounts to a violation of the fraud provisions under the securities laws. This proposition, as a matter of fact, is found in a number of earlier Commission opinions.²² The significance of the recent *Hughes* opinion in this respect is that it elaborates the doctrine and spells out in detail exactly what disclosure is required when a dealer who has put himself in a fiduciary position chooses to sell his own securities to a client or buys the client's securities in his own name.

Mrs. Arleen Hughes registered with the Commission both as a broker-dealer and as an investment adviser. The bulk of her business was with about 175 clients, each of whom signed a "Memorandum of Agreement" specifying that the firm was to act in all transactions as both investment adviser and principal except as otherwise agreed. The contract included an elaborate schedule of rates and charges applicable to each transaction. It specified maximum spreads which would be added to a so-called "base price" when the firm sold securities to a client or bought them from a client. For simplicity I shall speak here only of the sale side. And I shall not elaborate on the various methods by which the "base price" was computed except to say that it apparently bore some relation to the current market and that we did not charge that Mrs. Hughes was taking unreasonable spreads in violation of the first *Hughes* doctrine. The schedule in the client's contract specified that the amount added to the "base price" might vary from \$40 down to \$10 per \$1000 face value in the sale of bonds depending on the amount of the transaction, and from 3 points down to $\frac{1}{8}$ point in the sale of stock depending on the "base price."

The firm admittedly advised the clients with reference to well-balanced investment programs and made specific recommendations. It was also admitted that the firm's advice was followed in almost every instance. In roughly half the cases Mrs. Hughes sold her own securities from inventory, and in the remainder she first obtained a firm order and then went through the form of buying the security for her own account and confirming a sale to the client as principal. She did not make a practice of disclosing whether or not a particular security was being sold out of inventory, or what the current market or her own cost was. The most the clients could know was the maximum mark-up that might be taken under the schedule, which could be in theory as much as one point on a stock with a "base price" of \$1, or 100 per cent; fortunately, unduly high spreads were not taken in actual practice, as I have already indicated. Finally, most of her clients who testified—and they were very friendly toward her—were typically confused as to the difference between a principal and an agency transaction.

²² See Allender Co., Inc., 9 SEC 1043 (1941); William J. Stelmack Corp., 11 SEC 601 (1942).

On these facts the Commission held that it did not suffice merely to refrain from selling at prices not reasonably related to the current market, which is the duty of an ordinary dealer in a principal transaction. Nor does it suffice for the firm to disclose merely the maximum mark-ups it will charge. Rather, the Commission held, the firm must disclose fully the nature and extent of its adverse interest.

Just what does such disclosure entail? Traditionally the law has always required disclosure of the fiduciary's capacity and of his actual cost in this type of case (or, in the case of a purchase from a client, the fiduciary's resale price where known).²³ In addition, however, the Commission recognized the obvious fact that in the securities field there is another criterion of adverse interest which is usually a good deal more significant. That criterion is the current market price—namely, the best available bid or offer, as the case may be, which the fiduciary is able to discover in the exercise of reasonable diligence.²⁴ Of course, it is not essential to disclose the best available market price unless it is more favorable than the price at which the fiduciary proposes to buy from or sell to his client. Furthermore, disclosure of cost and market will normally be the same where the fiduciary affects an approximately contemporaneous transaction with another dealer to offset a transaction with a client. However, where the fiduciary has held a security in inventory for some time before selling it to a client, the fiduciary's cost, though still significant, is of secondary importance, and disclosure of cost alone without disclosure of current market may be positively misleading. Suppose, for example, the fiduciary paid 50 for a security in inventory and is charging the client 20, but the current market is 10; disclosure of cost alone would indicate that the client is getting a bargain, whereas in fact he is being "taken for a ride," and it's not a free one.

The Commission also spelled out in some detail how the required disclosure of capacity and market might be made. The nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases use of the term "principal" itself may suffice. In others, a more detailed explanation will be required. In all cases, however, the burden is on

23. *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 188 Mass. 315, 74 N.E. 653, 658 (1905); *Norris v. Beyer*, 124 N.J. Eq. 284, 1 A. 2d 460, 461 (1938); *Allender Co., Inc.*, 9 SEC 1043, 1054 (1941); *William J. Stelmack Corp.*, 11 SEC 601 (1942).

24. The fact situations which have been dealt with by the courts have related for the most part to unique properties rather than properties having a readily ascertainable market value, and generally relief has been based on failure to disclose the fact that the fiduciary was selling for his own account or to disclose the amount of his cost or profit. However, even in these situations the courts have recognized that the fiduciary is under a duty to obtain or dispose of the property for his principal at the best price discoverable in the exercise of reasonable diligence. *Doyen v. Bauer*, 211 Minn. 140, 300 N.W. 451, 455 (1941); *Rodman v. Manning*, 53 Ore. 336, 99 Pac. 657, 658 (1909); *Van Dusen v. Bigelow*, 13 N.D. 277, 100 N.W. 723, 724-5 (1904); *Ridgeway v. McGuire*, 176 Ore. 428, 158 P. 2d 893, 895-6 (1945); *Berkley Sulphur Springs v. Liberty*, 10 N.J. Misc. 1067, 162 Atl. 191, 192 (Ch. 1932); 2 RESTATEMENT, AGENCY § 390, comment *a* (1933).

the firm which acts as fiduciary to make certain that the client understands that the firm is selling its own securities.²⁵ In disclosing market price, where it is more favorable than cost, the firm must make certain that the quotations it furnishes to clients are reliable and truly indicative of the current market. These quotations need not be taken from any particular source. But they must be true reflections of the market price at which the transactions could be effected as agent with reasonable diligence.²⁶

25. The *Arleen W. Hughes* proceeding was instituted to determine whether the respondent's registration as a broker-dealer should be revoked under Section 15(b) of the Securities Exchange Act of 1934, 49 STAT. 1377 (1936), 15 U.S.C. § 78o(b) (1940). A revocation order under that section requires a finding of willful violation of either the Securities Exchange Act of 1934 or the Securities Act of 1933. Hence the Commission's discussion with respect to capacity was confined to the requirements of the anti-fraud provisions of those two statutes which were at issue in the proceeding. SECURITIES ACT OF 1933 § 17(a), 48 STAT. 84, 15 U.S.C. § 77q(a) (1940); SECURITIES EXCHANGE ACT OF 1934 §§ 10(b), 15(c)(1), 48 STAT. 891 (1934), 52 STAT. 1075 (1938), 15 U.S.C. §§ 78j(b), 78o(c)(1) (1940). The Commission noted in the *Arleen W. Hughes* opinion, however, that in the case of an investment adviser registered under the Investment Advisers Act of 1940 there is an additional provision in the latter statute which makes it unlawful for the adviser, "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." *Arleen W. Hughes*, SEC Securities Exchange Act Release No. 4048 (1948) 14, n. 17; INVESTMENT ADVISERS ACT OF 1940 § 206(3), 54 STAT. 852, 15 U.S.C. § 80b-6(3) (1940). The Commission, by way of dictum, interpreted that section of the Investment Advisers Act as imposing an obligation upon a registered investment adviser proposing to act for his own account to disclose in writing before the completion of *each* transaction of purchase or sale the fact that he is acting as "principal" and to obtain the consent of his client to his acting in that capacity. Apart from the requirement of writing, this disclosure, the Commission stated, is merely declaratory of the common law. Moreover, the requirement imposed by Section 206(3) is not exclusive; an investment adviser who acts as a broker or dealer is subject also to the anti-fraud provisions of the 1933 and 1934 Acts which the Commission applied in the *Arleen W. Hughes* case. The registrant's contention that as a registered adviser she was subject only to the Investment Advisers Act "would produce the anomalous result," the Commission held, "of permitting a broker-dealer who registers as an investment adviser to escape these anti-fraud provisions in trading with his clients, and thus avoid, as a fiduciary, obligations which would have been his as an ordinary trader." *Arleen W. Hughes*, *supra* at 16.

26. Although the Commission concluded in the *Arleen W. Hughes* case that the registrant had willfully violated the anti-fraud provisions of the 1933 and 1934 Acts, it withheld the entry of a revocation order for thirty days in order to give her an opportunity to submit proof that she had conformed her methods of business operation to the views expressed in the Commission's opinion. She thereupon proposed to amend certain provisions of the "Memorandum of Agreement." She proposed that the agreement provide a uniform rather than a maximum schedule of rates and charges; that the charges be set forth in dollars and cents as well as points; that the charges in the case of certain lower-priced securities be reduced; that the "base price" be defined as the mean between the bid and asked prices on the day of purchase by the client, or the lowest asked price if there were no bid; and that in the absence of an asked price there would be no sales to clients. Under the proposal, however, the confirmation was to continue to set forth only the client's total cost, together with a statement that the securities had been purchased by the firm contemporaneously with the sale to the client (in which event it was to be specified that the "base price" was the actual cost to the firm) or that the securities had come from the firm's inventory (in which event it was to be specified that the "base price" was the mean between the bid and asked prices or the lowest asked price as the case might be). The Commission rejected this proposal because of (1) the failure to itemize the market price and the investment advisory charge in each particular transaction and (2) the failure to disclose the firm's cost in so-called inventory transactions. *Arleen W. Hughes*, SEC Securities Exchange Act Release No. 4073 (1948), *appeal pending*, App. D.C. On the former point the Commission stated (page 3): "The very fact that registrant now proposes a technique which would still require the client to refer back

Now, just to keep the record straight, this case does not enact any market disclosure rule of general applicability. It should hardly seem necessary to mention this fact, except that counsel did argue in the *Arleen Hughes* case that that was what we were trying to do and that it was illegal without a specific rule, such as the market disclosure rule which was proposed by the Trading and Exchange Division several years ago and circulated to the public for comment²⁷ but later specifically rejected by the Commission.²⁸ That proposed rule—and I do not want to get into its merits—would have required disclosure in all arm's-length principal transactions. In the *Arleen Hughes* case, however, the Commission emphasized in so many words that "it is not intended that the disclosure requirements, which we have found applicable to registrant, be imposed upon broker-dealers who render investment advice merely as an incident to their broker-dealer activities unless they have by a course of conduct placed themselves in a position of trust and confidence as to their customers."²⁹ This should make it quite clear that we are not burying the market disclosure rule with one hand and digging it up with the other.

To sum this all up, the two doctrines, represented by the two *Hughes* cases, are as follows: First, a firm acting as principal in an ordinary dealer's transaction must simply refrain from charging a price which is not reasonably related to the current market without disclosing what the market is. Secondly, a firm which is in fact in a fiduciary relation to a client—whether it calls itself a broker or a dealer—cannot deal with its client for its own account without making scrupulously full disclosure of its adverse interest, which includes at least three elements. The first is the capacity in which the firm is acting. The second is the dollars-and-cents cost of securities which it sells to its clients (or, if it buys securities from its clients, the proposed resale price where known). And the third element of adverse interest is the best current market price ascertainable by the firm in the exercise of reasonable diligence where that price is better than the firm's price. All this, of course, is aside from the duty an agent always has to use reasonable efforts to give his principal any relevant information which he has notice the principal would desire to have.³⁰

to the agreement to discover the investment advisory charge and the 'base price,' while she refuses to itemize them specifically at the time a transaction is being effected, indicates a belief on her part—which we think is wholly justified and borne out by the evidence in the record before us—that clients either will not understand the technique or will not make the cross-reference between the two documents but, rather, that they will in either event remain uninformed of these material facts." The Commission stayed its revocation order to enable the registrant to file a petition for judicial review and to apply to the court for a further stay. Petitions for review and stay have since been filed in the Court of Appeals for the District of Columbia.

27. Proposed Rule X-15C1-10, July 29, 1942.

28. SEC Securities Exchange Act Release No. 3940 (1947).

29. *Arleen W. Hughes*, SEC Securities Exchange Act Release No. 4048 (1948) 12, *appeal pending*, App. D.C.

30. The common law recognizes that an agent who deals with his principal on his

To be entirely accurate I should add that it is over-simplifying somewhat to consider the two *Hughes* doctrines as entirely distinct. Even in the first *Hughes* case the court, though considering the firm as a principal in a simple vendor-purchaser transaction, referred to its special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. In most cases there is, of course, some similar element of advice and of disparity between the knowledge of market conditions possessed by the dealer and the customer. We have felt, however, that the essential doctrine of the first *Hughes* case is applicable even in a genuinely arm's-length transaction, where the customer was previously unknown to the dealer and can take care of himself and was not solicited and received no advice from the dealer; and I believe this factual extension of the first *Hughes* case would be upheld by the courts.

This brings me to an important chapter so far missing in the story. To say this much without more is a little like the law school professor who was asked by a first-year student what the difference was between a question of law and a question of fact, and replied that questions of law are decided by the judge and questions of fact by the jury. That is all very true, but it did not inform the student how to tell which category a particular question fell under. Similarly here, before one can tell which of the two *Hughes* doctrines to apply, it is necessary to decide whether a firm is acting in a particular transaction as a dealer pure and simple or as a fiduciary.

In some cases, as in the *Arleen Hughes* case itself, the answer is easy: A firm which is registered as an investment adviser, and which admittedly renders investment advice with respect to the same transactions in which it purports to act as principal, can hardly deny its fiduciary status. But suppose the firm is not registered as an adviser and has no fancy contracts with customers; it simply buys and sells securities as principal, rendering the incidental investment advice which is universal in the industry and without which it could hardly operate. When does such a firm cross the line from the first *Hughes* doctrine to the second?

For one thing, the confirmation, while important, does not give a conclusive answer. The Commission's confirmation rule, which is essentially

own account in regard to the subject matter of his employment may be excused from this duty where the principal has manifested that he either knows all material facts in connection with the transaction or does not care to know them. RESTATEMENT, AGENCY § 390 and comment *b* (1933). Presumably, however, at least so far as the anti-fraud provisions of the securities laws are concerned, any sort of waiver or "advance ratification" on the part of a fiduciary's client will be construed very strictly, particularly in the case of a relatively unsophisticated investor. Section 14 of the 1933 Act and Section 29(a) of the 1934 Act provide that any waiver of compliance with any provision of the statute or of the rules and regulations of the Commission shall be "void." 48 STAT. 84 (1933), 15 U.S.C. § 77n (1940); 48 STAT. 903 (1934), 15 U.S.C. § 78cc(a) (1940). At the very least these sections indicate a congressional feeling that by and large the professional broker-dealer and the investor do not bargain on a par with each other. The Commission did not reach the problem in the *Arleen W. Hughes* opinion.

declaratory of the common law, requires the firm to advise the customer in writing before the completion of each transaction whether it is acting as a dealer for its own account, as a broker for the customer, as a broker for some other person, or as a broker for both sides. And, where the firm is acting as broker for the customer or for both sides, its confirmation must state the source and amount of all commissions and either state or announce that it will furnish on request the name of the person on the other side of the transaction and the date and time when the transaction took place.³¹

Obviously, where a firm confirms as broker for the customer there is no problem. The first has assumed all the obligations which the law imposes upon an agent. But the sending of a principal confirmation is not always conclusive that the firm is really dealing at arm's-length and hence subject only to the first *Hughes* doctrine. All you have to do is to see one or two cases where a salesman gets a lonely widow 80 years old to think he is the most wonderful fellow in the world because he sends her flowers on her birthday or maybe rubber tips for her crutches (this actually happened in one case). When you see a few characters of that sort purporting to act as principal in arm's-length transactions, it becomes obvious that a principal confirmation cannot be conclusive.³²

How then do you decide? I am afraid the answer cannot be given with anything approaching mathematical certainty. The only answer I know depends not so much on any magic words but upon all of the surrounding circumstances, including the degree of sophistication of the parties and the course of conduct between them. And this is one time you can't blame the lawyers. The law must operate on the habits of people and the way most of us do business.

A customer does not typically walk into a firm's office with a lawyer at his elbow and say, "Will you buy me 100 shares of X stock at 50 or better on a one-per cent commission?" This would be a clear agency transaction. Or, if a customer were to come in off the street the way a housewife walks into a grocery store and say, "Do you have any X stock?" and upon receiving an affirmative answer were to ask, "How much will you charge me for 100 shares of the X stock you have?" and the firm were to say "48" and the customer were to say, "Let me have it," it would be clear that the parties had entered

31. Rule X-15C1-4.

32. *Birch v. Arnold & Sears, Inc.*, 288 Mass. 125, 192 N.E. 591 (1934); *Porter v. Wormser*, 94 N.Y. 431, 447 (1884); *Allender Co., Inc.*, 9 SEC 1043, 1054-5 (1941); *Herbert R. May*, SEC Securities Exchange Act Release No. 4061 (1948) 15. Where the relationship from the start has been that of *broker* and customer, the mere sending of a confirmation reading "We confirm purchase from you" does not change the relationship to one of *dealer* and customer. *Johnson v. Winslow*, 155 Misc. 170, 279 N.Y. Supp. 147 (Sup. Ct. 1935), *aff'd*, 246 App. Div. 800, 285 N.Y. Supp. 1075 (1st Dep't 1936), *aff'd*, 272 N.Y. 467, 3 N.E. 2d 872 (1936). For a discussion of what constitutes adequate disclosure of capacity in the confirmation, see *Bates and Douglas, Secondary Distributions of Securities—Problems Suggested by Kinney v. Glenny*, 41 YALE L.J. 949, 985-94 (1932).

into a principal transaction. But what usually happens? If a customer does come in without solicitation, he is apt to say, "Buy me 100 shares of X stock"—which is in effect an invitation for an agency transaction. But the salesman happens to be interested in principal transactions. So some vague talk ensues which leaves the question of capacity quite muddled and the firm then sends a "principal" confirmation. Very likely a court of law would hold that this amounted to an agency transaction unless the firm could show very clearly that it had made and the customer had accepted an express counter-offer to enter into a principal transaction.

Even more typically, of course, the customer does not come in off the street but is actively solicited by a salesman, who will almost inevitably render some advice as an incident to his selling activities, and who may go further to the point where he instills in the customer such a degree of confidence in himself and reliance upon his advice that the customer clearly feels—and the salesman knows the customer feels—that the salesman is acting in the customer's interest. When you have gotten to that point, you have nothing resembling an arm's-length principal transaction regardless of the form of the confirmation. You have what is in effect and in law a fiduciary relationship. Whether or not it is technically an agency relationship does not matter, because an agent is simply one type of fiduciary and the obligations in this respect are the same.

In a number of broker-dealer revocation proceedings in the early forties, around the same time that the first *Hughes* doctrine was being developed, the Commission found that firms purporting to act as principals were under all the circumstances of those cases in a fiduciary position and hence subject to the same duties of disclosure as agents. Some of you may remember the names of *Allender* and *Stelmack* as the leading cases of that variety.³³

I am sure that many more of you will remember the name of Oxford. The *Oxford* case, which was decided about two years ago, was essentially a very flagrant case of that kind; one customer was a 90 year-old widow, and the other was a young spinster lady 10 years her junior. Had the Commission simply followed its earlier line of cases—the *Allender* and *Stelmack* cases—there would have been no alarm in the industry. However, I am sure there was some language in the opinion—perhaps not too happily chosen—which, considered out of context, had the industry in something approaching a state of consternation for awhile. I refer to the Commission's statement to the effect that a firm which solicits an order for a security when it knows that it does not have the security in inventory is normally making the purchase for its customer and hence is subject to the duties of an agent.³⁴ If that state-

33. *Allender Co., Inc.*, 9 SEC 1043 (1941); *William J. Stelmack Corp.*, 11 SEC 601 (1942).

34. *Oxford Co., Inc.*, SEC Securities Exchange Act Release No. 3769 (1946) 14-15.

ment were taken literally, I believe it is safe to say that most of the over-the-counter securities business would be put on an agency basis. I am confident that no such result was intended by the Commission. I am equally confident that, insofar as the *Oxford* case may have been interpreted in some quarters as automatically making a transaction an agency transaction where there is solicitation without inventory, the *Oxford* doctrine is not dead—it never lived. Witness the fact that about half the transactions in the recent *Hughes* case clearly fell within the *Oxford* pattern; yet there was no mention of either the *Oxford* case as such or its reasoning.

The present significance of the *Oxford* case, therefore, is simply this: Only a consideration of all of the circumstances can determine whether a particular transaction falls in the principal or in the agency category, and hence within the formula of the first or the second *Hughes* case. One circumstance is the presence or absence of inventory at the time of the transaction and another is the degree or the absence of solicitation. But when a salesman calls a customer and says, "I haven't heard from you in some time and I think you might be interested in XYZ preferred," and the customer orders 100 shares and the firm then goes out and buys 100 shares for its own account, confirming as principal at a price related to the current market, the firm is within its rights. It may be an agent under all the circumstances, but it is not automatically an agent just because it has solicited an order and then bought the stock to fill it.³⁵ It would be nice if there were some such simple formula which could be readily applied—not necessarily this one—but unfortunately life, at least in this field of endeavor, is not that simple.

I do not wish to leave you, however, on a discouraging note. The fact is that with every case decided by the Commission the situation becomes clearer. I think that is notably true of the recent *Hughes* case. And insofar as there may still be unsettled problems, or doubts in your minds as to the applicability of any of the Commission's rules or cases to some particular situation, we are available at all times to consult with you and give you the benefit of our own opinions for what they may be worth. Both our principal office in Washington and our several regional offices, including the one in Chicago, are staffed with lawyers whose job it is to lend interpretative assistance to interested members of the public. Here is something you can get free from the government. Don't hesitate to avail yourselves of it.

This language has since been quoted or referred to in only two Commission opinions, both of which followed shortly after the *Oxford* case. *Norris & Hirschberg, Inc.*, SEC Securities Exchange Act Release No. 3776 (1946) 22-23, *appeal pending*. App. D.C.; *Investment Registry of America, Inc.*, SEC Investment Advisers Act Release No. 42 (1946) 15.

35. See Douglas & Bates, *Stock "Brokers" as Agents and Dealers*, 43 *YALE L.J.* 46, 60-61 (1933); Bates and Douglas, *supra* note 32.