Michigan Law Review

Volume 62 | Issue 4

1964

Current Problems in Securities Regulation

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COMMENTS

CURRENT PROBLEMS IN SECURITIES REGULATION

A former Commissioner of the Securities and Exchange Commission once stated that people in the securities industry could be reasonably sure they would not get into trouble with the Commission so long as they did what most of them agreed was the decent and honorable thing to do.[1] The recent *Report of Special Study of Securities Markets*[2] has demonstrated that, although there is presently no widespread pattern of fraud, in many instances those in the securities industry do not act in a decent and honorable manner. Thus, while the fundamental structure of the securities market is sound, and the basic regulatory patterns of the securities acts can be said to require no fundamental reconstruction, the present shortcomings must be analyzed and ultimately remedied if the securities market is to operate at an optimum level of efficiency and integrity. The acquisition of capital from the general public is so important to national economic growth that a securities market which operates at anything less than an optimum level cannot be tolerated. Therefore, it is essential that acts and practices which undermine public confidence in the securities market and harm the investors who furnish the funds necessary to adequate economic progress be eliminated. This comment analyzes four areas of central significance to adequate protection for the investor: (1) qualifications of those in the securities industry who deal with the public; (2) dissemination of corporate publicity; (3) dissemination of investment advice; and (4) selling practices in the securities industry. The findings and recommendations of the Special Study are given special attention insofar as they bear upon the problems covered. In certain areas, however, recent developments in court and Commission decisions have brought about changes equally as significant as the findings and recommendations of the Special Study. Thus each section covers the background and recent developments in the designated area, as well as the Special Study itself.

1 These are the words of the late Judge Healy, quoted in Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516 (1948).

2 *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as *Special Study*].

I. QUALIFICATIONS OF SECURITIES PERSONNEL DEALING WITH THE PUBLIC

The quality of personnel in the securities industry is highly significant in determining the impact of the industry upon the public. Securities personnel who deal with the public are in a key position, for the buying public must depend upon the ability and integrity of such personnel in obtaining access to the securities markets. The most important factor influencing the quality of personnel is the qualifications required for entering and remaining in the industry. Yet the present scheme of securities regulation does not impose sufficently high standards in this regard. This is amply demonstrated by a brief survey of the relevant agencies controlling industry qualifications.

The Securities and Exchange Commission exercises supervisory jurisdiction over the entire regulatory structure of the exchanges and the over-the-counter markets under the Securities Exchange Act of 1934[3] and the Investment Advisers Act of 1940.[4] The philosophy behind these acts is simply that anyone should be able to enter the securities field unless barred by specific acts of misconduct. Thus no standards relating to knowledge, training, or experience in the securities business are imposed at the federal level. The New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the regional exchanges have generally adequate qualification standards for personnel of member firms. The selective basis of exchange membership, however, denies the public protection from the abuses that are widespread in other segments of the securities industry. The National Association of Securities Dealers (NASD), the self-regulatory association which polices the over-the-counter market, has prescribed examination and character requirements, but not training standards. While the overwhelming majority of over-the-counter brokerage firms which deal with the public are members of the NASD, there are significant sectors of the securities industry which do not belong to the NASD. State Blue Sky laws constitute the only source of restrictions on entry into the industry for the remaining brokers and dealers, and even in those states which have established qualification standards, the strictness of the controls and the quality of their administration vary widely.

As will be seen below,[5] a high percentage of violations of Commission, exchange, and self-regulatory association rules are attributable to personnel with inadequate experience in the industry, and to firms with insufficient capitalization. This suggests that there is a relationship between the factors of experience, technical competence, and financial stability and those of integrity and business reliability. Thus the imposition of higher qualifica-

3 48 Stat. 881 (1934), as amended, 15 U.S.C. § 78 (1958 & Supp. IV, 1963).

4 54 Stat. 847 (1940), as amended, 15 U.S.C. §§ 80b-1 to 80b-21 (1958 & Supp. IV, 1963). For a study of background of the provisions of these acts, see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959).

5 See notes 24 & 35 *infra*.

tion standards might well have the effect of raising ethical standards and practices as well as technical competence itself.

It will be the purpose of this section to analyze the present state of qualification standards in the securities industry, to examine the major defects in the regulatory structure, and to evaluate the solutions proposed by the Securities and Exchange Commission[6] and by the Special Study of Securities Markets.[7]

A. *Securities Personnel Who Deal With the Public*

There are several categories of persons in the securities industry who deal with the public.[8] The broker is an agent of a private investor and handles the latter's order to buy or sell securities. For this service, a commission is charged. Section 3(a)(4) of the 1934 act[9] defines a broker as one who *engages in the business* of performing securities transactions for the account of others. In contrast, a dealer acts as a principal by buying securities for his own account and subsequently selling to customers from his own inventory.[10] The dealer's profit is determined by the difference between the price he pays and the price he receives for the same security. Section 3(a)(5) of the 1934 act[11] defines a dealer as one who buys and sells securities for his own account *as part of a regular business.* A dealer should be sharply differentiated from a trader. A trader is a private investor who regularly buys and sells securities for his own account but does not handle other persons' securities or money. Typically, broker-dealers are owners or principals of securities firms—either individual proprietors, partners, or officers. On the major exchanges, members act primarily as brokers for the public—buyers or sellers of listed stocks; approximately seventy-five percent of the total round-lot share volume on such exchanges consists of agency transactions for customers.[12] Exchange rules limit the ability of members to deal with listed securities for their own accounts. For example, Rule 92 of the New York Stock Exchange provides that no member shall buy or initiate the purchase of any security for his own account or for any account in which he or his member organization is directly or indirectly interested

6 The Securities Exchange Commission has presented to Congress legislative proposals for amendment of the Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. § 78 (1958 & Supp. IV, 1963). H.R. 6789, 88th Cong., 1st Sess. (1963); S. 1642, 88th Cong., 1st Sess. (1963). These proposals are based on the recommendations of the Special Study. See also H.R. 6793, 88th Cong., 1st Sess. (1963). The Securities Exchange Commission is herein referred to as the SEC or the Commission.

7 *Special Study* pt. 1, at iii-ix.

8 The scope of this section is limited to personnel in the securities industry who deal with the public. For instance, the specialist on an exchange, who usually deals only with members on the exchange floor, is not included. Investment advisers are given attention here only incidentally; regulation of investment advisers is considered in detail in section III *infra.*

9 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(4) (1958).

10 For a more comprehensive treatment of the distinction between brokers and dealers, see section IV *infra.*

11 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(5) (1958).

12 *Special Study* pt. 2, at 9.

while the member has knowledge that his organization holds an unexecuted market order to buy the security in the unit of trading for the customer.[13] In the over-the-counter market, however, a firm or individual may combine the functions of broker and dealer, acting in one capacity or the other, depending upon the circumstances. Thus, an exchange firm which participates in the over-the-counter market may decide to trade unlisted stock on a principal rather than an agency basis.[14]

Other functional roles are present. One or more may be performed by any given person. The supervisor, as the head of the branch office of a broker-dealer firm, may have influence and responsibility similar to that of the firm's owners. The salesman, who is employed by a broker-dealer firm to execute securities transactions for and with the public, has the most frequent personal contact with the public. From the standpoint of the public, however, the most important person in the industry is often the investment adviser, who is responsible for recommending that the customer buy or sell particular stocks. Investment advisers include every person who *engages in the business* of furnishing investment advice for a fee, either by managing investors' portfolios, or by publishing a subscription service, or both.[15] In some firms, salesmen or the broker-dealer principal himself may make investment recommendations. While some broker-dealers are registered investment advisers,[16] an investment adviser as defined in section 2(11) of the Investment Advisers Act of 1940[17] does not include any broker or dealer whose performance of such service is solely incidental to his business as a broker or dealer and who receives no special compensation for his advice. Many firms employ analysts, who base their investment advice on research. In such a case, the salesman acts as a conduit in the dissemination of investment advice. The investor may also engage the services of an independent investment adviser, using the broker-dealer firm only to perform the actual transaction. The dissemination of investment advice is given more attention in section III *infra.*

B. *Regulation of Securities Personnel*

1. *Federal Controls*

Broker-dealer firms effecting any transaction in the over-the-counter market, except those whose business is exclusively intrastate, must register with the Securities and Exchange Commission under section 15(b) of the

13 NYSE Rule 92.

14 A relatively small but increasing percentage of listed stock is traded in the over-the-counter market by firms not members of an exchange. Also, some issuers choose not to list their stocks even though the security would satisfy exchange trading standards. See *Special Study* pt. 1, at 14.

15 Investment Advisers Act of 1940 § 2(11), 54 Stat. 848, as amended, 15 U.S.C. § 80b-2(a)(11) (1958).

16 As of June 30, 1962, 1836 investment advisers were registered with the Commission. Those broker-dealers which are registered investment advisers primarily engage in the brokerage business. *Special Study* pt. 1, at 19.

17 54 Stat. 848 (1940), as amended, 15 U.S.C. § 80b-2(a)(11)(c) (1958).

1934 Act.[18] The securities industry includes a small group of large broker-dealer firms which employ numerous salesmen and supervisors at numerous branch offices; they hold a dominant share of the public business. This group consists primarily of large firms which do a general business on both the exchanges and the over-the-counter markets, firms which are members of the NASD and one or more exchanges, and large mutual fund sales organizations—not members of any exchange and sometimes not even members of the NASD. On the other hand, there are many small firms in the securities industry; they have a less substantial but still significant share of the public business. In fact, the vast majority of registered broker-dealers have only one office. Of the nearly 6,000 broker-dealers registered with the Commission on June 30, 1962, thirty percent were sole proprietorships.[19]

The standards for denial of registration of a firm by the Commission under section 15(b) of the 1934 Act[20] relate primarily to specified past acts of misconduct. These statutory disqualifications include the filing of a false or misleading statement in the application for registration, a conviction within the ten years preceding for a felony or misdemeanor concerning securities, an injunction by a federal or state court against conduct involving securities, and willful violation of the Securities Act of 1933,[21] the 1934 Act, or any of the rules and regulations of the Commission. In addition, the Commission must find that denial or revocation of the registration of a broker-dealer firm is in the public interest. In applying for registration, a firm must complete application form BD and list whether any of its personnel are subject to any of the statutory disqualifications. The Commission may deny or revoke the registration of a firm upon a finding that the broker-dealer principal, partner, director, officer, branch office manager, or "any person directly or indirectly controlling or controlled" by the broker-dealer has committed one of the proscribed acts of misconduct.[22]

Section 15(b) does not establish standards of competence as to knowledge, training, and experience in the securities business for the firm's personnel as a prerequisite to the firm's registration. Factual findings of the Special Study demonstrate the high number of inexperienced principals in newly registered broker-dealer firms. For example, of the 210 firms which registered with the Commission during the first three months of 1961, 58,

18 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78*o*(b) (1958).

19 *Special Study* pt. 1, at 16.

20 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 78*o*(b) (1958). On the denial and revocation of registration of broker-dealer firms, see 2 Loss, SECURITIES REGULATION 1301-58 (1961), and cases therein cited [hereinafter cited as Loss].

21 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77a (1958 & Supp. IV, 1963).

22 Securities Exchange Act of 1934 § 15(b), 49 Stat. 1377, as amended, 15 U.S.C. § 78*o*(b) (1958). A brokerage firm, therefore, can be registered only if *none* of its personnel are subject to any of the statutory disqualifications. The Commission has taken the position that an employee of a broker-dealer is a controlled person within the meaning of § 15(b) of the 1934 Act. See 2 Loss 1314-23. However, the Commission frequently consents to the hiring of a person subject to a revocation order upon condition that he be appropriately supervised and not be given any managerial responsibility. See 2 Loss 1329-30.

or 28 percent, did not have experienced persons as principals, and over half the firms had principals with less than two years experience.[23] Generally, the most recently registered securities firms—especially those with inexperienced principals—have been responsible for a heavy preponderance of the more severe disciplinary penalties assessed by the NASD. In addition, such firms have frequently violated the net capital rule of the Commission and have often engaged in underwriting speculative stock issues.[24]

Investment advisers[25] must register with the Commission under section 203 of the Investment Advisers Act of 1940.[26] Any one of a similar group of specific acts of misconduct constitutes statutory disqualification,[27] but no positive standards of competence or integrity are prescribed for investment advisers at the federal level. Newly registered investment adviser firms, like new broker-dealers, exhibit a high number of inexperienced principals. During a three-month period in 1961, 79 firms, with a total of 141 principals, registered with the Commission. Eighty-nine principals, or 63 percent, had no prior experience in the securities business.[28]

Section 15(b)(D) of the Exchange Act, which deals with willful violations of the 1933 Act, the Exchange Act, or any of the rules and regulations by the Commission promulgated pursuant to these acts,[29] is utilized by the Commission when it seeks to revoke the registration of a securities firm. In order to determine whether brokerage firms are in compliance with section 15(b)(D), the Commission undertakes periodic examinations of broker-dealer firms through its regional offices. A typical full-scale examination of a brokerage firm determines its financial condition, its selling practices, its treatment of customers' funds and securities, and its compliance with the credit regulations of the Federal Reserve Board[30] and the bookkeeping and financial report rules of the Commission.[31]

Section 15(c)(3) of the Exchange Act[32] gives the Commission authority to promulgate rules with respect to financial responsibility of broker-dealer firms in order to protect investors. Thus the Commission has adopted Rule 15c3-1,[33] which prescribes that no broker or dealer shall permit his aggregate indebtedness to exceed an amount equal to twenty times his net capital. The Special Study found that low capital firms have a much

23 *Special Study* pt. 1, at 65. See also 23 SEC ANN. REP. 78 (1957).
24 *Special Study* pt. 1, at 66-67.
25 On the regulation of investment advisers generally, see section III *infra*.
26 54 Stat. 850 (1940), as amended, 15 U.S.C. § 80b-3 (Supp. IV, 1963).
27 Investment Advisers Act § 203(b), 54 Stat. 850, as amended, 15 U.S.C. § 80b-3(b) (Supp. IV, 1963).
28 *Special Study* pt. 1, at 146.
29 Securities Exchange Act of 1934 § 15(b)(D), 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 78*o*(b)(D) 1958).
30 See Comment, *Civil Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T*, 61 MICH. L. REV. 940 (1963).
31 On the inspection procedures of the Commission, see 20 SEC ANN. REP. 43 (1954); 22 SEC ANN. REP. 112 (1956); 25 SEC ANN. REP. 107 (1959).
32 52 Stat. 1075 (1938), 15 U.S.C. § 78*o*(c)(3) (1958).
33 17 C.F.R. § 240.15c3-1 (Cum. Supp. 1963).

greater chance of falling into net capital difficulties than firms with higher capital. For example, 210 of the 220 broker-dealers whose reports indicated violation of the Commission's capital rule ratio had net capital of less than 5,000 dollars.[34] Moreover, low capital firms have been involved in a high proportion of the Commission's revocation actions and have engaged excessively in the underwriting of "unseasoned," speculative stock issues.[35] Neither the Commission nor the NASD imposes minimum capital requirements upon securities firms. It would appear that the net capital rule, as it presently stands, does not by itself insure the sound financial status for brokerage firms which is necessary to protect the public.

2. *NASD Regulation*

Section 15A of the Exchange Act[36] authorizes the registration of national securities associations to provide self-regulation in the over-the-counter market similar to that provided by the exchanges in the exchange markets. At the present time, the NASD is the only registered national securities association.[37] The NASD rules allow member firms to grant discounts on prices or commission rates only to member firms.[38] Thus a member firm must deal with each nonmember firm on the same terms and conditions as it deals with the general public. Membership in the NASD is an economic necessity if one is to engage profitably in almost any phase of underwriting and most over-the-counter business. The overwhelming majority of securities firms doing business in the over-the-counter market, including member firms of the exchanges, have therefore joined the NASD. The Special Study covered 4,964 over-the-counter firms and found that 4,417 were members of the NASD.[39] Nevertheless, there remain many firms not members of the NASD, including firms whose business is limited to the exchanges; certain mutual fund, real estate security, and investment adviser firms; and put and call dealers.

The NASD by-laws bar from membership any broker or dealer who has been subject to (1) a suspension or expulsion order by an exchange or association for unjust and inequitable conduct, (2) a denial or revocation of registration order by the Commission, (3) an order of suspension or expulsion from membership in an exchange or association, entered by the Commission, or (4) a conviction within the ten years preceding for a felony or misdemeanor involving fraud.[40] These exclusions apply not only to the

[34] *Special Study* pt. 1, at 91.

[35] *Id.* at 91-92.

[36] 52 Stat. 1070 (1938), 15 U.S.C. § 78*o*-3(a) (1958). The essential purpose of the Maloney Act of 1938, which added § 15A to the Exchange Act, was to provide for a self-regulatory association in the over-the-counter market. See 2 Loss 1359-64.

[37] On the NASD, see generally Cherrington, *National Association of Securities Dealers*, 27 HARV. BUS. REV. 741 (1949); White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959).

[38] NASD RULES OF FAIR PRACTICE art. III, § 25.

[39] *Special Study* pt. 1, at 16.

[40] NASD BY-LAWS art. I, § 2(a); see 22 SEC ANN. REP. 117 (1956). The Exchange Act

broker-dealer principal, but also to any partner, officer, director, branch office manager, or any person directly or indirectly controlling or controlled by the broker-dealer.[41] Thus, to become a member of the NASD, a broker-dealer principal must show that all of its personnel are free of such disqualifications.[42] To enforce compliance with its by-laws and rules of fair practice, the NASD has its own inspection program and a well organized disciplinary procedure.[43]

Prior to 1955, the NASD required no standards as to experience and knowledge of the securities business. In that year, however, the NASD amended its by-laws and restricted admission to those firms whose proprietors, partners, officers, and other persons controlling the firm had had one year's experience in the securities business or had passed a written examination.[44] The new by-laws also prohibited member firms from employing salesmen who had neither had one year's experience in the securities business nor had passed a written examination for registered representatives.[45] At first, the NASD gave the same relatively easy examination to all classes of inexperienced personnel, such as proprietors, branch office managers, and salesmen. Recently, however, the NASD has taken steps to increase the breadth and difficulty of its written examination for salesmen.[46] The use of an examination as the primary test of the competence of a securities salesman is highly advisable in view of the diverse occupational backgrounds and educational levels of applicants seeking to become registered representatives.[47]

provides that association rules must make an over-the-counter broker or dealer eligible for membership unless he has been guilty of specific violations of securities laws or exchange or association rules. The act, however, allows the association to restrict membership geographically, or by the type of business of the members, or on such other specified and appropriate basis as appears to the Commission to be necessary or appropriate for the protection of investors. Securities Exchange Act of 1934 §§ 15A(b)(3) & (4), 52 Stat. 1070 (1938). 15 U.S.C. §§ 78*o*-3(b)(3) & (4) (1958).

41 NASD BY-LAWS art. I, § 2(a), art. XV, § 3(b).

42 The Commission must approve the registration of a salesman whose record shows a prior revocation by the NASD, the SEC, or an exchange. See NASD, THE NASD AND THE REGISTERED REPRESENTATIVE 40-41 (1961). See also 2 Loss 1381-87.

43 See 2 *id.* at 1371-74; see White, *supra* note 37, at 256-58. See also MAYER, WALL STREET: MEN AND MONEY 230-32 (1955).

44 NASD BY-LAWS art. I, § 2(b); see 22 SEC ANN. REP. 119 (1956).

45 NASD BY-LAWS art. I, § 2(b). Registered representative includes every employee of a member firm engaged in the managing, supervising, solicitating, trading, handling, and selling of listed or unlisted securities. NASD BY-LAWS art. XV, § 1.

46 Since 1961, the NASD has given qualifying examinations. In 1961, 3% of the 30,790 examinations scored resulted in failure; in 1962, the failure rate was 14% of 16,186 examinations. Since November 1962, with an increased passing grade, one-third of those taking the examination have failed to achieve a passing score. *Special Study* pt. 1, at 120. It should be noted that since July 1, 1963 a single combined examination has been given for salesmen employed by members of the NASD and the New York and American Stock Exchanges. Two hours are devoted to general securities subjects and NASD problems. The third hour deals with exchange problems of a more complex nature. *Ibid.*

47 A 1961 NASD survey revealed that 99% of the newly registered representatives attended high school and 68% spent some time at college. *Id.* at 96. A 1960 NASD survey

The NASD has recently taken the position that principals and supervisors should have a greater degree of knowledge of the securities business than that of salesmen. Consequently, the Board of Governors of the NASD in 1962 authorized the development of a separate three-hour written examination for all proprietors, partners, and officers of member firms who lack one year's experience in the securities industry. A new type of examination for principals and branch office managers, including material on supervisory responsibility, was initiated on December 1, 1963. The Special Study reported that most general securities firms require a supervisor to have three years experience in the securities business, although some may require as little as one year. Low-capital firms and certain mutual fund firms, however, often have supervisors with no experience and limited education.[48]

The NASD does not make an independent determination of the integrity of an applicant for a position as a salesman. However, it does require that a member who employs a registered representative have reason to believe that the person is of good character and business repute. A responsible partner, officer, director, or branch office manager must sign a certification to this effect after a reasonably diligent investigation of the applicant's background.[49] If the member firm is not sufficiently industrious in searching for unfavorable aspects of a candidate's past history, it may be subjected to disciplinary action by the NASD.

Since the NASD entrance requirements concerning competence and integrity are directed at personnel who are engaged in the managing, supervising, trading, and selling of listed and unlisted securities, an analyst who participates solely in research activities for the brokerage firm need not comply with these qualifications. Furthermore, the New York Stock Exchange does not impose on analysts separate entrance requirements pertaining to research and evaluation of securities. Nevertheless, the Special Study found that the level of educational background of those engaged in research is unusually high. The great majority hold a college degree, and a considerable number have undertaken graduate studies in different fields. Moreover, some firms have training programs for analysts, and others hire only experienced analysts. Some firms, however, still allow inexperienced analysts with minimal training or supervision to make investment recommendations to the public.[50]

The NASD, by tightening its examination and character requirements,

showed that 47% of the salesmen came from professional categories, such as accountants, teachers, engineers, and lawyers, and from relatively skilled occupations in a supervisory capacity. On the other hand, 19% came from a heterogeneous group of occupations. *Id* at 95. Furthermore, the Special Study found that about 50% of the firms covered in the survey had no particular educational prerequisites for prospective salesmen, and 75% of the firms had no requirements of previous experience in the securities industry. *Id.* at 100.

48 *Id.* at 136.

49 NASD RULES OF FAIR PRACTICE art. III, § 27(c); see Matters of Vickers, Christy & Co., SEC Securities Exchange Act Release No. 6872, August 8, 1962.

50 *Special Study* pt. 1, at 145.

is seeking to bring better qualified personnel into the over-the-counter firms. The effort of the NASD to raise its qualification standards is deficient in one major respect: it does not require a minimum training period for registered representatives and does not examine or approve the training programs of its members. However, the NASD has recently prepared a training guide for use by member firms in their training program.

The Special Study found that training programs of firms not members of the major exchanges typically involve some on-the-job training, supplemented by lecturing or tutoring sessions. In addition, the *Report* noted that mutual fund firms tend to devote substantially fewer hours to on-the-job training than general securities firms. Even so, over half the firms not specializing in mutual funds give no on-the-job training at all.[51] Furthermore, the Special Study indicated that a substantial number of NASD firms give no more training than is required to pass the written examination and become familiar with the type of securities in which the particular brokerage firm specializes.[52] Thus, it would appear that a major weakness of training programs of firms in the over-the-counter market is the tendency to overemphasize the business of the particular firm, leaving registered representatives lacking in over-all knowledge of the securities industry. To remedy these deficiencies, a proper training program should accomplish two primary objectives. First, all securities salesmen should be given more comprehensive instruction in all aspects of the securities business. Second, all personnel should be taught the importance of developing professional responsibility in the firm-client relationship.

3. *Exchange Regulation*

Upon registration as a national securities exchange under section 6 of the 1934 Act,[53] an exchange must establish membership rules which are just and adequate to insure fair dealing and to protect investors.[54] The New York Stock Exchange requires that an applicant for membership or allied membership serve six months as a trainee in a member firm if he proposes to do business with the public and lacks previous experience in the securities business.[55] The Midwest and American Stock Exchanges

[51] *Id.* at 111.

[52] *Id.* at 110.

[53] 48 Stat. 885 (1934), 15 U.S.C. § 78f(f) (1958).

[54] Securites Exchange Act of 1934 § 6(d), 48 Stat. 886, 15 U.S.C. § 78f(d) (1958). The Commission has supervisory authority over exchange affairs. Under § 19(b) of the 1934 Act, it may amend the rules of the exchanges with respect to the financial responsibility of the members and similar matters when the exchanges fail to act after appropriate notice. 48 Stat. 898 (1934), 15 U.S.C. § 78s(b) (1958). Moreover, the SEC, under § 19(a) of the 1934 Act, has the power to withdraw the registration of a national securities exchange. 48 Stat. 898 (1934), 15 U.S.C. § 78s(a)(1) (1958). On exchange regulation, see generally 2 Loss 1149-1276.

[55] NYSE RULE 301.12. Only individuals can hold seats or be members of the exchange. NYSE CONSTITUTION art. IX, §§ 1-2. The upper limit on Exchange membership is 1,374. As of June 30, 1962, the membership of the NYSE was 1,366. This figure included 1,011 individuals affiliated with 672 firms. About 500 NYSE firms do business with the public.

impose six-month training periods upon prospective members and allied members.[56] Under Rule 342 of the NYSE, a member firm must secure the approval of the Exchange for its choice of a branch office manager as a new supervisor in either an existing office or a new regional office.[57] The Special Study found that large New York Stock Exchange member firms seldom appoint personnel with less than ten years experience to positions of supervisory responsibility.[58]

Any candidate for the position of registered representative in the NYSE —which includes all employees engaged in soliciting, trading, handling, and selling listed and unlisted securities[59]—must undergo a six-month training period if he has had no previous experience in the securities industry.[60] Each salesman-trainee is expected to undertake on-the-job training supplemented by organized study. The Special Study determined that a dozen large member firms have organized classroom training in such depth that it might be called a school.[61] For example, Merrill Lynch, Pierce, Fenner & Smith, Inc., in its model training program, requires all its trainees to spend fourteen weeks of intensive classroom training at the New York City home office. A total of 420 classroom hours are spent on a broad range of securities subjects. However, since the cost of intensive classroom training is very high, most NYSE firms, both large and small, merely combine on-the-job training with courses taken by correspondence or at local universities.[62] A salesman-trainee who performs his on-the-job training at the home office of a member firm in a metropolitan center will likely learn much about the important aspects of the industry. Nevertheless, the Special Study found that a major problem with on-the-job train-

Special Study pt. 1, at 12, 16. There is no upper limit on the number of allied members in the New York Stock Exchange; there were 6,238 in 1962. *Id.* pt. 1, at 12. In general, an allied member has no right to be on the floor of the exchange. NYSE CONSTITUTION art. IX, § 11.

56 *Special Study* pt. 1, at 80-81. It is significant that the investigations of the Special Study have accelerated the efforts of the various regulatory bodies to impose higher qualification standards for securities personnel. For example, as of January, 1962, an applicant for regular membership on the American Stock Exchange was not required to have any experience, knowledge, or training in the securities business, and no examination tested his qualifications. Now the six-month training period is required. See SEC, REPORT ON ORGANIZATION, MANAGEMENT, AND REGULATION OF CONDUCT OF MEMBERS OF THE AMERICAN STOCK EXCHANGE 7 (1962).

57 NYSE RULE 342.

58 *Special Study* pt. 1, at 138.

59 NYSE RULE 10.

60 NYSE RULE 345.15. It should be noted that the NYSE provides for a system of limited registration under which the salesman may sell only mutual fund shares or stock selected by the salesman's firm under a Monthly Investment Plan. Formerly, the NYSE required only one month's training for limited registrants. See NYSE RULE 301.15(b); NYSE RULE 301.11(b). The Exchange now requires that limited registrants have three months of training. Also, limited registration selling may continue only for a seven-month period. The examination for limited registrants contains two-thirds of the material in the regular NYSE test for registered representatives. See *Special Study* pt. 1, at 126-28.

61 *Id.* at 105.

62 *Id.* at 106-07.

ing is that firms are frequently content to let their trainees watch the regular employees sell securities for the full six-month training period. The candidates do not obtain actual training practice under the supervision of regular firm personnel.[63] Moreover, many firms send their trainees to a remote branch office far from the financial centers of the nation, where on-the-job training consists of the performance of menial tasks. The major defect in the training requirements for salesmen on the New York Stock Exchange is that, while the Exchange imposes a six-month training period, it does not evaluate the quality of the training programs established by the member firms.

Prior to December, 1962, applicants for membership and allied membership in the New York Stock Exchange had to pass either the examination for registered representatives or specified courses at universities approved by the Exchange.[64] The Board of Governors of the NYSE, however, has now established a compulsory written examination for members and allied members; it covers general securities subjects, exchange rules and procedures, the responsibilities of proprietors of member firms, and the supervision of offices, salesmen, and accounts. Inexperienced members and allied members who plan to service customers' accounts must also pass the Exchange examination for registered representatives.[65] The revised compulsory examination for registered representatives now covers securities market procedure, securities and their analysis, and elements of finance. In addition, the NYSE plans a separate written examination dealing with problems of supervisory responsibility for branch office managers. Both the American and Midwest Stock Exchanges require that registered representatives pass a written examination; these exchanges will soon require an examination for proprietors similar to that of the NYSE.

In the matter of character standards, the NYSE undertakes an elaborate investigation of the integrity of a prospective member or allied member. It utilizes the facilities of its staff as well as independent investigating agencies to check the applicant's business history, personal reputation, and educational background. Applicants must be sponsored by two members or allied members of at least one year's standing who will recommend the candidate from personal knowledge of him and of his business connections.[66] In an effort to improve the quality of its members' salesmen, the NYSE has recommended that its member firms require applicants to take aptitude tests and undergo a series of personal interviews. In addition, some exchange firms frequently hire an outside investigating agency to check on the background of the applicant prior to the final decision to accept him for employment.

All exchanges impose on their member firms requirements as to both

63 *Id.* at 107.
64 NYSE RULE 301.12.
65 *Special Study* pt. 1, at 78.
66 NYSE RULE 301.24.

minimum capital and aggregate debt to net capital ratios. For example, the New York Stock Exchange requires that a member firm doing a general business with the public have net capital of 50,000 dollars and maintain a twenty-to-one ratio between its aggregate indebtedness and its net capital.[67] In addition, the initial net capital of a member firm must be at least 120 percent of the minimum net capital requirement.[68] The Commission has exempted all members of the major exchanges from its net capital rule because the capital requirements of the exchange are more comprehensive than Rule 15c3-1.[69]

4. *State Controls*

The Securities Exchange Act of 1934 contains an express provision preserving the jurisdiction of state Blue Sky securities laws.[70] A state has a legitimate interest in establishing qualification standards for brokers, dealers, and salesmen in order to protect its citizens. Consequently, forty-seven states require the registration of broker-dealers,[71] and forty-eight states impose the duty of registration upon salesmen.[72] Supervisors and analysts, however, insofar as they do not engage in selling activities, need not register under state Blue Sky laws. It is significant that in New York, the leading commercial state of the nation, the registration requirements for broker-dealers and salesmen may be easily satisfied.[73] An applicant need only list his business history for the preceding five years, his criminal record, and his educational background. Registration is automatic. Since there are no provisions for the denial or revocation of the registration of broker-dealers and salesmen, it is apparent that the registration provisions are only an adjunct to the criminal fraud provisions.

It would appear that state Blue Sky legislation could be extremely helpful in protecting the public in two particular areas. First, the states might enact minimum capital surety bond requirements.[74] Since the state

67 NYSE RULE 325(a). The American and Midwest Stock Exchanges require that member firms doing business with the public have net capital of $50,000 and $25,000, respectively. ASE Rule 446(a); *Special Study* pt. 1, at 88.

68 NYSE RULE 325(a).

69 17 C.F.R. § 240.15c3-1b2 (Cum. Supp. 1963). The exemption may be withdrawn by the Commission upon ten days notice to the exchanges when it is necessary in the public interest.

70 Exchange Act § 28(a), 48 Stat. 903 (1934), 15 U.S.C. § 78bb(a) (1958).

71 Delaware, Nevada, and the District of Columbia do not have Blue Sky securities legislation. Wyoming does not require the registration of broker-dealers.

72 Wyoming requires that a promoter offering securities for sale "either as principal or through brokers or agents" file the names and addresses of his agents, partners, and ten percent shareholders with the secretary of state. WYO. STAT. ANN. §§ 17-103(7), (8) (1957).

73 N.Y. GEN. BUS. LAW § 359(e).

74 Section 202(e) of the Uniform Securities Act provides that the Administrator may by rule require broker-dealers to post surety bonds up to $10,000, but no bond is required for any registrant whose net capital exceeds $25,000. See LOSS & COWETT, PROPOSED UNIFORM SECURITIES ACT (1956). New Mexico provides for both a minimum capital requirement and a net capital rule. N.M. STAT. ANN. § 48-18-20 (Supp. 1961). Michigan provides that every broker-dealer must post a $10,000 surety bond. MICH. STAT. ANN. § 19.762 (1959).

securities commissions would be familiar with the securities transactions generally prevalent in the community, they could establish an absolute minimum capital for the one-man proprietorship and require increased capital for firms with additional branch offices and salesmen. The defrauded private investor could resort to the surety bond in satisfaction of his claim against the firm. Second, the state securities commissions should be given power to deny the registration of broker-dealers and salesmen for lack of training, knowledge, or experience in the securities business, and to revoke registrations for dishonest or unethical selling practices. Such a provision applicable to broker-dealers is included in the qualification section of the Uniform Securities Act, presently adopted by fifteen states.[75] Under the Uniform Act the administrator is authorized in his discretion to give a written examination to any class of applicants.[76] Unfortunately, the enforcement of state Blue Sky laws remains handicapped by low budgets, small staffs, and local political pressures.[77] Thus, with the possible exception of a few major industrial states, the effectiveness of state securities legislation in protecting the public against abuses by personnel in the securities industry is extremely uncertain. The public must therefore look to the Commission, the exchanges, and self-regulatory associations for adequate qualification standards and nonpartisan enforcement.

C. *The Special Study Report*

1. *Recommendations at the Federal Level*

Under the present federal law, when an employee of a broker-dealer firm violates any provision of the securities acts or any of the regulations issued pursuant to these acts by the Commission, the SEC must proceed against the firm. This may be a considerable hardship on an innocent firm unaware of the dishonest conduct of its employee. Consequently, the Commission and the Special Study have proposed that the SEC be given the power to take disciplinary action directly against the individual wrongdoer.[78]

75 Uniform Securities Act §§ 204(a)(2)(I), (a)(2)(C). States which have adopted the qualification section of the Uniform Securities Act: ALA. CODE tit. 53, § 29 (Supp. 1961); ALASKA COMP. LAWS ANN. §§ 45.55.030 to .55.060 (1962); ARK. STAT. §§ 67-1237 to -1240 (Supp. 1961); COLO. REV. STAT. ANN. §§ 125-10-2 to -10-5 (Supp. 1961); KAN. GEN. STAT. ANN. § 17-1254 (Supp. 1961); KY. REV. STAT. ANN. § 292.330 (1962); MD. ANN. CODE art. 32A, §§ 15-18 (Supp. 1962); MONT. REV. CODES ANN. § 15-2006 (Cum. Supp. 1963); N.J. REV. STAT. §§ 49:3-9 to -11 (Supp. 1962); OKLA. STAT. ANN. tit. 71, §§ 201-04 (Supp. 1962); S.C. CODE §§ 62-101 to -122 (1962); WASH. REV. CODE ANN. § 21.20.040 to .130 (1961). Three other states have adopted the Uniform Act without the qualification section for broker-dealers: HAWAII REV. LAWS §§ 199-1 to -20 (Supp. 1961); IND. ANN. STAT. §§ 25-829 to -853 (1960); VA. CODE ANN. §§ 13.1-501 to -527 (1956).

76 Uniform Securities Act § 204(b)(6). Kansas requires an examination only of those broker-dealers and salesmen who have not passed the tests for the American, New York, Midwest, or Pacific Coast Stock Exchanges. KAN. GEN. STAT. ANN. § 17-1254(b) (Supp. 1961) and Rule 81-8-1, 1 CCH BLUE SKY L. REP. ¶ 19613 (1962).

77 See 1 Loss 105-107. *But see Blue Sky Crackdown*, The Wall St. J., Jan. 31, 1963, p. 1, col. 8.

78 *Special Study* pt. 1, at 160. H.R. 6789, 88th Cong., 1st Sess. 14, 17 (1963); S. 1642, 88th Cong., 1st Sess. 14, 17 (1963).

A serious problem encountered by the Special Study involves the extent to which many smaller firms have hired "boiler-room" salesmen with past records of employment by firms against which the Commission has taken disciplinary action. While these boiler-room veterans were willing participants in the proscribed conduct of the firm, the Commission was often unable, for administrative reasons, to make them parties to the disciplinary proceedings.[79] This problem would be remedied if the Commission could bring disciplinary proceedings directly against individual wrongdoers. Moreover, the Commission has recommended that it be made unlawful for a firm to hire a salesman without the consent of the Commission when a disciplinary order has been entered against him, and the firm with reasonable care should have known of the order.[80]

The Commission has proposed that it be given the power to take disciplinary action against a firm or employee who aids, abets, counsels, or fails reasonably to supervise the employee who actually committed the violation of the particular provision, rule, or regulation.[81] Thus the Commission could put pressure on firms to improve their procedures for detecting violations of the securities acts by their employees. At the same time, however, the firm with an adequate supervisory system would be protected. A brokerage firm could assert as a valid defense in an action brought against it by the Commission that it had established checking procedures which were reasonably designed to detect securities violations by its employees, and that it reasonably performed its duties under such a system without knowledge of the activities of the fraudulent salesman.[82]

At present, full revocation of a firm's registration is the Commission's only disciplinary tool. This may be a harsh remedy when the firm has committed only a minor violation. At the same time, it does not seem just that the firm should totally escape any penalty. The Commission has therefore proposed that it be given the power in its discretion to revoke fully, or suspend up to twelve months, the registration of an offending firm, or the right of any person to be associated with the firm.[83] Alternatively, the Commission could censure the guilty firm.[84] Thus the Commission would be adequately equipped to deal with a relatively minor violation by a broker-dealer principal or salesman. As a supplementary measure, the Commission has suggested that the conviction disqualification for registration be broadened to include any felony or any misdemeanor involv-

79 See 2 Loss 1314-23.

80 H.R. 6789, 88th Cong., 1st Sess. 17 (1963); S. 1642, 88th Cong., 1st Sess. 17 (1963).

81 H.R. 6789, 88th Cong., 1st Sess. 15 (1963); S. 1642, 88th Cong., 1st Sess. 15 (1963).

82 H.R. 6789, 88th Cong., 1st Sess. 15-16 (1963); S. 1642, 88th Cong., 1st Sess. 15-16 (1963).

83 H.R. 6789, 88th Cong., 1st Sess. 14, 17 (1963); S. 1642, 88th Cong., 1st Sess. 14, 17 (1963).

84 H.R. 6789, 88th Cong., 1st Sess. 14, 17 (1963); S. 1642, 88th Cong., 1st Sess. 14, 17 (1963).

ing securities, to correspond with the requirements of the Investment Advisers Act.[85]

2. *Compulsory Membership in Self-Regulatory Associations*

It should be recognized that the Special Study and Commission proposals at the federal level relate only to improved detection and punishment of the prohibited acts of misconduct constituting statutory disqualification. No affirmative standards of knowledge, experience, and training have been proposed. Both the Special Study and the Commission have taken the position that self-regulatory associations should have the primary responsibility for promulgating such positive qualification standards for their member firms. As a condition of registration with the Commission, the broker-dealer would be required to become a member of a registered national securities association.[86] The self-regulatory associations would be given power to require standards of experience, training, and knowledge, including a mandatory examination for each class of applicants. This proposal constitutes the most important recommendation of the Special Study in the area of qualifications, for it combines two vital objectives. Under this compulsory membership plan, stricter qualification standards would lead to a higher level of professional responsibility among member firms in their dealing with private investors. Moreover, the fact that a self-regulatory group rather than a government agency will enact the higher entrance standards is likely to be conducive to more enthusiastic response by member firms, in both the designing and enforcement of such standards. Ultimately, higher qualification standards for securities personnel should engender increased public confidence in all phases of the securities markets.

The Special Study recommended that the basic test for the competence of securities personnel be the examination.[87] The ideal examination would contain a core of basic securities subjects, with sections of increased breadth and difficulty for those performing proprietary or supervisory responsibilities. The Special Study also proposed that an experience requirement be imposed on at least one principal of each broker-dealer firm, and preferably all supervisors.[88] This proposal is desirable because proprietary and supervisory positions should be filled by men with acknowledged abilities in leadership, supervision, and coordination of firm activities. Firms with inexperienced principals, it should be remembered, have been involved in a large percentage of the serious disciplinary actions by the SEC.[89] Finally, the Special Study urged that all analysts and investment advisers whose

[85] H.R. 6789, 88th Cong., 1st Sess. 17-18 (1963); S. 1642, 88th Cong., 1st Sess. 17-18 (1963); see *Special Study* pt. 1, at 159.

[86] H.R. 6789, 88th Cong., 1st Sess. 14-23 (1963); S. 1642, 88th Cong., 1st Sess. 14-23 (1963). See also *Special Study* pt. 1, at 159.

[87] *Id.* at 160-61.

[88] *Id.* at 161.

[89] See notes 24 & 35 *supra.*

unsupervised investment recommendations are actually transmitted to the public should be subjected to an entrance examination.[90] Such a recommendation is meritorious, since one who directly advises private investors about securities should be subjected to at least a minimal requirement of competence.

With reference to standards of integrity, the Special Study proposed that there be established local character and fitness committees to pass on the character of each applicant. However, the Special Study disapproved of the NASD system of member certification of the integrity of registered representatives on the ground that member firms too frequently make only cursory checks of the backgrounds of their candidates.[91] However, the NASD system is not entirely without merit, because it places maximum responsibility on the firm to train only those applicants of the highest integrity. While committees of the self-regulatory associations may appropriately supervise the general character standards of salesmen, it is the individual firm which makes the final decision to hire the applicant. A member firm, therefore, should have an obligation to use reasonable diligence in its character check upon potential salesmen. Stronger disciplinary action by self-regulatory associations could make this duty one that must be obeyed in fact. The NASD is now processing over 30,000 applications each year for registered representatives;[92] obviously, character committees cannot feasibly make a thorough check on the background of each candidate.

It is submitted that all the self-regulatory associations should require a six-month training program for inexperienced personnel of member firms, as the NYSE presently does.[93] The content of a minimum training program should include on-the-job training, supplemented by organized outside study, either at a local university or by correspondence. The associations should supervise the manner in which firms carry out their training programs. A salesman-trainee should not be allowed to deal with the public until his training period has been completed. In addition, the associations might require a minimum rate of compensation for salesmen-trainees in order to decrease the high rate of turnover during training periods.[94] This turnover rate resulting from inadequate compensation makes it more difficult to train and retain capable men.

The Special Study recommended that the self-regulatory associations be given power to enact minimum capital requirements for member firms.[95] The NASD has long advocated such a requirement. Indeed, in *National Ass'n of Securities Dealers*[96] the NASD proposed an amendment to its by-

90 *Special Study* pt. 1, at 158.
91 *Id.* at 117-118, 161.
92 *Id.* at 117.
93 See note 55 *supra*.
94 *Special Study* pt. 1, at 96-98.
95 *Id.* at 161-62.
96 12 S.E.C. 322 (1942); *cf.* DeWitt Investment Co., 27 S.E.C. 976 (1948) (NASD may not impose quantitative standards for membership).

laws requiring that all members and prospective members dealing directly with the public have a minimum net capital of 5,000 dollars. The Commission, however, held that a minimum capital requirement was not an appropriate basis for determination of membership under the 1934 Act. The Commission has now proposed that self-regulatory associations be given authority to promulgate standards dealing with financial responsibility of member firms.[97]

The minimum capital requirement is a worthwhile recommendation. The paramount public interest necessitates that firms with marginal capital be excluded from participation in the securities industry. Factual findings from the Special Study demonstrate that low capital firms have engaged excessively in the underwriting of speculative stocks and have incurred a large proportion of violations of the net capital rules of the SEC.[98] Even a competent person ought to be prevented from starting his own brokerage firm if he does not have adequate financial backing. Such a person, however, could be employed as a salesman for a member firm.

3. *The Part-Time Salesman*

Another major problem facing the Special Study was the future of the part-time salesman. Unlike the exchanges, which require that all registered representatives devote their full time to the business of their member firms,[99] the NASD has permitted its member firms to employ part-time salesmen. During 1961, of the 40,590 persons registered as salesmen with the NASD, 20,990 stated that they were employed on a part-time basis with NASD member firms.[100] Mutual fund firms, in particular, have hired a large percentage of part-time salesmen. Opponents of part-time salesmen have argued that this group lacks adequate training, engages in overly aggressive selling tactics, and exhibits improper supervision. The Special Study concluded that, where these characteristics exist in securities firms, they are common to both full-time and part-time salesmen. The Report therefore recommended that part-time and full-time salesmen should be subjected to the same qualification standards.[101] This suggestion that improved entrance standards be applicable to all salesmen across the board is reasonable. It would appear that if a man desires to sell securities in the over-the-counter market on a part-time basis, he ought to be able to do so, provided he can comply with standards adequate to protect the public. In the remote areas of the country, a part-time salesmen could promote interest in stock investment. Such a salesman, however, should get no special privileges because of his limited status.

97 H.R. 6789, 88th Cong., 1st Sess. 26 (1963); S. 1642, 88th Cong., 1st Sess. 26 (1963).
98 *Special Study* pt. 1, at 91-92.
99 See, *e.g.*, NYSE RULE 346.
100 *Special Study* pt. 1, at 112.
101 *Id.* at 161.

D. *Conclusion*

The Special Study concluded that, with regard to standards and qualifications of personnel in the securities industry, the philosophy underlying the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 is outmoded. These acts were motivated by the belief that any person not guilty of particular acts of misconduct constituting statutory disqualification should be permitted to operate his own brokerage firm. The contention of the Special Study, however, is that the tremendous growth and complexity of the securities industry[102] requires that personnel satisfy standards of knowledge, experience, and training, and that securities firms demonstrate adequate financial responsibility. To accomplish this objective, both the Special Study and the Commission have recommended that all broker-dealer firms be compelled to become members of self-regulatory associations.[103] Such a requirement would be a condition of the firm's registration with the SEC. Thus each group—put-and-call dealers, real estate securities firms, and mutual fund firms—might have its own self-regulatory association. These associations would have the responsibility of enacting qualification standards. This proposal is an excellent recommendation, since it would likely engender enthusiastic response by the member firms in both the promulgation and the enforcement of standards.

The associations must devise a comprehensive scheme of entrance requirements designed to assure that personnel entering the securities industry are adequately trained. An examination with a core of basic securities subjects should be required of all securities salesmen. The examination should contain sections of increased difficulty and breadth for those with ownership and supervisory responsibilities. In particular, ethical considerations should be stressed in the examination. The Special Study has proposed that at least one principal of each broker-dealer, and preferably every supervisor, be required to have experience in the industry. The associations could establish certain categories of work which would qualify as adequate experience. This would be particularly important when a firm recruits a supervisor from an outside organization. Also, the associations should require a six-month training period, prior to which a salesman could not sell to the public. In addition, the associations should establish a model train-

102 Although the number of member firms on the New York Stock Exchange has only increased from 586 firms in 1945 to 672 firms in 1962, the number of salesmen employed by exchange firms has risen from 7,989 at the end of 1945 to 32,555 at the end of 1962. Also, the number of branch offices has increased from 841 in 1945 to 2,737 in 1962. *Id.* at 46. In particular, the Merrill Lynch firm, the nation's largest brokerage firm in terms of income, has increased the number of its salesmen from 1,038 in 1951 to 2,054 in May 1962. Bache & Company has increased the number of its salesmen from 100 in 1945 to 1,414 in 1962. *Id.* at 22. Likewise, the number of NASD members has more than doubled since 1945. In 1962 there were 4,771 firms, as compared with only 2,372 in 1945. The number of registered representatives in the NASD has increased from 24,843 in 1945 to 94,444 in 1962. The number of branch offices operated by NASD members has risen from 790 in 1945 to 4,713 in 1962. *Id.* at 36.

103 *Id.* at 159.

ing program and maintain effective surveillance over the quality of the training programs of their member firms. The associations should also adopt an educational prerequisite for registered representatives. At the same time, however, it would seem that in appropriate cases an applicant with inadequate formal education should be able to qualify upon successful completion of the training program and a high mark of achievement on the examination. Member firms should certify the integrity of an applicant after a reasonably diligent search of his background. Local character committees could supervise both the firm's investigatory techniques and the general character standards for salesmen. Finally, a minimum capital requirement should be adopted by the associations. Such a rule would eliminate the marginal capital firms which are responsible for a large percentage of violations of the Commission's regulations.

The eventual result of a comprehensive set of qualification standards enacted by the self-regulatory associations might well be the evolution of the securities industry into a profession. The broker-dealer might assume a professional status similar to that of the lawyer or physician. A profession has been defined as "a limited and clearly marked group of men who are trained by education and experience to perform certain functions better than their fellowmen."[104] A profession is characterized by a clear demarcation of functions. Thus the lawyer advises his client only as to applicable law. In a similar manner, the stockbroker should advise his customers concerning the relevant attributes of the securities under consideration. Another important aspect of a profession is that its members have been subjected to rigid entrance requirements. At the present time, outside of the NYSE, the entrance requirements for securities personnel have not reached a level characteristic of the professions. Thus the stockbroker is not presently regarded as a member of a profession. However, the self-regulatory associations, by raising the qualification standards for entrance throughout the securities industry, could enable brokers and salesmen to attain a greater degree of professional discipline and public esteem.

A profession is also characterized by the paramount responsibility of its members to the public. Professional men have a duty to society to prefer the social good and the welfare of the profession to individual economic objectives which might prejudice those goals. It is clear, however, that fraudulent practices are all too frequent in the securities industry today. Nevertheless, since the Special Study found that inexperienced principals are responsible for a large part of the more serious violations of the securities acts and regulations, it is reasonable to believe that, with better trained personnel, unlawful activity within brokerage firms might be sharply decreased. Finally, a most important attribute of a profession is the existence of professional organizations which formulate standards of ethical and business conduct and have the power to exercise disciplinary control over the

[104] TAEUSCH, PROFESSIONAL AND BUSINESS ETHICS 13 (1926).

actions of individual practitioners. This objective dictates greater authority for self-regulatory associations.

The securities industry should adopt as a primary goal the achievement of public recognition of the stockbroker and his fellow workers as members of a profession. Enlarged control by self-regulatory associations would be a major step in this direction. Self-regulation would also avoid the dangers involved in excessive direct government controls.[105] The first step in this direction should be association enactment and enforcement of higher qualification standards for members of the securities industry who deal with the public.

II. CORPORATE PUBLICITY

The availability and dissemination of information concerning publicly held corporations has a significant impact on the volume traded and the market price of a corporation's securities.[106] Under present law, required disclosures are limited by their failure effectively to reach the problems of "unofficial"[107] corporate publicity after the issuance of securities, and the publicity problems arising from issuance. Thus, the finding of the Special Study that some corporate public relations departments and their financial public relations consultants have prepared and disseminated material contrary to the basic philosophy and purpose of full disclosure and protection of investors[108] points up the need for new laws and policies to set a higher minimum level of required disclosure, encourage additional voluntary disclosure, and police the substantive merits of all corporate publicity.

A. *Prevailing Disclosure Requirements*

The prevailing requirements of corporate disclosure can be categorized in the following four groups: statutory disclosure arising from the issuance of new securities; statutory disclosure resulting after the issuance process is completed; requirements imposed on listed corporations by the stock exchanges; and requirements imposed on corporations the securities of which are included in the NASD's retail quotations for the over-the-counter market. The problems emanating from these requirements relate to definition of standards and effectuation of a meaningful enforcement procedure. On the other hand, the thrust of the Special Study's findings and recommendations dealt with the areas where the need for regulation of corporate publicity had not been deemed necessary or proper in the past. Thus, in order to determine what additional regulation is warranted, one must first look at the existing requirements and evaluate their advantages and failings.

105 Bowen, *Business Management: A Profession?*, 297 AM. ACAD. POL. & SOC. SCI. ANNALS 112, 117 (1955).

106 *Special Study* pt. 3, at 70.

107 "Unofficial" publicity is all information disseminated about a corporation which is not required by statute, the SEC, or any group acting as a regulatory body.

108 *Id.* at 2.

The statutory requirements of disclosure arising from the issuance of a new security stem from section 5 of the Securities Act of 1933.[109] Under section 5(c) it is unlawful for any person, directly or indirectly, to make use of any means or instrument of interstate commerce or of the mails, to offer to sell or offer to buy a security, unless a registration statement has been filed with the Commission as to such security.[110] The registration statement requires the inclusion of a wide range of significant factual information[111] which, upon filing, must be made available to the public.[112] In addition to the registration statement, a prospectus containing the same information must be prepared by the corporation for distribution.[113] During the period between filing and the effective date of a registration statement, no written communication offering the security may be used, except an identifying statement or prospectus.[114] After the effective date, sales publicity other than a prospectus may be used; however, for a forty-day period following the effective date or the commencement of the public offering, a prospectus must either precede or accompany all such publicity.[115] These detailed requirements assure a means whereby those interested may have information upon which to make investment decisions. However, several factors militate against the effectiveness of these requirements. One of these is that few people analyze or even read the prospectus. Also, difficulties arise with respect to the provision that no "offer" can be made prior to the effective date of registration. Little can be said about the human foible of failure to take advantage of the available information; however, clarification of the requirement that no "offer" be made prior to the effective date of registration is needed, as its ambiguity dampens the full effectiveness of the policy of full disclosure. Section 2(3) defines "offer to sell" as including every attempt or offer to dispose of, or solicitation of an offer to buy, a security or an interest in a security for value.[116] This definition of "offer to sell" is considerably broader than the common-law concept of an offer, and it has been so construed by the courts. The problem of whether there is a violation of this provision when publicity disseminated prior to registration concerns either the issue itself or the issuing corporation. While it is clear that a short press release announcing a quarterly dividend does not constitute an "offer," and that a full-fledged publicity campaign advertising the issue before filing is a violation, whether an activity between these extremes constitutes a violation rests solely on the facts of each particular case.

109 Since all issues of securities offered publicly, by use of the mails, or by other interstate means, fall within the registration requirements, most new issues, including those not registered on an exchange, are included. *Id.* at 2-3.

110 68 Stat. 684 (1933), as amended, 15 U.S.C. § 77e (1958).

111 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1958).

112 48 Stat. 78 (1933), 15 U.S.C. § 77f(d) (1958).

113 68 Stat. 685 (1933), as amended, 15 U.S.C. § 77j (1958).

114 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e(b)(1) (1958).

115 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(10) (1958).

116 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77b(3) (1958).

To add some certainty to this area, the Commission, in 1954, published Release No. 3844,[117] dealing with the publication of information prior to, or after the effective date of registration. The release set out a series of examples of corporate publicity surrounding issuance and stated the Commission's opinion on each in the hope of clarifying the law in this area. In the first set of examples the Commission stated that both the distribution of a brochure through the underwriter-promoter and the dissemination of a series of press releases, in an attempt to awaken the public, are violations. Additionally, the Commission pointed out that violative publicity need not be aimed at the general public. Another example was an investment banking firm which was about to underwrite an issue of securities. Without being fully aware of the prospective underwriting, the research department prepared a brochure on the company in line with its customary policy of distributing reports to its clients concerning securities it had previously sold. The Commission concluded that the participation of this underwriting firm in the distribution would propound difficulties under section 5. This example illustrates some of the major problems of uncertainty in this area. First, is the knowledge of one department in a firm imputed to the research department? Second, assuming no such imputation of knowledge, should the publication of a brochure containing typical financial information be construed as a violation of the act when such publication is in accord with past patterns of publicizing the issuing company? Clearly, more than mere knowledge of the coming issue combined with an intent to publish is necessary, because the true intent of the firm may be to advise its clients rather than awaken interest to purchase the new securities. The final set of examples raised problems concerning speeches delivered by company officials. The Commission's position seems to be as follows: provided the speech has not been arranged in contemplation of a public offering, no objection should be made to its delivery; however, distribution of a printed copy of the speech is frowned upon, and a request might be made by the Commission that each member of the group who received a transcript also receive a prospectus. The Commission seems to be on very shaky ground in this area, because a printed version of a speech, with respect to the audience, certainly constitutes no more an "offer to sell" than does oral delivery. Moreover, it seems apparent—even when a printed speech reaches those not present at the delivery—that if the oral delivery was not an "offer," its printed counterpart cannot constitute an "offer" unless it is distributed later as part of a selling effort.

To solve some of these problems, Edward N. Gadsby, then chairman of the Commission, made two speeches in 1958 in which he delineated the general test of what constitutes an "offer to sell."[118] His suggested test

117 SEC Securities Act Release No. 3844, March 2, 1954.

118 *Gun Jumping Problems Under Section 5*, 188 COMM. AND FIN. CHRON. 2536 (1958); *Current Problems Under Section 5 of the Securities Act of 1933 and Release N. 3844*, address by Edward N. Gadsby before the Central States Group of the Investment Bankers Association.

weighs the circumstances surrounding a publication, the publication's content, the timing, to whom it was addressed or communicated, the publisher, the manner of its publication, and its over-all effect, all with the purpose of determining whether the release was a normal corporate publication or an attempt to condition the market. Although not in conflict with the case law nor different from other legal tests which attempt to treat each case separately on its facts, Gadsby's test is obviously indefinite. Its indefiniteness is detrimental because it results in a minimum of corporate publicity during the period preceding the issuance of securities. The lack of full disclosure, especially when manifested by the withholding of information, may influence the price of a corporation's stock, and is likely to result in undue advantage for insiders and pave the way for fraud. Thus, in order to achieve the goal of full, accurate disclosure, and to retain the force of section 5(c), a more definite test is needed, even though it might result in less flexibility.

After the issuance of new securities has been completed, additional disclosures are required by the Securities Exchange Act. Section 12 requires all listed corporations to file a registration statement analogous to that required upon issuance.[119] In addition, section 13[120] and regulations pursuant thereto require that the information on record be kept up to date by annual reports which include such information as a certified balance sheet, a profit and loss statement, a listing of those who are the principal security holders, the remuneration of officers and directors, and the status of stock options exercised or outstanding.[121] Furthermore, periodic reports of unusual events, such as changes in control, changes in asset distribution, the institution of material legal proceedings, and any matter which requires a vote of the security holders must be reported pursuant to Commission regulations.[122]

Section 14 of the Securities Exchange Act,[123] dealing with proxies, also establishes disclosure requirements. By rules promulgated pursuant to that section, the Commission requires a filing of solicitation materials and prescribes a waiting period. Although "solicitation" is defined very broadly,[124] its thrust and effect is very similar to the treatment of "offers to sell." Thus the Commission has taken the position that a prepared speech or release for inclusion in general news media is proxy solociting material if it is

119 68 Stat. 686 (1933), as amended, 15 U.S.C. § 77*l* (1958).

120 48 Stat. 908 (1933), as amended, 15 U.S.C. § 77m (1958).

121 Form 10-K—Regulations pursuant to § 13 of the Securities Act.

122 Form 8-K—Regulations pursuant to § 13 of the Securities Act. Also, short forms of uncertified profit and loss and earned surplus statements are required semi-annually. Form 9-K. Some real estate companies must report statements of profit and loss, cash flow, and cash distributions to shareholders on a quarterly basis. Form 7-K.

123 48 Stat. 84 (1933), 15 U.S.C. § 77n (1958).

124 "(i) Any request for a proxy whether or not accompanied by or included in a form of proxy; (ii) Any request to execute or not execute, or to revoke, a proxy; or (iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." Rule 14a-1. 17 C.F.R. § 240.14a-1(f) (Cum. Supp. 1963).

intended to condition public opinion and the opinion of stockholders favorably to the publishers of the material.[125] The key seems to be an intent to align public opinion to the solicitor's cause. Despite the absence of an articulated test of what elements constitute a "solicitation," it is likely that the Commission's test applied to publicity consituting an "offer to sell" is a sound analogy for the conservative attorney to follow in advising clients.

The net effect of the "disclosure requirements" after issuance, with the limited exception of proxy solicitation rules, is significant; but their full effectiveness is curtailed because they are in general limited to those securities registered on national exchanges, and by the fact that the disclosure requirements do not prohibit the corporation from disseminating inconsistent information.[126]

The stock exchanges themselves encourage, and in many instances require, the disclosure of information about corporations listed on their exchanges. The New York and American Stock Exchanges both require prompt disclosure of any developments which might affect security values or influence investment decisions of stockholders or the investing public,[127] and encourage the telling of all phases of the corporation's story through advertising and other means in all of the available news media. The basis for requiring these prompt disclosures is to prevent insiders from obtaining any advantage by acquiring information before it is available to the public.[128] Accordingly, the NYSE has a stock-watching program to seek out and detect any unusual activity or rumors about a corporation or its securities. Upon discovery of such activity, the Exchange will usually urge full disclosure or, in the extreme, suspend trading until the market for the stock is stabilized.[129] Both the exchanges require all listed companies to issue annually to their shareholders independently audited financial statements. Furthermore, these same statements must be submitted to the statistical services, the newspapers, and the wire services.[130] The NYSE also requires listed corporations to solicit proxies for all shareholders' meetings, and the AMEX is in the process of adopting this same policy.[131] The Midwest and Pacific Coast Stock Exchanges have analogous prompt disclosure provisions requiring the reporting of all dividend news. They also investigate a listed company when unusual activity occurs in its stock,[132] and require corporations to send their shareholders independently audited statements.[133] However, neither the Midwest nor the Pacific Exchange has any formal policy concerning the distribution of other corporate news by listed companies.

125 SEC v. Okin, 132 F.2d 784 (2d Cir. 1943).

126 See *Special Study* pt. 3, at 89-90.

127 N.Y. Stock Exchange, Company Manual A20-22; *Special Study* pt. 3, at 98.

128 *Special Study* pt. 3, at 98.

129 *Id.* at 97-98.

130 *Id.* at 5.

131 *Ibid.*

132 *Id.* at 98-99.

133 *Id.* at 5.

The disclosure provisions of the exchanges encourage the availability and dissemination of corporate publicity; however, there is no meaningful policy regarding the substantive content of such publicity. The view is that, since an exchange is normally unable to determine the accuracy of corporate publicity at the time it is issued, an attempt to do so at a later time would be second guessing the company.[134] Furthermore, the prompt disclosure requirements prevent a company from giving out information on a "hold for release" basis.[135] Thus, the opportunity for financial reporters to make independent investigations which might lead to unbiased articles is virtually eliminated, leaving editors with the choice of accepting the release substantially as it comes from the corporation or of foregoing the dissemination of such information.[136] It seems clear, then, that the interaction of the prompt disclosure requirements with both the strict rule against "offers to sell" prior to the effective date of registration on a new stock issue, and the solicitation provisions for proxies, present the possibility that inconsistent duties may be imposed on the corporation.

The final group of disclosure requirements is that promulgated by the National Association of Securities Dealers. Since 1962, corporations included in the national and regional quotation lists of the NASD have been required to make prompt disclosure to the press of any corporate development which may affect the value of the companies' securities or have an influential effect on an investor's decision to buy or sell.[137] These new requirements, although subject to the same limitations as the prompt disclosure requirements of the exchanges, serve the important purpose of bringing a substantial segment of the publicly held corporations under some form of duty to disclose.

Although there exists a significant amount of information flow due to the existing requirements of disclosure, it is apparent that there are defects in the scope of the system. Elimination of these defects and the formulation of a coordinated, comprehensive plan for the comprehensive and effective disclosure of all valid substantive information concerning publicly held corporations is certainly in order.

B. *The Study's Findings of Abuse and Potential Abuse of Corporate Publicity*

The Special Study indicated that some of the corporate publicity disseminated over the past years has been inaccurate and misleading, and that these abuses have become increasingly frequent.[138] Some of the more fla-

134 *Id.* at 99.

135 A bulletin distributed on a "hold for release" basis provides a time interval in which those receiving it may investigate its merit.

136 See *id.* at 98.

137 *Id.* at 99.

138 *Id.* at 65. The Special Study based its findings on an intensive study of the financial public relations activities of forty-six companies which were sent questionnaires, and on an extensive examination of "five of these companies whose activities stood out as demonstrating current or emerging problems."

grant abuses stem from the activities of financial public relations consultants. As an illustration of methods used in the financial public relations industry, the Study set forth a detailed publicity proposal submitted by such a consultant to the General Development Corporation, a Florida land developing company the common stock of which is traded on the American Stock Exchange. The suggested publicity campaign was divided into four parts, covering company relations with the investment community, the financial press, its stockholders, and the general public. In furtherance of these relations, the primary devices suggested were "field trips" to Florida for executives of influential investment firms, security analysts, and investment advisers; dinners and luncheons with investment and securities men coupled with speaking engagements before investment and analyst associations; frequent press releases based on advanced timing considerations; a letter giving figures on company progress "disguised as a news item"; the publication of a monthly or quarterly shareholder's magazine or newsletter; and a series of "corporate image" advertisements in *The Wall Street Journal, Business Week, Barron's* and other news magazines.[139] Obviously, all of these suggested recommendations could be used in a manner which would preclude the proliferation of inaccurate or misleading information; however, the Special Study found that entertainment, field trips, and luncheons are an important part of the financial public relations budget,[140] and that speaking engagements, especially before such groups as the New York Society of Security Analysts, are a prime goal of the public relations agent.[141] These findings lead one to believe that there is a likelihood that the information disseminated as a result of this type of publicity program will be based on undue influence rather than objective, factual reporting. This seems especially true when the "field trips" are to properties located in Florida or other desirable places of recreation. Indeed, the lesson which can be drawn from these promotion suggestions is that if corporations must spend significant sums of money and exert a considerable amount of energy in order to tell their stories, many will come to feel that such activity should produce immediate beneficial results.[142]

The preparation of material for the use of security analysts is another area where financial public relations activities may result in the dissemination of incorrect and misleading information. This is especially true in cases where it is the public relations man who writes the final version of

139 *Id.* at 78-81.

140 *Id.* at 85.

141 *Id.* at 83.

142 The Study reported that in 1961 the General Development Corporation invited twenty-one analysts to its Florida properties. The trip lasted over four days, including one day at the company's country club. "Of the 18 brokerage houses represented on these junkets, 5 issued market letters favorable to the company within 3 months . . . and 6 others indicated approval in internal communications. In addition, an investment advisory service recommended the stock and a large foundation which was represented on the trip purchased a large block of convertible debentures." *Id.* at 86.

material to be sent to investors over the name of investment advisers.[143] For instance, one firm regularly prepares a report for its corporate clients emphasizing favorable information which many times includes highly optimistic predictions. It then provides many brokerage firms with copies of these reports complete with the latter firms' names printed thereon so that they can distribute "tout sheets" to their customers at no expense.[144] Although these reports do carry a notation stating their origin, the print is generally small enough for many customers to be misled into thinking that the brokerage house is responsible for them.[145]

If the attitude of the financial public relations consultant were that of an unbiased third party whose job was only to take basic data from the corporation and make it available to the public via the media of information dissemination, the danger that much of said information may be incorrect or misleading would be greatly reduced. This, however, is not the case. The attitude of the financial public relations consultant can be most likened to that of a salesman of its client's stock.[146] This is evidenced by the advertisements which consultants use in attempting to secure corporations as clients.[147] When the totality of the publicity disseminated is prepared and distributed by those who appear to be unbiased but who are actually salesmen with the natural tendency to "puff" concerning their wares—avoiding the bad points and overstating the good points—the detrimental effects of reliance thereon is readily apparent.[148] Some companies compensate these consultants with options to purchase the company's stock.[149] The Study specifically stated that this practice does not necessarily imply manipulation of the stock's price for personal gain or any analogous improper intent on the part of the parties, but does suggest that, since the consultant has no obligation to disclose his financial interest, those who accept the publicity releases may not be aware that the information they receive comes from an interested source under a situation in which conflict of interest may produce a prejudiced result.[150]

143 *Id.* at 80-81.

144 *Ibid.*

145 The Dewitt Conklin reports had the following statement printed in small type: "This report is released and distributed for and on behalf of the company in the interest of developing closer relations among the company, its stockholders and the financial community. The information contained and any opinions expressed in this report are solely those of the Management of the Company." *Id.* at 81.

146 "Whatever words are used, little doubt remains that their purpose is to increase stock prices. Indeed some financial public relations men concede that they are salesmen of their client's stock." *Id.* at 71.

147 A large portion of such advertising lauds the prowess of the public relations firm in placing articles in the press and having close contacts with security analysts and advisers. *Id.* at 81.

148 The reliability of the publicity, even if the financial public relations consultant is not acting as a salesman, is also subject to question, because the consultant usually acts as a conduit between the corporation and the public without checking the validity of the information. *Id.* at 86-87.

149 *Id.* at 68-69.

150 *Id.* at 69-70.

Another abuse is the use of publicity by one in control of a corporation to further his own personal goals. The study cites, as one of the most flagrant abuses of publicity by a corporate insider to influence stock prices, the case of *SEC v. Louis E. Wolfson*,[151] which concerned an attempt to depress the price of American Motors Corporation common stock in order to cover a large short position. In this incident, Wolfson's financial consultant told a financial reporter that Wolfson and members of his family were in the process of liquidating some seven percent of the outstanding stock of American Motors. An article quoting the consultant, which appeared shortly thereafter, had the effect of depressing the stock price, whereupon Wolfson was able to cover a substantial portion of his short position.[152] Fortunately, the Commission was able almost immediately to obtain an injunction requiring Wolfson to disclose the true facts and delaying him from further covering his short position. Although most publicity does not include falsified information and is generally not incorrect or misleading, this by no means mitigates the problems of insider dealings.[153]

The snowballing effect—the rapid enlarging of a story at each repetition—which occurs when an influential publication carries information about a corporation, increases the detrimental reliance of the public on incorrect or misleading information, because the placing of only one item can achieve a totally unrealistic reaction.[154] The possibility that the public may rely to its detriment occurs even when the facts promulgated are correct, because the presence of a barrage of information tends to excite the public and cause price increases, even though the substance of the information, if presented alone, would not have the same effect. Thus, by an adroitly placed bit of news, a corporation can cause substantial fluctuations in the price of a given security. This effect was clearly illustrated in the *Report* by the example of how Joseph Purtell, the senior editor in charge of the business-news section of *Time* magazine, was able to make substantial gains by simply purchasing shares of a corporation shortly before an article on the company was due to appear.[155] In one specific instance, a 350 percent price increase occurred in a period of less than a month, during which rumors that *Time* was going to publish an article were circulated and the article appeared. A questionnaire circulated by the Study showed that a very large portion of those who purchased shares during the rise were prompted to do so by the magazine article.[156] Although this example is not

[151] Civil File No. 135-30, S.D.N.Y.

[152] *Special Study* pt. 3, at 72-73.

[153] See *id.* at 71.

[154] These are inherent limits to the effectiveness of such activity because an information source can only remain respected when the information it disseminates holds true or, "like the boy who cried 'wolf' [it] will end up being ignored." *Id.* at 76.

[155] Joseph Purtell is no longer associated with *Time* magazine. *Id.* at 72-73.

[156] *Id.* at 20. The price of Technical Animations, Inc. Class "B" common stock rose from $4 to $13.75 between April 10, 1961, and April 27, 1961. *Id.* at 73, 75. A more recent example of the effect a strategically placed magazine article can have on the price of a stock of a corporation is that of Barnes Engineering Corp., reported in *Newsweek*,

an instance of abuse of publicity by a corporation, it does emphasize an area in which corporate management should feel some duty to the public. If a corporation has any part in the initiation or promulgation of a scheme whereby individuals will gain personally from a snowballing effect, it should be subject to sanctions. Even if the corporation is an innocent bystander—especially when incorrect information about its activities or financial data is being put forth—it should feel ethically bound to see that this information is corrected by taking all reasonable steps under the circumstances.

The significance of the snowballing effect is also evident in the area of over-enthusiastic or premature publicity concerning new product developments or sales and earnings estimates.[157] The Study set forth an instance involving the Fairbanks Whitney Corporation in which the company reported that it would soon obtain new pre-eminence in its field by virtue of a practical desalinization technique. This report received wide publicity in such respected magazines as *Fortune, Look,* and *Newsweek,* as well as *The Wall Street Journal* and other newspapers. Furthermore, the company was mentioned in the advisory material of several prestigious brokerage houses. Unfortunately for those who purchased in reliance on the publicity, the predictions failed to materialize.[158] Even if the company made the announcements in good faith and acted accordingly ever since, it was undoubtedly the initial cause in a chain of events which produced a misleading and inaccurate picture upon which some of the advisory services and, more important, the public relied. Thus, management should not only exercise caution and restraint in the release of such material, but should feel a duty once an erroneous impression has been created to see that it is corrected.

These areas cited by the *Report* should not be considered abuses in the sense of unlawful acts which merely require the strengthening of sanctions now in existence. Rather, they should be thought of as problem areas

Oct. 14, 1963, pp. 96-98. It is noted therein that "What turned out to be as wild a stock buying spree as the Street had seen since the glamour-issue days of 1959-61 was a direct reaction to an article in the *Saturday Evening Post.* The thermograph, said the *Post,* 'promises to save lives by detecting the hot infra red glow thrown off by deadly ailments, including cancer.'" Stock in the Barnes firm was selling for under $18 when the *Post* article appeared and added $10 in a single day. The American Stock Exchange stopped trading because the orders could not be matched. After a day off the board it was put back on and the price went up to $44. Again trading was held up; orders continued to pour in and the ticker flashed "PRESENT INDICATIONS 50-55 . . . WILL NOT OPEN TODAY." However, trading never did open, and the president of the American Stock Exchange suspended the stock indefinitely because the stock's activity "reflected a confused situation." One week after the appearance of the *Post* article, with the Amex suspension, Barnes gravitated to the over-the-counter market, where the stock's price dropped to $28.

157 See *Special Study* pt. 3, at 20.

158 The Fairbanks Whitney Corporation announced that it would soon have a commercial disalinization plant in operation. It also announced completion of the first mass-production unit, and promised to announce plans for a world wide marketing process. Presently, two years after such predictions, the fulfillment is still wanting due to "technical delays." *Id.* at 91-92.

where unethical practices can occur which might well be declared unlawful, but which due to a present lack of statutory framework remain unpunishable. Thus, they emphasize the need for new legislation and policies which can act not only as guide-lines for higher standards of conduct, but as mechanisms for the enforcement of such conduct.

C. *Correction of Abuses and Potential Abuses of Corporate Publicity*

The presence of inaccurate and misleading information, although its incidence be infrequent and its proliferation unintentional, has the effect of presenting an unreal picture upon which the investing public may rely to its detriment. Recognizing that there exist today numerous areas of abuse or potential abuse, a scheme to encourage the development of accurate and complete dissemination of corporation publicity is needed.

In order to evaluate the merit of any specific corporate publicity activity, one must keep in mind the possible underlying motivations for such publicity. In any given instance, the primary purpose of the corporation's use of publicity may be to sell the corporation's products, to increase its prestige with the financial community in order to borrow capital readily, to increase the price of its stock in order to facilitate financing by the issuance of additional shares, to enable present shareholders to realize a gain, or to proliferate the corporate name because of the egoism of a high corporation officer.[159] Most, if not all, of these reasons for the dissemination of information can lead to beneficial results by making available, as a basis for sound investment decisions, information about a publicly traded corporation. Abuses will arise when the net effect of publicity, due to any motivation, results in information which creates erroneous impressions. If the reason for the flow of publicity is the presentation of a product within a normal advertising campaign, we might accept a deleterious effect in order not to hamper corporate activities aimed at bona fide commercial purposes, although the same effect might not be so palatable if the goal were merely personal gain or egoism. Thus, not only must the net effect of the publicity be considered, but the practical justifications, if any, for such a consequence should be weighed. In addition to the motivation factor, the cause of and responsibility for the misleading publicity must be evaluated.

In developing a standard for regulating the dissemination of factually incorrect information, one must start from the premise that ideally all such information should be curtailed. However, the application of a strict standard prohibiting the dissemination of all incorrect information would, in effect, require every organization which accepts any information from a corporation to research it thoroughly before passing it on. This stringent burden of research seems so restrictive that it would probably result in a great depletion in the number of financial public relations consultants and thus lead to a curtailing of the reliable voluntary corporate publicity now

159 *Id.* at 78.

being disseminated.[160] Since the application of strict liability to financial public relations consultants is not desirable, a flexible standard for regulating the dissemination of incorrect information by them is needed, one which will hold them accountable for disseminating any incorrect information they knew or should have known about. On the other hand, the imposition of strict liability on the corporate source, although it might likewise decrease the flow of voluntary publicity, seems desirable, because any false publicity disseminated by a corporation about itself is best suppressed. Thus a financial public relations firm would receive treatment different from that of a division of a corporation performing the same function. However, under a flexible standard, those firms closely associated with the corporation could be subjected to a greater degree of care than those firms acting at arm's length vis-à-vis the corporation. This should make the difference between the treatment accorded a corporate division and a private firm which has an equal opportunity to corroborate the publicity it disseminates, almost minimal.[161]

It seems that the problem of defining the standard to be applied is most difficult in the area of dissemination of incomplete information. Here, if one wishes to bring up questions of degree he meets the almost unsolvable problem of "sales talk" vis-à-vis actual omission of material facts. Another difficult question is whether a publicity release is complete when it mentions only a new development of the corporation, without placing it in the setting of the industry and the economy as a whole. In this area also there must be a flexible standard, weighing all of the circumstances, if any type of meaningful regulation is to occur. Such flexibility is necessary because the numerous fact situations which can arise would be impossible to cover in any single piece of legislation.

The matter of saturation publicity raises questions of propriety as well as of degree. Saturation publicity is intensive, simultaneous coverage of a development in all available news media. Although such publicity is complete and accurate, its mere presence may cause a change in stock prices from what would be the uninfluenced normal pattern. The basic question here is whether a public market should be affected by extensive, albeit accurate publicity, when the aim may be to condition the market for financial activities. The statutory treatment of "offers to sell" prior to issuance and proxy solicitations answers this question in the negative by regulating publicity which might condition the market. By analogy, one might reason that all conditioning of the market is bad. However, in

160 Since many corporations seem to consider the use of financial public relations firms a "luxury," curbing such expenditures when budgets must be cut, the increased cost of supporting thorough research would probably be enough to curtail a significant portion of the information normally distributed in this manner. See *id.* at 67.

161 If account is not taken of a financial public relations consultant's ability to corroborate its publicity releases, a premium would be placed on the splitting off of a corporate division in order to avoid the automatic sanction if the information it disseminates is incorrect.

furtherance of bringing forth as much corporate information as possible, it seems best that regulation be limited to the areas of "offers to sell" prior to issuance, proxy solicitation, and, hopefully, manipulations for personal gain which do not have a foundation in furtherance of a corporate business purpose. This result seems best when one considers the constitutionally protected right of freedom of speech. Although it seems clear that the present regulations and any suggested regulations curbing manipulative or misleading practices would not fall within constitutional proscriptions,[162] the desire to regulate must always be weighed against the goal of our society for freedom of activity and speech whenever possible.

The type of enforcement mechanism most suitable for the policing of these solutions must also be considered. Although the law has not been specifically concerned with "unofficial" corporate publicity, there are numerous statutory regulations designed to curb manipulative and fraudulent activties of professionals in the securities markets; these suggest some possible answers.

The provision most applicable to curbing abuses of corporate publicity is Rule 10b-5, promulgated under section 10(b) of the Securities Exchange Act. Section 10(b) makes it unlawful for any person, directly or indirectly, to make any untrue statement in connection with the purchase or sale of any security, or 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 not misleading.[163] Despite judicial holdings that 10b-5 gives a private remedy to investors without the presence of privity of contract between the plaintiff and defendant, the applicability of the rule to fraudulent corporate publicity is limited by the requirement that the information be disseminated in connection with a purchase or sale of the security.[164] Furthermore, the effectiveness of the rule is limited by the uncertainity of the extent of liability for unintentional misrepresentation and the degree of reliance on the defendant's misrepresentations by the plaintiff.[165]

Many states have also attempted to regulate false and fraudulent practices; however, the extent and effectiveness of these statutes has been limited by strict construction and failure of prosecution. Thus, although the Martin Act[166] in New York, for example, does contain provisions broader than the federal acts, the Study pointed out that only one case was reported during the recent bull market, and there the court limited the act's application to purchases through the misrepresenting party.[167]

The only self-regulatory body in the financial public relations industry

162 Problems might arise if sanctions were imposed for the dissemination of correct information simply because it fell in an area where there have been a few practices which could be classified as unethical.

163 48 Stat. 891 (1934), 15 U.S.C. § 78(b) (1958).

164 See 3 Loss 1767-71 for a general discussion of this area.

165 See Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960).

166 Martin Act, N.Y. GEN. BUS. LAW, art. 23A.

167 *Special Study* pt. 3, at 97.

is the Public Relations Society of America. This organization includes over 4,000 practitioners and encompasses many leading financial publicists; it has a meaningful Code of Professional Ethics.[168] However, its policing has thus far involved only disputes concerning fees or clients. Despite this dearth of effective self-regulation, it would be most desirable if this association were to become an effective force so that direct government control would not be necessary.

These various provisions and modes of curbing manipulative and fraudulent activities suggest the possibility of an extension or liberalizing of their provisions in order to cover the full range of abuses and potential abuses of corporate publicity. Although this seems to be a fertile ground for constructive action, this will not suffice to effectuate all of the desirable corrective changes needed in this area. Therefore, a regulation and enforcement program analogous to those existing under the labor and antitrust laws should be considered. Not only do these areas provide a framework for the policing by a federal agency of adherence to objective standards, but they also exhibit systems wherein both private causes of action and government injunctive powers can be accommodated. Furthermore, they provide examples of methods whereby the corporation and its officers can be subjected to both civil and criminal sanctions when necessary.

D. *Recommendations of the Special Study*

The Special Study concluded that prevention of abuses in the dissemination of information concerning publicly held corporations is not entirely within the realm of legal control, due to the large volume of corporate publicity, the paramount aim of full and prompt disclosure, the difficulty of making judgments concerning specific items of publicity, and the proximity of the field to the constitutional right of freedom of expression.[169] However, in its three specific recommendations it did suggest certain statutory actions, along with other remedies.[170] The first recommendation was that the stock exchanges and the NASD establish a set of high standards for the dissemination of corporate publicity, to which the corporations the securities of which they list or quote would be required to conform. These could take the form of statements of policy covering the types of disclosure and publicity required or expected, and the types that should be discouraged or excluded under certain circumstances. The second recommendation was that consideration be given the enactment of a statute providing criminal sanctions and civil liability for intentional or reckless dissemination of false and misleading statements, including forecasts un-

168 The Code of Ethics includes the following prohibitions: (1) A member is not to engage in any practice which tends to corrupt the integrity of channels of public communication; (2) A member is not intentionally to disseminate false or misleading information and is obligated to use ordinary care to avoid dissemination of false or misleading information. *Id.* at 99.

169 *Id.* at 102.

170 *Ibid.*

warranted by existing circumstances which might reasonably be expected to affect transactions in the issuer's securities. The third recommendation was that the rules requiring disclosure under the securities acts be revised to require disclosure of material facts concerning the compensation paid or payable to any financial public relations consultant in the form of any equity of the issuer.

Although the Study's recommendations are significant, they fail to advocate the necessary statutory reform needed to correct the problem shown to exist. This is especially true with regard to the second recommendation, which suggested only that a statute be "considered." If the Study's recommendations are to manifest themselves in genuinely effective reforms, a force speaking with stronger conviction as to the need for new statutory enactments will have to appear.

E. *Conclusion*

The Study, in dealing with the practice of paying public relations advisers in equity securities of the issuer, recommended that all such payments be disclosed in the corporation's registration statements, offering circulars, proxy statements, and subsequent reports. There is no question that disclosure is an effective way of dealing with this problem; however, the mere reporting that a financial public relations consultant has been compensated in the equity securities of its employer does not seem sufficient. The recommendation fails to deal with those abuses which are fostered by the large expenditures on entertainment and "field trips" made by a number of corporations. Short of complete prohibition, the best way to eliminate excessive expenditures is to require that such expenditures be fully reported. Furthermore, in order to make these required disclosures more effective, it seems wise to require that all the data included in the registration statement, offering circulars, proxy statements, and subsequent reports be distributed to the corporation's shareholders at least once a year. This would not only bring these new disclosures to light and facilitate the dissemination of the other information included; it would also eliminate the resultant misleading of innocent shareholders carried on by some corporations which distribute to their shareholders information different in import from that required to be furnished to the Commission.

Another recommendation of the Study deals with the general problem of creating applicable standards for the dissemination of corporate publicity. The Study's suggestion was that the stock exchanges and the NASD can accomplish significant results by establishing high standards to which companies over which they have some control would have to conform. Once again, there is no question as to the wisdom of the recommendation. It seems judicious to urge the independent associations and exchanges to provide as much as possible of the needed regulation themselves, since it minimizes the cost of administration and, more important, produces less friction and avoids creating depressing effects on the market. Despite these advantages of self-regulation, it is questionable whether promulgation of high standards alone would be sufficient, unless accompanied by a change in the exchanges' attitude toward the policing of the substantive sufficiency of disclosures. This is true because one of the major weaknesses of the present regulation carried on by these groups is their failure to concern themselves with the substance of corporate disclosures. These failures of self-regulation, while not sufficient to outweigh the value of autonomous action by the exchanges, demonstrate that self-regulation itself is not sufficient to curb all abuses of corporate publicity. Nevertheless, strict enforcement by the Public Relations Society of America of its Code of Professional Standards for the Practice of Public Relations should be encouraged. Action of this nature is the form of self-regulation which one might hope would render unnecessary the enactment and enforcement of regulatory legislation.[170a]

The remaining recommendation of the Study also dealt with the applicable standards for the dissemination of corporate publicity; however, the Study limited the thrust of this suggestion for a statutory solution by advising merely that consideration be given to it, rather than advocating that immediate action be taken, as with its other two recommendations. Furthermore, the Study limited its suggestion for criminal sanctions and civil liability to intentional or reckless actions. Unfortunately, the failure to state that statutory action is necessary implies a belief that the other two suggestions can alleviate the primary abusive practices in corporate publicity.

If civil liability is limited to intentional or reckless actions, the shortcomings of the laws covering manipulations and fraud, which fail effectively to reach the corporation or its agents, still remain. Thus, it seems that this final recommendation should have advocated positive action. It also should have been wider in scope so as to provide a solution to the problems of when a corporation is under a duty to come forward and disclose, what remedies are available when violations occur, and who should have the right to enforce the remedies.

The answers to these problems of corporate publicity are not easily found; however, it seems that there exist in the regulation of proxies and in national labor and antitrust legislation fertile analogies which could be adopted and used effectively in the regulation of corporate publicity. The Commission, if given power to exercise a prompt form of injunctive relief, would be able to curb many abuses; moreover, if it had the power to require positive disclosures, it could curb nonfeasance as well as misfeasance. The basis for action such as this would have to be a general authorization of power encompassing the duty to see that no false or misleading impressions are created which could affect the prices of the securities of a publicly held corporation. The problem of investigating such matters would be accomplished most efficiently if private individuals and the exchanges, in addition to the Commission, were empowered to file complaints. These

170a Concerning a new financial code of the Public Relations Society of America, see New York Herald Tribune, Jan. 9, 1964, p. 31.

complaints could then be handled before an administrative tribunal subject to judicial review. The major accomplishment of such a system would be its ability to provide adequate remedies. Private causes of action could be brought for damages as well as injunctive relief, without the limitations inherent in the laws designed to prevent manipulation and fraud; the Commission could also obtain quick equitable relief.

Finally, although this problem is covered in other areas of the Special Study,[171] it seems imperative that the post-issuance disclosure requirements not be limited to securities listed on the national exchanges, but also apply to certain securities traded in the over-the-counter market. The opportunity to mislead the public exists in both markets.

III. INVESTMENT ADVICE

When an investor asks the question, "What stock should I buy?" there are many people who will give him an answer, ranging from fly-by-night "tipsheet" publishers to highly competent personal investment counselors. Some will give him the answer gratis, but with the hope that when he does buy he will avail himself of their brokerage services. From others, the advice will be forthcoming for the price of a subscription fee. If the investor prefers personalized service, and his investment capital is sufficient to qualify him for such benefits, the fee for advice will be based on a percentage of the money invested.[172] There are still other advisers who will not wait for the potential investor to pose his inquiry; rather, they expound their views regarding investment, for public consumption, in newspapers, magazines, and books. All these persons are referred to generally as "investment advisers." Still, the list would not be complete without the addition of a large and indefinable group composed of lawyers, accountants, insurance companies, banks, and all others who may be in a position to convey investment advice.[173] Taken as a whole, the advice thus disseminated has great influence on the private investor and, in turn, on the entire securities market. It is the purpose of this section to point out the significant problems presented by the continual flow of investment information, to discuss the legal and ethical responsibilities of the advisers, to evaluate present controls in the area, and to offer some suggestions as to improved solutions to the problems presented.

171 *Id.* at 1-64.

172 Personal investment advice and management tends to be out of the price range of the average investor. For instance, Lehman Brothers limits its investment advisory service to clients with $400,000 or more to invest. Generally, the fee for personal investment advice amounts to one half of one percent of the money invested. See MAYER, WALL STREET: MEN AND MONEY 195 (2d ed. 1959).

173 Although a well-placed magazine or newspaper obviously can affect the price of a stock, recommendations of this kind have far less effect on the investing public than the recommendations of those in the business of disseminating investment advice. See *Special Study* pt. 1, at 332. The material below will be directed toward analysis of the problems stemming from the activity of the latter group.

A. *Present Regulation of Investment Advice*

1. *Federal Regulation*

The Investment Advisers Act of 1940 was passed as Title II of the bill of which Title I was the Investment Company Act.[174] Its passage followed a report on investment advisers in which the Commission described the growth of the investment advisory business and pointed out the more obvious problems involved in it.[175] The significant portions of the act required registration of investment advisers with the Commission; prohibited fraud or deceit in dealings with a client or prospective client; forbade investment advisory contracts providing for compensation to the adviser on the basis of capital gains from, or appreciation of, securities purchased; prohibited assignment of advisory contracts by the adviser without the consent of the party advised; and required that the adviser give full disclosure when selling or purchasing securities for a client while at the same time acting on the other side of the transaction as principal for his own account or agent for one other than the client.[176] The term "investment adviser" as defined in section 202(a)(11) of the act means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities.[177] "Investment adviser" does not include: (a) a bank or holding company affiliate which is not an investment company; (b) a lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (c) a broker-dealer whose performance of such services is incidental to the conduct of his business and who receives no compensation therefor; (d) publishers of newspapers, news magazines, and business and financial publications of regular and general circulation; (e) those persons whose advice is confined to obligations guaranteed as to principal or interest by the United States; and (f) any other persons so designated by the Commission.[178] The following investment advisers are exempted from the registration requirements of the act: (1) an investment adviser whose clients are residents of the state of his business, and who does not furnish advice with respect to any security traded on a national exchange; (2) an investment adviser whose only clients are investment companies and insurance companies; and (3) an investment adviser who in the preceding twelve months had less than

174 54 Stat. 847 (1940), as amended, 15 U.S.C. § 80b (1958 & Supp. IV, 1963).

175 SEC, INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES (1939).

176 Investment Advisers Act §§ 203, 205-08, 54 Stat. 850 (1940), as amended, 15 U.S.C. §§ 80b-3, 80b-5 to -8 (1958 & Supp. IV, 1963).

177 Investment Advisers Act § 202(a)(11), 54 Stat. 847 (1940), 15 U.S.C. § 80b (1958).

178 *Ibid.*

fifteen clients and did not hold himself out to the public as an investment adviser.[179]

Professor Loss has deemed the Investment Advisers Act of 1940 "little more than a continuing census of the Nation's investment advisers in this country."[180] This observation is substantiated by the fact that proceedings under the act since its promulgation in 1940 have averaged one or two per year,[181] and that these actions have been largely confined to the most blatant types of fraud.[182] The deficiencies in the act have not gone unnoticed by the Commission. As early as 1945 the Commission formally urged improvement of the act.[183] Prior to the passage of the bill amending the act in 1960, a congressional committee noted that, of the five acts administered by the Commission, the Investment Advisers Act of 1940 was by far the least adequate to meet the problems it was supposed to solve.[184] In fact, the amendments to the act were the only part of the Commission's legislative program which, at that time, was supported without dissent in the industry.[185]

The 1960 amendments gave the Commission additional grounds for denial of registration to an applicant.[186] In order to facilitate adequate investigation of potential registrants, the Commission was given the power to postpone the effectiveness of the initial registration.[187] Previously, the Commission was required to decide within thirty days whether to approve the application for registration.[188] Moreover, with respect to advisers already registered under the act, the Commission can now suspend registration for a period not to exceed twelve months.[189] Prior to 1960 the only disciplinary tool possessed by the Commission was outright revocation of registration.[190] Of course, an unregistered adviser is for all practical pur-

179 Investment Advisers Act § 203(b), 54 Stat. 850 (1940), 15 U.S.C. § 80b-3(b) (1958).

180 2 Loss 1393.

181 Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 248 (1959).

182 For instance, in the fiscal year 1961 there were two proceedings brought by the Commission under the act. In one, the registration of an investment adviser who solicited and accepted money for subscriptions to an investment letter, but did not publish it, was revoked. SEC Investment Advisers Act Release No. 108, Oct. 4, 1960. In the other, the Commission revoked the registration of an investment adviser who had simultaneously violated the fraud provisions of the Securities Act of 1933, 48 Stat. 74 (1933), as amended, 15 U.S.C. § 77 (1958 & Supp. IV, 1963), and § 206 of the Investment Advisers Act, 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6 (Supp. IV, 1963), relating to perpetration of fraud on a client. SEC Investment Advisers Act Release No. 109, Oct. 31, 1960.

183 SEC, PROTECTION OF CLIENTS SECURITIES AND FUNDS IN THE CUSTODY OF INVESTMENT ADVISERS (1945).

184 S. REP. No. 1760, 86th Cong., 2d Sess. (1960).

185 *Ibid.*

186 Investment Advisers Act § 203(b), 54 Stat. 850 (1940), as amended, 15 U.S.C. § 80b-3(d) (Supp. IV, 1963).

187 Investment Advisers Act § 203(e), 54 Stat. 851 (1940), as amended, 15 U.S.C. § 80b-3(e) (Supp. IV, 1963).

188 54 Stat. 851 (1940).

189 Investment Advisers Act § 203(d), 54 Stat. 850 (1940), as amended, 15 U.S.C. § 80b-3(d) (Supp. IV, 1963).

190 54 Stat. 851 (1940).

poses out of business, as he is permitted to use neither the mails nor any instrumentality of interstate commerce in connection with his advisory business.[191] It is apparent that the harshness of the revocation penalty precluded disciplinary action by the Commission in instances in which a penalty of some lesser degree would have been appropriate.[192] The Commission now has the power to require the keeping of books and records,[193] and to require the filing of reports by investment advisers.[194] A complementary provision forbids public disclosure of information obtained by the Commission in examination or investigation, except in the case of public hearings or upon request by Congress.[195] In short, the Commission staff is placed under a duty of nondisclosure similar to that of a bank examiner. By far the most important provision of the 1960 amendments is that empowering the Commission to define "fraudulent, deceptive, and manipulative" practices and to prescribe by rules means reasonably designed to prevent them.[196] The wording of this section is almost identical to section 15(c)(2) of the Exchange Act, which relates to broker-dealers.[197]

With the passage of the 1960 amendments to the Investment Advisers Act, only two of the major proposals concerning investment advisers suggested by the Commission since 1945 remain unenacted: an amendment to section 205 of the act, requiring advisory contracts of registered advisers to be in writing, and the addition of a section prohibiting a registered adviser from having custody of his client's securities or funds unless his registration application discloses that he had or might have such custody.[198] Considering the revelations of the Special Study,[199] it is doubtful that either of these proposals will receive sufficient attention to become law. It is apparent that far more prevalent and serious deficiencies exist in other areas of investor protection. Furthermore, it appears that the Commission, through the use of its new rule-making power, has provided sufficient protection for an investor whose securities and funds are in the hands of an investment adviser.

To date, the Commission has issued three sets of regulations pursuant to the rule-making power given it by the 1960 amendments. First, the Com-

191 Investment Advisers Act § 203(a), 54 Stat. 850 (1940), 15 U.S.C. § 80b-3(a) (1958).

192 For instance, two advisers were permitted to remain in business although the firm they controlled had been found guilty of taking secret profits at customers' expense and of willfully falsifying its registration statement. H. Evan Taylor, 26 S.E.C. 637 (1947).

193 Investment Advisers Act § 204, 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-4 (Supp. IV, 1963).

194 *Ibid.*

195 Investment Advisers Act § 210, 54 Stat. 854 (1940), as amended, 15 U.S.C. § 80b-10 (Supp. IV, 1963). There are no similar nondisclosure provisions relating to investigations under other acts administered by the Commission.

196 Investment Advisers Act § 206, 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6 (Supp. IV, 1963).

197 52 Stat. 1075 (1938), 15 U.S.C. § 78*o*(c)(2) (1958).

198 See SEC, PROTECTION OF CLIENTS SECURITIES AND FUNDS IN THE CUSTODY OF INVESTMENT ADVISERS (1945).

199 See generally *Special Study* pt. 1, at 330-479.

mission has formulated an extensive list of records which must be kept by every investment adviser.[200] These include: memoranda setting forth the details of any transaction or instruction relating to the sale or purchase of any security; bills or statements relating to the business of the investment adviser; and originals of communications received and sent with regard to recommendations or advice proposed or made, exchanges of securities, and buy and sell orders. Second, the Commission has promulgated rulings dealing with advertisements by investment advisors.[201] Any testimonial relating to the adviser is prohibited. Reference to past recommendations which would have proved profitable is likewise prohibited. The adviser, however, may list his recommendations within one year of the advertisement if there is printed on the first page of the advertisement, the following words: "It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities in this list." The regulation also provides, in effect, that there can be no claim that a chart or graph will predict the future of a stock. Third, the Commission has promulgated rules concerning the adviser's possession of his clients funds or securities. It is deemed a fraudulent, deceptive, or manipulative practice for any investment adviser to take action with regard to his client's funds or securities unless the adviser (1) segregates, identifies, and holds such funds or securities in a reasonably safe place; (2) deposits all funds in a bank account or accounts containing only the client's funds, maintained in the name of the adviser as agent or trustee, and keeps adequate records of such accounts; (3) gives notice to the client of the location of the funds and securities; (4) sends each such client an itemized statement at least every three months showing the funds or securities in the adviser's custody, and all debits, credits, and transactions affecting the client's account during such period; and (5) provides for verification of funds and securities of the client by an independent public accountant, without notice to the adviser, at least once a year.[202] However, this regulation does not apply to an investment adviser also registered as a broker-dealer under section 15 of the Securities Exchange Act of 1934 if the broker-dealer is in compliance with or exempt from section 15c(3)(1).[203]

The impact of the new regulations is readily apparent. Since the three sets of rules were promulgated, the registrations of investment advisers have been revoked in eight cases, and three proceedings have been instituted to revoke the registrations of others.[204] The regulations have opened the door

200 17 C.F.R. § 275.204-2 (Cum. Supp. 1962).

201 17 C.F.R. § 275.206(4)-1 (Cum. Supp. 1962).

202 27 Fed. Reg. 2150 (March 6, 1962).

203 *Ibid.* The regulation of investment advice given by broker-dealers is given further attention in section IV *infra*.

204 Revocations: SEC Investment Advisers Act Release No. 153, Nov. 26, 1963 (Justin Stone & Associates, Inc.); SEC Investment Advisers Act Release No. 148, Sept. 4, 1963 (Dynamics Letter, Inc.); SEC Securities Exchange Act Release No. 134, Dec. 31, 1962 (J. H. Logan & Co.); SEC Securities Exchange Act Release No. 130, Oct. 4, 1962 (Seymour J. Schlesinger); SEC Securities Exchange Act Release No. 128, June 20, 1962 (Carroll Till-

to aggressive policing of investment advisers—a course not available before 1960. For instance, in the proceeding which resulted in the revocation of the registrations of Carroll Tillman and Francis Ryan,[205] doing business as the Tillman Survey, the Commission charged that Tillman, aided and abetted by Ryan, published and distributed advertising material which contained untrue statements and which was false and misleading. Among other infractions, the misrepresentations in the advertisements consisted of comparisons between the securities recommended by Tillman and other securities, without adequate disclosure of the material differences between the securities, and representations that a list of ten stocks presented was selected in accordance with seven tests prescribed by Tillman, which tests could allegedly uncover enormously profitable securities.

2. *State Regulation*

State regulation of investment advisers is a comparatively recent development, although there is a noticeable trend in this direction.[206] In 1958, sixteen states required the registration of investment advisers;[207] by 1962, the number had risen to twenty-five.[208] However, according to a survey of the twenty-five states requiring adviser registration, in only sixteen can the security commission or other appropriate officer deny registration to those applicants he considers unqualified.[209] Thus, in a little over one-fourth of the states requiring registration, it is but a mere formality.

The relevant provisions of the Uniform Securities Act, adopted by the National Conference of Commissioners on Uniform State Laws in 1956, are integrated with similar provisions relating to broker-dealers. Section 102 of the Uniform Act, dealing with investment advice, is analogous to the Investment Advisers Act, as amended in 1960. Unlike the federal statute, however, the Uniform Act requires that the investment advisory contract be at least in part in writing.[210] The Uniform Act also gives the administrator the power to deny, suspend, or revoke an application for registration if he feels the applicant or registrant is not qualified on the basis of such factors as training, experience, and knowledge of the securities

man and Francis Ryan); SEC Securities Exchange Act Release No. 127, June 12, 1962 (Anne Casely Robin, doing business as The Profit Maker); SEC Securities Exchange Act Release No. 129, June 9, 1962 (Owen K. Taylor, Inc., Edward Blatt, Walter Rosenbusch, and Financial Forecasters, Inc.); SEC Securities Exchange Act Release No. 126, June 5, 1962 (William H. Biesel). The following proceedings were instituted under the Investment Advisers Act to determine whether the registrations of certain investment advisers should be revoked: SEC Investment Advisers Act Release No. 151, Oct. 30, 1963 (Spear & Staff, Inc.); SEC Investment Advisers Act Release No. 144, May 8, 1963 (Paul K. Peers, Inc.); SEC Investment Advisers Act Release No. 139, March 25, 1963 (Market Values, Inc.).

205 Investment Advisers Act Release No. 128, June 20, 1962 (ordering the revocation of the registrations of Carroll Tillman and Francis Ryan).

206 See Loss & COWETT, BLUE SKY LAW 20-21 (1958).

207 *Ibid.*

208 1 Loss 47.

209 *Id.* at 48-49.

210 UNIFORM SECURITIES ACT § 102(b).

business.[211] In contrast, there are no provisions in the federal act allowing the Commission to deny or revoke a registration due to lack of ability of the adviser. Moreover, the Uniform Act provides that the administrator may require a minimum capital figure for broker-dealers and investment advisers.[212] To date, the Uniform Securities Act has been adopted in fifteen states and is expected to become law in several others.[213]

3. *Self-Regulation*

Private associations of investment advisers play a minimal role in self-regulation. Presently, there are two such groups organized on a nation-wide basis. The Investment Counsel Association of America (ICAA) is an organization of fifty-four firms "primarily engaged in the giving of continuous advice as to the investment of funds of clients on the basis of the individual needs of each client."[214] The Institute of Chartered Financial Analysts was formed in 1959 with the objective of fostering higher educational standards in the field of financial analysis by conducting examinations designed to test individual competence and skill. The Institute grants the designation of "chartered financial analyst" to persons who meet the standards established by the Institute for the professional practice of financial analysis.[215] The Special Study noted that both the Institute and the ICAA have embarked on a course aimed ultimately at "achieving professional recognition, much in the manner of accountants, whose drive for recognition started at the end of the nineteenth century."[216] Although it would seem that such a program might indirectly lead to a general raising of industry standards, the Study reported that the present program seems to hold only limited benefits for the public, as the immediate result will be confined to the conferring of an industry cachet upon certain analysts.[217] The small size of these organizations, the absence of substantial sanctions against their members, and the present focus on "status" rather than control of industry practices, all combine to render their effect *de minimis.*

The New York Stock Exchange has established certain guideposts for advisory material disseminated by member firms. It suggests that supporting information be offered with respect to recommendations relating to the sale or purchase of securities; that forecasts of future performance be clearly labeled as opinion; and that flamboyant language and misleading comparisons be avoided.[218] The NYSE has also suggested that a member organi-

211 *Id.* § 204(b)(6).

212 *Id.* § 202(d).

213 *Special Study* pt. 1, at 82. The following states have adopted the Uniform Securities Act: Alabama, Alaska, Arkansas, Colorado, Hawaii, Indiana, Kansas, Kentucky, Maryland, Montana, New Jersey, Oklahoma, South Carolina, Virginia, and Washington.

214 ICAA by-laws art. 1, § 1, as quoted in *Special Study* pt. 1, at 149. It is obvious that this association encompasses a very small percentage of the 1,836 advisers registered under the Investment Advisers Act.

215 *Special Study* pt. 1, at 149.

216 *Id.* at 150.

217 *Ibid.*

218 Quoted in *Special Study* pt. 1, at 376-77.

zation recommending a security in which it has a position should consider whether such an interest ought not to be stated in the material. The Special Study, however, reported that if most firms "consider" including a statement of their position, the results of such consideration "appear almost universally to be negative."[219] Furthermore, the Study reported that most firms pay little heed to any of the afore-mentioned guideposts.[220] The NYSE also has a program for review of market letters and sales literature, which is reported to be "considerably short of vigorous and aggressive self-regulation."[221] Similarly, the NASD has certain general restrictions on advice published by broker-dealers, the enforcement of which is equally uninspiring.[222] Since few advisory firms are engaged in selling, advisers are for the most part beyond the compass of the NYSE and NASD rules.

B. *Present Problems and Recommended Solutions*

Aside from the problems relating to the qualifications of investment advisers, the Special Study indicated that, from the point of view of protection of the average investor, the present major deficiencies in the operation of advisers relate to (1) the widespread practice of "scalping," *i.e.*, the adviser has a position in a particular stock, recommends investor action in that stock, and after market response to his recommendation, sells or buys accordingly, reaping gains from the market action that he has generated; (2) the problem of "snowballing" recommendations, *i.e.*, an adviser recommends a stock in his publication, whereupon another writing his market letter on the basis of the first recommends the same stock even more vigorously, and so on; (3) inadequate research practices; and (4) the predominant orientation toward "buy" recommendations—both in broker-dealer literature and that disseminated by the subscription services.

At the time the *Report* of the Special Study was published, it was doubtful whether the practice of scalping was in fact proscribed by the Invest-

219 *Id.* at 377.

220 *Ibid.*

221 *Id.* at 379. In response to criticism by the *Report* of the Special Study, the NYSE recently issued an expanded set of rules governing member firms' market letters, research reports, and other communications with the investor. Among the more significant of the new rules are the following: (1) a tighter requirement that member firms recommending securities in market letters disclose their own dealings in the issues; (2) a provision requiring that member firm claims that they are equipped to provide research facilities have a reasonable basis; (3) a requirement that reports and recommendations prepared by someone other than the brokerage firm (such as a company's public relations agent) identify the source; (4) a requirement that brokerage firms' internal wires and market letters conform to the rules for market letters shown to the public; and (5) a requirement that a firm's recommendation to buy or sell a stock have a basis which can be substantiated as reasonable. These new rules were reported in The Wall Street J., Sept. 25, 1963, p. 9, col. 2. One must remember, however, that the Special Study's criticism was directed toward the lack of enforcement of exchange rules rather than the lack of rules; thus, whether the present action of the NYSE is indicative of a policy that will in fact meet the objections of the Special Study remains to be seen.

222 See Comment, *The Regulation of Investment Advisers*, 14 STAN. L. REV. 827 (1962).

ment Advisers Act. However, in the recent case of *SEC v. Capital Gains Research Bureau, Inc.*[223] the United States Supreme Court held that the practice of "scalping" is in fact a form of fraud or deceit on the client and as such within the practices forbidden by the Investment Advisers Act of 1940. In five instances Capital Gains had acquired a position in certain issues and then recommended that its customers purchase the same securities, each time without disclosing its position in the market or its intention to sell. It then sold the securities it held at a considerable profit.

In investigating the problem of scalping, the Study found no consistent attitude on the part of advisory firms toward the propriety of recommending securities in which the firm is disposing of its position, or toward the necessity of disclosing that it has a position.[224] Some firms stated that they will not solicit purchases by their public customers of a security in which they are liquidating an investment position, while others will not prepare a market letter or research report on such a security.[225] On the other hand, many firms do not disclose their position in the securities which they recommend, and some even ask their adviser-salesmen to "crank up on it as . . . very attractive" when they are trying to "unload."[226] The Special Study recommended, with respect to advisers and broker-dealers subject to self-regulatory organizations, that thorough statements of policy standards be established requiring disclosure of existing positions in written investment advice.[227] With regard to those not subject to self-regulation, the Study recommended organization into self-regulatory bodies, or alternatively that the Commission extend and strengthen its own regulatory measures,[228] with the same objectives in mind. However, it would seem futile to hope for the emergence of a self-regulatory body or bodies in the near future, as the investment advisory business has flourished since the end of World War I with no significant move in this direction. Furthermore, the wide variations of opinion on the part of those in the field with respect to ethical standards would certainly make it difficult for such a body to form a meaningful set of rules. Disclosure of the adviser's position seems definitely preferable to a total prohibition from taking a position, as an advisory-broker-dealer firm may legitimately want to build up a position in a stock which it is about to recommend, in order to have shares available for its

223 84 Sup. Ct. 275 (1963). The Court of Appeals for the Second Circuit had refused to find Capital Gains guilty of wrongdoing under the fraud section of the Investment Advisers Act, stating that, at most, the defendant merely profited personally from the predictable effect of its investment advice; however, there was a vigorous dissenting opinion, SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606 (2d Cir. 1962), 61 MICH. L. REV. 1185 (1963).

224 *Special Study* pt. 1, at 371.

225 *Id.* at 371-73.

226 *Ibid.*

227 *Id.* at 386.

228 *Id.* at 387.

customers at a price which will not reflect the market impact of its recommendation. A disclosure rule promulgated by the Commission would seem the most appropriate remedy. Specifically, under section 206(4) of the Investment Advisers Act, as amended in 1960,[229] the Commission should define nondisclosure of one's position as deceptive or manipulative and require full disclosure of the adviser's position in any security which he recommends.

The matter of "snowballing" recommendations is but one aspect of a more general problem relating to inadequate research. If there were adequate research departments in all of the advisory firms who claim to have them, recommendations could in fact be based on the firm's independent evaluation of each company with which it deals, and there would be no need for "cribbing" and using other advisory letters for source material. The *Dunn Engineering* case,[230] reported in detail by the Special Study, presents a graphic illustration of the disastrous effects of this phenomenon. In this case, a chain reaction of various market letters, each based at least in part on a previous letter, resulted in the enthusiastic recommendation of Dunn Engineering by broker-dealers and subscription publishers within a few weeks of its bankruptcy, long after the appearance of obvious signs that the company was in bad trouble.

The Special Study reported several examples of wholly inadequate researching of recommended securities.[231] Most unfortunate was the finding that "frequently there is a broad gap between the practices followed and the standards professed to the public."[232] The most significant shortcoming with respect to advice disseminated by broker-dealers is that research staffs are often so burdened with preparing internal publications, answering individual inquiries, providing portfolio reviews, and working on special advisory services for institutional investors that there is insufficient time to devote to material for investors generally.[233] The prime shortcoming of subscription publication research is that the publications attempt to cover far more securities than their staffs can adequately evaluate.[234] The brunt of inadequate research, in the form of ill-prepared market letters and tout sheets of broker-dealers, is borne by the small investor; it was he who was hardest hit in the 1962 downturn of the market.[235] Institutional

229 That section provides: "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentalities of interstate commerce, directly or indirectly . . . (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall for the purpose of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." Investment Advisers Act § 206, 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6 (Supp. IV, 1963).

230 *Special Study* pt. 1, at 334-44.

231 *Id.* at 351-53.

232 *Id.* at 350.

233 *Ibid.*

234 *Id.* at 363-67.

235 U.S. News & World Report, Oct. 1, 1962, pp. 56-59.

investors generally pay for and receive priority treatment with regard to research skill and investment advice.[236] The Special Study has recommended that reckless dissemination of investment advice by broker-dealers and investment advisers be expressly prohibited by statute or rules of the Commission and the self-regulatory agencies. The most adequate remedy would be Commission rules prohibiting reckless dissemination of investment advice. The Commission has the authority to promulgate such rules by virtue of its power under both the Exchange Act and the Investment Advisers Act to prohibit "fraudulent, deceptive, or manipulative practices.[236a] A market letter or report appearing or stated to be the product of research when in fact it is not is obviously "deceptive." It is apparent that the Commission, by a broad interpretation of the fraud section of the Securities Exchange Act, is attempting to protect the investor from similarly deceptive representations coming from broker-dealers in connection with the offer and sale of securities. For instance, in the case of *Brown, Barton, and Engel*[237] the Commission suspended the broker-dealer registration in question on the basis of sections 10(b) and 15(c)(1) of the Securities Exchange Act.[238] The respondent had made false and misleading representations with respect to *future* prices, listings, and availability of certain stock. Additionally, he failed to make a diligent and reasonable investigation of the issuer before recommending the stock. The Commission felt that suspension of the registration was necessary in the public interest and for the protection of investors.

The detrimental effect of unreliable investment advice is the same whether attendant to an offer to sell securities or part of a market report of an investment adviser; in either case, the investor is led to act on representations purportedly the product of an accurate evaluation, when in fact no such evaluation has taken place. The rules suggested would effectuate the degree of investor protection toward which the Commission was striving in the *Brown* case, but at the same time would expand its compass to include *all* advice disseminated by both broker-dealers and investment advisers. The flexibility of the rules is both desirable and necessary. Aside from the fact that definite standards would be hard to formulate, flexible rules would be more in keeping with the fact that informal, behind-the-scenes conferences play a significant part in Commission supervision, and

236 *Special Study* pt. 1, at 357.

236a Exchange Act § 15(c)(2), 52 Stat. 1075 (1938), 15 U.S.C. § 78*o* (1958); Investment Advisers Act § 206, 54 Stat. 852 (1940), as amended, 15 U.S.C. § 80b-6 (Supp. IV, 1963).

237 Brown, Barton & Engel, SEC Securities Exchange Act Release No. 6821, June 8, 1962.

238 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78 (1958 & Supp. IV, 1963). The composite effect of these provisions and the rules enacted thereunder is to make unlawful the use of the mails or the facilities of interstate commerce in connection with the purchase or sale of any security by means of a scheme to defraud, any untrue or misleading statement of a material fact, or any act, practice, or course of business which operates or would operate as a fraud or deceit upon customers, or by means of any other manipulative, deceptive, or fraudulent device.

would allow the Commission to draw upon its experience in enforcing the analogous general fraud section of the Securities Exchange Act.

Whether restrained and dignified or exuberant and flamboyant, whether distributed by broker-dealers or advisers, the tone of most investment advice points to one course of action: BUY.[239] This fact would not be disturbing in itself if it were not coupled with a great difference of opinion in the securities industry as to the extent of a firm's obligation to make the recipients of its published advice aware of significant changes in the circumstances of a company whose security it has recommended.[240] Although one firm reporting to the Special Study group suggested that there may be a moral obligation to follow up recommendations and give periodic reports until a sell recommendation is made, most firms indicated that no organized effort is made to follow up on stock favorably recommended.[241] There are several reasons why advisory firms don't want to give "sell" advice. First, such advice can result in refusal by management of the issuer of the "unrecommended" security to continue as a source of information for the adviser. A few firms feel that problems would be created by customers who might receive the advice late.[242] Most important, the ominous possibility of losing underwriting business as a result of management's adverse reaction is ever-present for firms who do underwriting as well as disseminate investment advice. Nevertheless, these rationalizations do not compensate for the fact that, in purporting to act for the investor in giving advice concerning the investor's portfolio, the investment adviser has assumed a position tantamount to, if not actually that of a fiduciary. Logic, as well as reasonable business morality, dictates that "sell" recommendations be forthcoming when the market so warrants. A call for legislation or regulation would not seem to be the answer to this deficiency, for innumerable problems, including those presented by the first amendment, would result from an attempt to formulate a regulation in any way delineating the substantive content of securities literature. In this light, it seems that the best "remedy" for the problem is cultivation of public awareness of the prevailing orientation toward "buy" recommendations. The report of the Special Study is in itself a step in the right direction. Once the investing public is aware of the fact that the prime concern of advisers is to *sell* securities, there should be far less misplaced reliance on the judgment of advisers.

A significant problem tangentially related to a discussion of investment advisers per se is that of unreasonable and collusively set advisory fees paid by mutual funds to investment advisers. Although this problem was not dealt with by the Special Study, it has been the subject of several recent cases litigated under the Investment Company Act. The following pattern

239 *Special Study* pt. 1, at 344-50.
240 *Id.* at 348.
241 *Ibid.*
242 *Special Study* pt. 1, at 348.

is usually present in these cases. The directors of the adviser are also the directors of the fund and are therefore able to fix the fees in the interest of the adviser rather than the fund. Thus the resultant advisory fee bears no relation to the reasonable value of the services rendered; and although there are poor results, the advisory contract is consistently renewed.[243] The Investment Company Act has adequate standards to gauge the fiduciary conduct of those directors of mutual funds who play such a dual role, and the Commission has the power to step in.[244] The question presented in the recent cases, however, relates to whether a mutual fund or shareholder thereof suing for breach of fiduciary duty has a private right of action by virtue of the Investment Company Act. An affirmative answer would supply much needed uniformity in the field. Without such a private right of action, a plaintiff is left to his common-law remedy, which of course depends on the laws of the various states. The federal courts are presently split on the question. The Court of Appeals for the Eighth Circuit, refusing to hold that a private remedy stems by implication from the Investment Company Act, has indicated that in a private action the directors of a mutual fund are to be held to their common-law duty of due care, rather than the fiduciary standards articulated in the act—with respect to advisory fees or otherwise.[245] On the other hand, the Second Circuit Court of Appeals has allowed a private right of action based on the alleged violation of eight different sections of the Investment Company Act, in which the plaintiffs sought to have the advisory contracts declared null and void, and to have the individual defendants repay the excessive advisory fees.[246] In the course of its opinion, the Court expressly rejected the Eighth Circuit's restrictive interpretation of the Investment Company Act.

Because the Investment Advisers Act was until 1960 a weaker regulatory device than the Investment Company Act, the Securities Act, and the Exchange Act, there are no reported cases in which a plaintiff has successfully recovered damages from an adviser by virtue of its provisions. The aggrieved investor's chances may be somewhat better since the act was strengthened by the 1960 amendments. Nevertheless, because most federal courts which have implied liability from the other federal securities acts have required buyer-seller privity[247]—a condition almost always lacking in a suit against an investment adviser—it seems that plaintiffs will remain dependent upon the common-law remedy: an action for deceit. Still, the possibility of a civil remedy for a plaintiff aggrieved by an investment

243 For a general discussion of this problem, see Comment, *Private Rights of Action Under the Investment Company Act*, 1961 DUKE L.J. 421.

244 See generally Investment Company Act, 54 Stat. 789 (1940), as amended, 15 U.S.C. § 80a (1958 & Supp. IV, 1963).

245 Brouk v. Managed Funds, Inc., 286 F.2d 901, 918 (8th Cir. 1961), *vacated as moot*, 369 U.S. 424 (1962).

246 Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961).

247 Comment, *supra* note 222, at 837.

adviser should not be completely foreclosed. It is settled that an action for damages can be based on the Securities Exchange Act, which makes it unlawful to use a manipulative or deceptive device in connection with the purchase or sale of securities.[248] Similar language was added to the Investment Advisers Act in 1960, and if one regards the investment adviser as a fiduciary, the fiduciary relationship should compensate for the lack of buyer-seller privity, at least in cases where the investor has paid for personal service or a subscription publication. The Special Study recommended that, by statute or rule, the reckless dissemination of investment advice be expressly made subject to civil liability in favor of customers reasonably relying thereon to their detriment.[249] However, this recommendation seems premature. The enactment of such a rule should await an authoritative ruling from a federal court to the effect that a civil liability cannot be implied from the Investment Advisers Act, as amended in 1960. Moreover, from the point of view of the general public, the Commission would be better off for the time being concentrating its efforts in the direction of adequate control to prevent deceptive practices from occurring at all.

C. *Conclusion*

Insofar as there is to be state regulation and/or registration of investment advisers, it should be part of the general state Blue Sky law and not be made the subject of separate legislation. There are several advantages of integrated Blue Sky legislation. If all aspects of legislation dealing with broker-dealers and investment advisers were part of a single legislative enactment, rather than piecemeal statutory rules, the adoption of uniform legislation among the states would be facilitated. Clear legislative statements of state policy would aid federal-state coordination in developing this area of the law. Furthermore, within each state, requirements of dual registration when a person is both a broker-dealer and an investment adviser would be eliminated, and economy and consistency in the administration of securities laws would be enhanced by a single set of provisions relating to rule-making, investigation, enforcement, and analogous procedures. But, on the whole, state action seems inadequate to cope with the problems presented by the investment adviser segment of the securities industry. The flow of advisory material is obviously interstate, and investor material of general circulation from a single source will reach most of the states. Most important, however, is the fact that the United States has a direct interest in maintaining the integrity of the securities markets, which play a vital role in the national economy.

On a nationwide basis, the assumption of more responsibility by existing self-regulatory organizations, the formation of self-regulatory organizations where there are none, the promulgation of regulations requiring

248 Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953).
249 *Special Study* pt. 1, at 387.

disclosure of the adviser's position in securities he recommends, the prohibition of reckless dissemination of investment information, and provision for a civil remedy for those hurt by reckless advice would provide more adequate protection for the investor. Yet, more than this seems to be required to raise the investment advice business to a high ethical plane and the level of professional competence it often professes to embody. Those in the advisory field will have to decide whether they are salesmen peddling their commodity—investment advice—for whatever it is worth, or professional men willing to assume a fiduciary responsibility in the selection and supervision of suitable investment portfolios. Only the latter answer will fully protect the investor from the undesirable results of the present predominant orientation of advisory material toward "buy" recommendations—a problem that seemingly cannot be solved by legislation or regulation. Whatever the results of the Special Study in the way of immediate legislation or rules, it seems that its most significant accomplishment in this sphere of the securities industry is that it has publicly posed the basic questions, and thereby set the stage for comprehensive government control of the field if the industry itself does not provide adequate solutions.

IV. SELLING PRACTICES

No examination of present-day selling practices in the securities industry can be limited merely to coverage of the Special Study findings and recommendations. In the area of selling practices, far more than in the three preceding sections, the courts and particularly the Commission itself have on their own initiative recently instituted sweeping and sometimes dramatic changes. Many of these alterations in the level of professional integrity required of the broker-dealer have transpired within recent months. The Special Study recommendations must be viewed in the light of these developments. Thus this section will devote as much attention to recent proceedings in the courts and the Commission as to the Study itself.

The merchandising of securities is a multimillion dollar industry which has come to play an integral part in the American economy.[250] The number of individuals owning shares in publicly held corporations in 1962 was estimated to be about 17,010,000, an increase of approximately 4,500,000 since 1959.[251] This rapid growth has been largely the result of an increased emphasis on sales techniques; and, because of his direct contact with the public, the activity of the securities salesman is critical to the sales effort.[252] The intangible nature of securities and the intricacies of the securities business as a whole present formidable obstacles to knowledgeable invest-

[250] The market value of the shares traded on the New York Stock Exchange alone in 1962 was $47 billion. NEW YORK STOCK EXCHANGE, 1963 FACT BOOK 1 (8th ed. April, 1963).

[251] Of these 17,010,000 persons, 6,666,000 had household incomes under $7,500, and the adult female shareholders outnumbered the adult male shareholders by 326,000. *Ibid.*

[252] *Special Study* pt. 1, at 250.

ment. As a result, the public must ordinarily rely heavily upon the advice and recommendation of the securities salesman, regardless of whether the salesman acts as agent or principal in the sale. Such reliance sets the stage for great potentialities for fraud, and it has been observed that "the business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision, and action."[253] The laws governing selling practices attempt to resolve the conflict between policies favoring traditional arm's-length transactions protected by the doctrine of *caveat emptor*, and the realities of public investment—a dependent relationship lacking many of the safeguards of the bargaining process.

A distinction between a securities broker and a securities dealer has developed as a part of the law of selling practices. Traditionally, their functions were separate, with the broker selling and buying as agent "for" his customer, and the dealer, acting as a principal, selling "to" and buying "from" his customer. With the advent of federal securities regulation, the functions of broker and dealer received separate legislative treatment, although the courts had previously recognized these distinctions and had employed certain differentiating characteristics to distinguish the dealer from the agent.[254] The Securities Act of 1933 included within the definition of dealer those who perform the functions of a broker,[255] but the Securities Exchange Act of 1934 distinguished between the two, defining a broker as "any person engaged in the business of effecting transactions in securities for the account of others,"[256] and a dealer as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise . . . ."[257]

The inconsistency inherent in a situation where the same firm or individual acts as both agent and principal has long been recognized. Nevertheless, the practice of combining these functions is prevalent throughout the securities industry, and almost universal in the over-the-counter market. In a 1936 report of the Securities and Exchange Commission it was stated

[253] Archer v. SEC, 133 F.2d 795, 803 (8th Cir. 1943).

[254] See Douglas & Bates, *Stock "Brokers" As Agents and Dealers*, 43 YALE L.J. 46 (1933). "Other courts have recognized . . . distinctions and in general have employed the following differentiating characteristics or earmarks to distinguish the dealer from the agent.

"(1) The form of the confirmation 'sold to you' rather than 'bought for your account' is evidentiary of a dealer-customer relationship.

"(2) The fact that the customer is not charged any commission is likewise evidence that the 'broker' acted as dealer.

"(3) The 'broker' when acting as a dealer usually acquires the stock at one price and transfers it to the customer at another.

"(4) If the 'broker' is selling from his inventory he is acting as a dealer.

"(5) He is nonetheless a dealer even though he had no inventory but was acquiring securities for his customer in the manner of any merchant." *Id.* at 60-61.

[255] Section 2(12), 48 Stat. 75 (1933), 15 U.S.C. § 77b(12) (1958).

[256] Section 3(a)(4), 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(4) (1958).

[257] Section 3(a)(5), 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(5) (1958).

that the combination of the broker and dealer functions in the same individual or firm involves a conflict of interest provocative of abuse of the fiduciary relationship inherent in the brokerage function.[258] It was found, however, that separation of the functions was so often economically unfeasible in smaller communities that the solution for this conflict was not to divorce the functions, but to control conflicts of interest by a strong administrative program of inspection and control.[259] One result of the program undertaken by the Commission subsequent to this report has been the virtual elimination of the distinction between broker and dealer, accomplished by application of a standard of fair dealing to all sales practices. Furthermore, the distinction between broker and dealer may now be illusory, since it is doubtful that the word "dealer" conveys the idea of an arm's-length relationship to the average customer or even to the trade.[260] This is true because of the broad definition used in the Securities Act, and because an agent may have a declared interest adverse to that of his principal in the very transaction to which the agency relates.[261] Whatever the reasons, distinctions between the two are generally ignored in the area of selling practices; and the Commission has adopted the inclusive designation "broker-dealer."[262]

The investor gains some protection against fraudulent selling practices of broker-dealers by virtue of the remedies provided by traditional common-law actions, such as deceit and rescission. Further protection has been found in an implied civil cause of action based on the Exchange Act of 1934.[263] The anti-fraud provisions of the federal securities acts, violation of which may subject a broker or dealer to civil, criminal, and administrative sanctions imposed by the Securities and Exchange Commission, provide specific protection for the investor. Finally, the national exchanges and the NASD have their own disciplinary proceedings designed to deal with fraudulent selling practices.

The material below examines the law as it exists today governing the fraudulent selling of securities,[264] the sanctions available against violators, the remedies available to a defrauded investor, and findings and conclusions of the *Report of Special Study of Securities Markets.*

258 SEC, REPORT ON FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALER AND BROKER 109 (1936).

259 *Id.* at 110-13.

260 See generally Lesh, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities,* 59 HARV. L. REV. 1237, 1248 n.45 (1946).

261 RESTATEMENT (SECOND), AGENCY §§ 23, 24, 389, 390 (1958).

262 See generally 2 Loss, 1215-23; 3 *id.* at 1500-08. Hereinafter the functions will be treated as combined, unless otherwise indicated.

263 Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

264 Excluded from this examination are those activities which do not involve direct contact with the public, *e.g.,* odd-lot houses, specialists, floor-traders, and pure wholesale dealers.

A. Laws Governing the Fraudulent Selling of Securities

Prior to 1933, the federal government could combat fraudulent selling practices only by bringing criminal charges under the mail fraud statute.[265] The Securities Act of 1933, however, embodied a general provision declaring fraudulent practices unlawful when connected with the offer or sale of any security.[266] This provision, section 17(a), has provided the basic language for all subsequent antifraud provisions:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[267]

The Exchange Act of 1934 included section 10(b), which made unlawful use of any "manipulative or deceptive device or contrivance in contravention of Commission rules" in the purchase or sale of any security whether registered on a national securities exchange or not.[268] Pursuant to this section, the Commission adopted Rule 10b-5, incorporating the language of section 17(a), but making it applicable to both the purchase and sale of securities.[269] The Exchange Act was amended to include section 15(c)(1), giving the Commission power to promulgate rules defining manipulative, deceptive, or other fraudulent devices or contrivances used by brokers or dealers in the purchase or sale of any security other than on a national securities exchange.[270] Pursuant to this authority, the Commission adopted Rule 15cl-2, which incorporated the basic language found in section 17(a) of the Securities Act.[271] Sections 15(c)(1) and 10(b) are virtually identical in that both apply to the purchase *or* sale of securities. Section 15(c)(1), however, is limited to over-the-counter activities by brokers and dealers, while section 10(b) extends both to markets and to "any person."[272]

It is within this statutory framework that the Commission and the courts have acted to protect the investing public from fraudulent selling prac-

265 18 U.S.C. § 1341 (1958). Ashby, *Federal Regulation of Securities Sales*, 22 ILL. L. REV. 635 (1928).

266 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q(a) (1958).

267 *Ibid.*

268 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958).

269 17 C.F.R. § 240.10b-5 (1949).

270 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78*o*(c)(1) (1958).

271 17 C.F.R. § 240.15cl-2 (1949).

272 For a discussion of the history of the anti-fraud provisions of the federal securities acts, see generally Loss 1421-30.

tices.[273] Perhaps the most successful, and certainly the most pervasive, implementation of these provisions has been the imposition of the so-called "shingle theory," which provides a standard of fair dealing unique in a field comprised essentially of merchandising. Under this theory, a licensed broker-dealer, in doing business with the public, is said to "hang out his shingle" and thereby represent that he has expertise in the intricate business of investment, and that the standards of his calling proscribe unfair dealing with less well-informed customers, even in transactions where technically the broker-dealer is dealing at arm's length.[274] This standard was first propounded in *Duker & Duker*,[275] where the Commission held that a broker-dealer allegedly acting as a principal willfully violated section 17(a) of the Securities Act and section 15(c)(1) of the Exchange Act by charging prices "clearly excessive and unreasonable" in light of the current market prices. The Commission stated that "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."[276] Although there was no evidence adducible from the Commission's opinion as to what the "standards of the profession" were, nor as to what constituted an "excessive spread" between current market and the price charged to the customer,[277] it was clear that the Commission had not relied upon traditional concepts of fraud, nor upon an agency relationship to provide the basis for the violation. However, reliance by the customers on their relationship with the dealer was emphasized as a factor to be weighed in determining the dealer's legal responsibility. In 1943 the shingle theory received unqualified judicial affirmation in *Charles Hughes & Co. v. SEC*.[278] Although the opinion of the Second Circuit in the *Hughes* case did not delineate the exact principles of law approved, the Commission has frequently utilized the holding of the case in proceedings against broker-dealers and their employees.[279] The fraudulent conduct in *Hughes* involved the common pattern of reliance and riskless trading, with the dealer held to have charged prices not bearing a reasonable relation to the current market price of the securities. However, the court went further than in preceding cases and suggested that reliance upon the dealer-customer relationship was not an element of a violation of the standard of fair dealing.[280]

273 As Rule 15cl-2 suggests, fraudulent selling practices are not limited to conduct adverse to the public, but may also be perpetrated against brokers and dealers by members of the public and by other persons in the securities business itself. 17 C.F.R. § 240.15cl-2 (1949).

274 See text accompanying note 262 *supra*.

275 6 S.E.C. 386 (1939).

276 *Id.* at 388. For a discussion of the early history of the standard of fair dealing, see Lesh, *supra* note 260, at 1237.

277 The Commission avoided the definitional problem by finding the spread clearly excessive and unreasonable.

278 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

279 See cases cited note 285 *infra*.

280 For subsequent judicial affirmation that reliance is not material to a breach of the implied duty of fair dealing, see Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Hughes v.

During the same period the Commission adopted an alternate solution to the problem of investor protection. The Commission revoked the registration of a broker-dealer which operated by securing the confidence of a customer—typically a widow uninitiated in securities investments who would turn over her savings for investment and reinvestment—and then charging prices marked-up 40 to 193 percent over the current market.[281] In finding this conduct to be a willful violation of section 15(c)(1) of the Exchange Act, the Commission relied on the theory that an agency relationship had been created between the securities firm and each customer by oral representations and other confidences implying trust, despite the firm's protestations that confirmations had been couched in the "sold to you" form.[282] This finding of an implied agency was related directly to the issue of fraud, since a failure to disclose material facts, particularly the amount of secret profits, is a violation of the fiduciary duty.[283]

The Commission thus has alternative standards by which to judge selling practices: a shingle theory including an implied representation of fair dealing, and a fiduciary duty resulting from an implied agency. While the effect of the latter is to superimpose on the securities acts common-law duties inherent in an agency relationship,[284] the shingle theory imposes no defined duties the breach of which constitutes fraud. Therefore, subsequent Commission proceedings where violations of the standard of fair dealing have been found have constituted efforts to define at least part of that duty "inherent in the relationship between a broker or dealer and his customer."

As suggested by the *Duker* and *Hughes* cases, it is a fraudulent practice for a broker-dealer to charge a price not bearing a reasonable relationship to the current market price without disclosing the extent of his profit.[285] The execution of unauthorized transactions[286] and the selling of securities at a market price materially affected by the seller[287] have also been held fraudulent. The latter proposition is based on the theory that quotation of a price to a customer is an implied representation that such price bears a reasonable relationship to the price prevailing in a free and open market.

SEC, 174 F.2d 969 (D.C. Cir. 1949); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

281 Allender Co., Inc., 9 S.E.C. 1043 (1941).

282 See note 254 *supra.*

283 An agent is subject to a fiduciary duty which may include a duty of full disclosure, and the mere failure to make such disclosure, if required, constitutes fraud. See RESTATEMENT (SECOND), AGENCY §§ 23, 24, 389 comment *b*, § 390 (1958); RESTATEMENT, CONTRACTS §§ 471, 472 (1932); RESTATEMENT, RESTITUTION § 8 (1937); RESTATEMENT, TORTS § 551 (1938).

284 *Cf.* Lesh, *supra* note 260, at 1274-75.

285 See, *e.g.*, George Wales Allen, 39 S.E.C. 297 (1959); Paul Carroll Ferguson, 39 S.E.C. 260 (1959); William Harrison Keller, Jr., 38 S.E.C. 900 (1959); Indiana State Securities Corp., 38 S.E.C. 118 (1957); E. H. Rollins, Inc., 18 S.E.C. 347 (1945); Scott McIntyre & Co., 11 S.E.C. 442 (1942). This implied representation has been held to apply to exchanges of securities as well as sales for cash. Jack Goldberg, 10 S.E.C. 975 (1942).

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

287 See, *e.g.*, Sterling Securities Corp., 39 S.E.C. 487 (1959); Daniel & Co., 38 S.E.C. 9 (1957).

. Thus, in the sale of an over-the-counter security where the selling broker-dealer dominates the market in that security, disclosure of the latter fact is required. Likewise, the doing of business by a broker-dealer is an implied representation of his solvency, and a failure to disclose insolvency is fraudulent in that such conduct violates the standards of the profession.[288] Recently, the shingle theory has been applied to "boiler room" salesmen.[289] Reliance by a broker-dealer upon fraudulent sales literature for information to be disseminated to customers may constitute breach of the affirmative duty to investigate the accuracy of information presented to the investing public.[290]

One of the most significant areas in which the Commission has employed the shingle theory is that of misrepresentations or omissions. While common-law actions for deceit require proof of *scienter* and reliance, as well as misrepresentation of a present material fact,[291] the Commission has taken the position that, under the standard of fair dealing, the scope of section 17(a) of the Securities Act and sections 10(b) and 15(c)(1) of the Exchange Act is not so limited.[292] Frequently, representations such as the following are held to be fraudulent: "you will double your money in six months,"[293] or "the return of the purchase price is insured."[294] The position of the Commission with regard to such statements is that "the antifraud provisions of the securities acts . . . contemplate at the very least, that recommendations of a security made to proposed purchasers shall have a reasonable basis and . . . they shall be accompanied by disclosure of known or easily ascertainable facts bearing upon the justification for the representations."[295] Avoidance of fraudulent misrepresentation in the sale of securities requires reasonable and adequate inquiry into all the material facts bearing upon the representation, accompanied by disclosure of such facts.[296] Thus, while those misrepresentations which constituted fraudulent selling practices under the common law remain so, the Commission has imposed an addi-

288 See, *e.g.*, Gill-Harkness & Co., 38 S.E.C. 646 (1958); Cobb & Co., 38 S.E.C. 166 (1958).

289 For a discussion of boiler room sales practices and proposed Commission controls, see Note, 72 YALE L.J. 1411 (1963).

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

291 *But cf.* Knickerbocker Merchandising Co. v. United States, 13 F.2d 544, 546 (2d Cir. 1926); Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174, 174 N.E. 441, 444 (1931).

292 For a comparison of the common-law action for deceit with securities fraud concepts, see 3 Loss 1430-44.

293 D. F. Bernheimer & Co., SEC Securities Exchange Act Release No. 7000, Jan. 23, 1963.

294 Ronald I. Gershen, 39 S.E.C. 874 (1960).

295 Best Securities, Inc., SEC Securities Exchange Act Release No. 6282, June 3, 1960. See also Ross Securities, Inc., SEC Securities Exchange Act Release No. 7069, April 30, 1963; Heft, Kahn & Infante, Inc., SEC Securities Exchange Act Release No. 7020, Feb. 11, 1963; B. Fennekohl & Co., SEC Securities Exchange Act Release No. 6898, Sept. 18, 1962; Mac Robbins & Co., SEC Securities Exchange Act Release No. 6846, July 11, 1962, *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963).

296 See, *e.g.*, Alexander Reid &. Co., SEC Securities Exchange Act Release No. 6727, Feb. 8, 1962.

tional duty of investigation, for failure of the securities salesman to acquaint himself with—and subsequently to disclose—the status of the security he is selling constitutes fraud. "Puffing," or seller's talk, an element of merchandising recognized and accepted under the common-law doctrine of *caveat emptor*, has been declared specifically inapplicable to securities sales.[297] Moreover, attempts to avoid this requirement of adequate basis and disclosure by couching the representation in terms of opinion have been held to violate the obligation of fair dealing, thereby subjecting the seller to the sanctions of the securities acts.[298] Nor will the seller be protected by a fortuitous rise in price if there was no adequate basis for predicting a price increase at the time of the sale.[299] However, in this area, as in others where specific types of conduct have been held contrary to the basic obligation of fair dealing borne by those engaged in the sale of securities, the Commission has not explicity defined maximum limits or the scope of the requirement, but rather has conditioned its findings on such analysis as this: "none of the information available . . . provided a basis for [the] unrestrained prediction."[300]

An omission violates the antifraud provisions of the securities acts[301] if such omission is of a material fact and such fact is necessary in order to make the statement rendered, in light of the circumstances under which it is made, not misleading. The prohibition against omission has obvious application to sales literature presenting a false picture of the future growth of a business. In fact, however, the literature seldom makes any real predictions; rather, it relies upon an implied impression of potential success. Consequently, an omission can rarely be said to make any statement misleading. On the other hand, where a business is, in fact, insolvent, omission has been found fraudulent when accompanied by such statements as "no risk" and "no chance of loss."[302] However, since the gravamen of the fraudulent conduct is failure to disclose the insolvency, it would appear that the result of such a finding could be as easily reached by applying the more recent "adequate basis" test. The shingle theory can be said to have imposed much the same duty in the area of fraudulent omission as in the

297 Archer v. SEC, 133 F.2d 795, 803 (8th Cir. 1943); *cf.* B. Fennekohl & Co., SEC Securities Exchange Act Release No. 6898, Sept. 18, 1962.

298 See Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Ross Securities, Inc., SEC Securities Exchange Act Release No. 7069, April 30, 1963.

299 See Heft, Kahn & Infante, Inc., SEC Securities Exchange Act Release No. 7020, Feb. 11, 1963.

300 Mac Robbins & Co., SEC Securities Exchange Act Release No. 6846, July 11, 1962, *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963). *But cf.* Alexander Reid & Co., SEC Securities Exchange Act Release No. 6727, Feb. 8, 1962, where the Commission stated that prediction of a specific price increase of a speculative and promotional security is a "hallmark of fraud."

301 Section 17(a) of the Securities Act and Rules 10b and 15(c)(1) under the Exchange Act.

302 See SEC v. Universal Serv. Ass'n, 106 F.2d 232 (7th Cir. 1939). For other cases involving fraud by omission see Otis & Co. v. SEC, 106 F.2d 579 (6th Cir. 1939); Schamber v. Aaberg, 186 F. Supp. 52 (D. Colo. 1960).

area of representations; in either case the violation is a failure to disclose, interpreted against the broad standard of fair dealing.

Since in each of the above enumerated situations fraudulent conduct was found because the seller failed in a duty defined as "fair dealing," the finding of an implied agency used to provide a duty standard is little more than an application of the shingle theory in slightly different terms. Under the shingle theory, implication of a representation of fair dealing provides a flexible standard whereby the Commission has considerable discretion in determining what constitutes fair dealing; under the implied agency rationale, the flexibility is provided in defining what conduct between the parties vests the salesman with an agent's fiduciary duty. Thus the legal consequences are almost always the same.[303] Nevertheless, the Commission has frequently proceeded on the theory that, where a broker-dealer, ostensibly dealing at arm's length, generates a relationship of complete trust and confidence with his customer, an implied agency is created.[304] It has been stated that the intent of the parties controls the creation of an agency relationship.[305] Nevertheless, in *Hughes v. SEC*,[306] where an agreement had been entered into with all customers that transactions were to be effected by the broker-dealer as principal, the Court of Appeals for the District of Columbia upheld the Commission's contention that a fiduciary duty existed, and held that since there had not been full disclosure of the difference between prices charged and current market price, the conduct was fraudulent. The court dismissed the written agreement as ineffectual because most customers could not understand its legal effect.

An implied general fiduciary duty has also been successfully utilized to curb "churning"—excessive trading of a customer's securities account to increase the broker-dealer's profits.[307] If the account is discretionary, *i.e.*, under power of attorney the broker-dealer may purchase or sell at his discretion, overtrading is specifically proscribed by the rules promulgated pursuant to the Exchange Act.[308] However, where no formal discretion is granted and the relationship is presumably that of a dealer-customer, it

303 *But see* Lesh, *supra* note 260, at 1253, where it is pointed out that in determining whether prices charged by the broker-dealer are unrelated to current market price, if the Commission proceeds on a shingle theory reasonable profits are non-fraudulent, while an agent or fiduciary is liable for even small secret profits.

304 See, *e.g.*, Reynolds & Co., 39 S.E.C. 902 (1960); Lawrence R. Leeby, 13 S.E.C. 499 (1943); William J. Stelmack Corp., 11 S.E.C. 601 (1942); J. Logan & Co., SEC Securities Exchange Act Release No. 6848, July 9, 1962. See also note 281 *supra* and accompanying text. For a list of suggested factors which may create this agency relationship, see Lesh, *supra* note 260, at 1269-74.

305 Allender Co., Inc., 9 S.E.C. 1043, 1053 (1941).

306 174 F.2d 969 (D.C. Cir. 1949). This case concerned Arleen W. Hughes, doing business as E. W. Hughes & Co., not to be confused with the *Charles Hughes* case, cited note 278 *supra*.

307 See, *e.g.*, Norris & Hirshberg, 21 S.E.C. 865 (1946), *aff'd sub nom.* Norris & Hirshberg v. SEC, 177 F.2d 228 (D.C. Cir. 1949); E. H. Rollins, Inc., 18 S.E.C. 347 (1945).

308 Rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1949). The self-regulatory agencies have similar prohibitions: NYSE rules 408, ¶ 2408, at 3702; 435, ¶ 2435, at 3775; NASD Rules of Fair Practice, art. III, § 15(a).

could be contended that no amount of trading is excessive, since each transaction is theoretically conditioned upon customer approval.[309] However, any situation in which a firm has such control over an account that it may engage in churning seems an appropriate case for the implication of an agency relationship, since the extent of control exercised suggests that a high degree of trust and confidence has been placed in the seller. The Commission has found such conduct to be a clear violation of fiduciary duty.

The similarity between the alternative standards imposed by the shingle theory and an implied agency is obvious. Since most selling violations involve several types of fraudulent practice, assimilation of the theories seemed a logical approach to the solution of investor protection. This the Commission proceeded to do. For example, in *Herbert R. May & Russell H. Phinney*[310] the Commission held that, since the requisite relationship of trust and confidence was present, the charging of prices greatly in excess of the market price was a violation of the anti-fraud provisions under either theory. As a principal, the dealer failed in his duty of fair dealing by not disclosing the market price; as an agent, he failed to divulge his profits in breach of trust. This juxtaposition suggests at least one conclusion: whatever the statutory prohibitions against certain selling practices, the laws governing the fraudulent sale of securities are today imbued with a standard of affirmative duty, whether this duty is based on an implied representation of fair dealing, or on an implied agency.

While it has been suggested that much of the Commission's policy should be characterized as an emerging "know your merchandise" rule,[311] this description embodies only half the duty imposed, in that a vital element of this obligation is a full disclosure of whatever facts are necessary to equalize the bargaining power of the parties. Although such fraudulent practices as churning and the charging of prices unrelated to the current market are not entirely disclosure violations, the decision to hold them fraudulent is based on the assumption that the customer might not have assented to the transaction had he gained full information concerning relevant market price or the amount and effect of the trading.[312] The Commission has reasoned that investor protection is best provided by apprising the customer of material facts so that a decision to buy, sell, or trade may be informed and well-considered.

However, to say that an industry geared to merchandising must deal fairly, whether at arm's length or in confidence, does not provide definite substantive limits within which a firm must confine its selling practices.

309 *Cf.* J. Logan & Co., SEC Securities Exchange Act Release No. 6848, July 9, 1962.

310 27 S.E.C. 814 (1948).

311 See Alexander Reid & Co., SEC Securities Exchange Act Release No. 6727, Feb. 8, 1962; Cary, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856 (1963).

312 See cases cited note 307 *supra*. The requirement is well-advised, since firms have been willing to tell customers that, because they were acting at arm's length, a profit of 40% was not too high, and have even told the Commission that the "sky is the limit" for profits in an over-the-counter transaction. Allender Co., Inc., 9 S.E.C. 1043, 1056 (1941).

What constitutes an excessive spread between the price charged a customer and the current market? What information must be disclosed? How much information, and of what kind, provides an adequate basis for predictions? When does frequent trading become churning? What course of dealing generates an agency relationship? These and similar questions[313] continue to plague those involved in the securities business. The Commission's policy is one of *ad hoc* determination of violation, and thus after-the-fact definition of duty; this is made necessary by the complexity of the securities business. The intricate nature of securities merchandising and the myriad abuses to which it is subject prompted regulation initially, and this same complexity prevents definitive legislation and precise judicial treatment. These unanswered questions are of degree, not of kind, and answers, for the most part, will be limited to specific fact situations. Nevertheless, Commission decisions and judicial affirmation thereof suggest partial guidelines. Moreover, recognizing that the imposition of an affirmative duty creates problems of vagueness and uncertainty, the Commission is at present promoting solutions to alleviate some of the harshness inherent in after-the-fact definition.

One such procedure is the official release, calling to the attention of the industry certain negative features of a particular security.[314] Dissemination of such information charges a dealer with knowledge that failure to disclose at least the information contained in the release is violative of fair dealing standards. Direction by release is perhaps better suited to control of selling practices than is either the exercise of the formal rule-making power, necessarily broadly couched, or case-by-case adjudication with its inherent uncertainty.[315] The release can provide antecedent examples of cases where disclosure of certain types of facts was thought to be essential, and a series of such releases would indicate concepts of duty in much the same manner as case decisions, while avoiding objections of after-the-fact vagueness. A second procedure is the expansion of the types of sanctions which may be imposed by the Commission. Under present law, the Commission has available only the sanction of denial or revocation of broker-dealer registration.[316] An amendment to section 15(b) of the Exchange Act, proposed by the SEC, would vest the Commission with discretion, in lieu of revocation of registration, to impose the lesser sanctions of suspension of registration for twelve months or less, or formal censure.[317] Availability of these additional sanctions would provide more flexible powers, so that the Commission could invoke measures appropriate for dealing with particular kinds

313 *Cf.* Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668, Nov. 8, 1961, where Rule 10b-5 was applied to require a duty of full disclosure by the corporate insider, although the imposition of the duty created conflicts with other obligations inherent in such a position. See generally Cary, *supra* note 311; 75 HARV. L. REV. 1449 (1962); 60 MICH. L. REV. 651 (1962).

314 See, *e.g.*, Volkswagenwerk, SEC Securities Exchange Act Release No. 6525, April 12, 1961.

315 See generally Note, 72 YALE L.J. 1411 (1963).

316 See note 333 *infra* and accompanying text.

317 S. 1642, H.R. 6789, 88th Cong., 1st Sess. § 6(b) (1963).

or degrees of misconduct, rather than being limited to a choice between no sanction or an excessive or inappropriate one.[318]

Another significant development in the rules governing the sale of securities presents a departure from past policy of the Commission and the self-regulatory associations; it also appears to pose many additional problems. This is the emergence of a so-called "suitability" rule. Article III, section 2 of the NASD Rules of Fair Practice provides as follows:

> "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[319]

In several cases in review of NASD action pursuant to this suitability rule,[320] the Commission has upheld NASD action, rejecting a contention that the suitability standard, because of vagueness, violates the nature and cause of accusation clause of the sixth amendment.[321] The securities acts do not contain any provision requiring suitability, nor has the Commission adopted such a rule under the acts. However, as indicated by the Special Study,[322] recent boiler-room cases have suggested that lack of suitability of a security recommended for purchase by a customer, in light of his particular financial situation and objectives, is a factor to be considered in determining whether a broker-dealer has fulfilled his obligation to treat his customers fairly.[323] In other words, it appears that the Commission has itself interjected a standard of suitability as one aspect of the duty of fair dealing, regardless of whether the NASD has moved against the broker-dealer under its Rules of Fair Practice. Although there are few cases to date wherein the Commission has suggested that the dealer must not only "know his merchandise," but also inquire into the needs and investment objectives of his customer and accommodate one to the other, the Special Study specifically recommended that "greater emphasis should be given by the Commission . . . to the concept of 'suitability.' "[324] This recommendation was endorsed by the Commission.[325] The possibility of increased attention

318 See *Special Study* pt. 1, at 188.

319 Although the NYSE has no "suitability" rule as such which compares to the NASD rule, it does have a "know your customer" requirement in Rule 405(1). This rule was primarily designed to protect member firms against irresponsible customers, and has generally been restricted to such use. *Id.* at 158.

320 Philips & Co., 37 S.E.C. 66 (1956); First Securities Corp., SEC Securities Exchange Act Release No. 6497, March 20, 1961; Boren & Co., SEC Securities Exchange Act Release No. 6367, Sept. 19, 1960; Gerald M. Greenberg, SEC Securities Exchange Act Release No. 6320, July 21, 1960.

321 Boren & Co., *supra* note 321.

322 *Special Study* pt. 1, at 238.

323 Mac Robbins & Co., SEC Securities Exchange Act Release No. 6846, July 11, 1962, *aff'd sub nom.* Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Best Securities, Inc., SEC Securities Exchange Act Release No. 6282, June 3, 1960.

324 *Special Study* pt. 1, at 329.

325 Letter from Chairman William L. Cary to Oren Harris, Chairman, Interstate and Foreign Commerce Committee, House of Representatives, April 5, 1963.

to the suitability requirement poses certain questions, most of which concern the scope of the rule. While a suitability rule is subject to the same objections of indefiniteness as are other postulations of duty, these objections may be answered in the same way as with other rules.[326] If the suitability rule is no more than a corollary of the duty arising under an implied agency through a confidential and discretionary course of dealing, it is simply another element tending to show fraud.[327] On the other hand, if the rule is applied as a requirement in all, or even most situations, it presents a distinct departure from previous policy. Congressional and Commission regulation has been consistent with the free enterprise system in that the duty of fair dealing is a standard attending the bargaining process but not affecting the consummated terms of the transaction itself. Disclosure and investigation incident to such disclosure are calculated to provide enough information that even the neophyte investor has a basis for determining the suitability of a security in light of his own financial situation.[328] However, broad application of a requirement that the dealer perform a suitability evaluation is an interference with the terms of the transaction and goes considerably further than simple elimination of arm's-length dealing between broker-dealer and customer. In addition, if the standards of suitability are "reasonableness" and "good faith," as they presumably would be, determination of suitability would be merely an after-the-fact substitution of the Commission's value judgment for that of the dealer. While heretofore the Commission has made such judgments, examination has been confined to readily ascertainable dealer conduct, such as churning, misrepresentation, or excessive price mark-ups. A judgment as to suitability necessarily includes inquiry into the speculative matter of customer needs and purposes, as well as the relative merits of the securities involved in the transaction. Since this valuation is one which the Commission has specifically avoided, and wisely so, in the past,[329] a rule combining such a determination with additional speculative elements is even less desirable. Significantly, however, the suitability requirement has been limited to situations where several other clear violations of the anti-fraud provisions were present,[330] or where high pressure sales techniques were used.[331] Thus, it may well be that the suitability rule will be limited to cases involving multiple frauds and peripheral areas involving a composite of selling prac-

326 *Cf.* text accompanying note 313 *supra.*

327 *Cf.* First Securities Corp., SEC Securities Exchange Act Release No. 6497, March 20, 1961.

328 In D. F. Bernheimer & Co., SEC Securities Exchange Act Release No. 7000, Jan. 22, 1963, the Commission cited three recent cases for the proposition that it is inconsistent with principles of fair dealing and violative of the securities laws to fail to disclose known or reasonably available information necessary to provide the investor with a fair picture of the security being offered.

329 See Mac Robbins & Co., SEC Securities Exchange Act Release No. 6846, at 11, 15, July 11, 1962.

330 Cases cited note 320 *supra.*

331 Cases cited note 323 *supra.*

tices contrary to the obligation of fair dealing, but where evidence of specific violations is difficult to obtain.

B. *Securities and Exchange Commission Sanctions*

After looking at what practices are deemed fraudulent under the federal securities acts, the various sanctions which may be imposed by the Commission on a seller who has violated these provisions should be examined. First, at the Commission level, a registered broker-dealer who engages in fraudulent practices in violation of the securities acts may find himself subject to several possible sanctions. The Commission may bring a civil proceeding in a federal court enjoining the broker or dealer from engaging in further fraudulent activities,[332] and the federal court may issue a temporary or permanent injunction which may later serve as the basis for revocation of registration, provided the revocation is in the public interest. Through its own administrative procedures, the Commission may revoke the broker-dealer registration.[333] The effect of such a revocation is to remove the broker-dealer, its proprietors, and any salesmen who are found to be a cause of the revocation, from the securities business until permission for re-entry may be obtained. The only way the Commission can proceed against an individual salesman is through an action against the broker-dealer, and this is rather harsh where only one saleman in a large firm is guilty of violations. During the pendency of the revocation proceedings, the Commission may temporarily suspend the registration for the protection of investors.[334] Finally, in situations of extreme abuse and fraud, the Commission may transmit evidence to the United States Attorney General, who may at his discretion bring a criminal action against the offenders.[335] The Commission has observed that criminal proceedings are more effective than administrative sanctions in combating boiler-room activities.[336] During the years 1959 and 1960, the Commission referred an average of forty-six cases per year to the Attorney General,[337] and in the fiscal year ending June 30, 1961, 126 convictions were obtained in forty-five cases.[338] Certainly the criminal sanction is a very powerful deterrent in the fraud area, and continued referrals and vigorous prosecution are desirable.

C. *Self-Regulatory Agency Sanctions*

A broker or dealer may also be subject to sanctions imposed by one or more of the several self-regulatory bodies existing in the securities in-

332 48 Stat. 899 (1934), 15 U.S.C. § 78u(e) (1958).

333 48 Stat. 895 (1934), 15 U.S.C. § 78*o*-b (1958). The Commission may also expel or suspend from a national securities exchange any member who has violated a provision of the Exchange Act. 48 Stat. 898 (1934), 15 U.S.C. § 78s(a)(3) (1958). A similar provision exists with regard to the NASD. 52 Stat. 1070 (1938), 15 U.S.C. § 78*o*-3(1)(2) (1958).

334 48 Stat. 895 (1934), 15 U.S.C. § 78*o*-b (1958).

335 48 Stat. 899 (1934), 15 U.S.C. § 78u(e) (1958).

336 25 SEC ANN. REP. 3 (1959).

337 27 SEC ANN. REP. 259 (table 26) (1961).

338 *Id.* at 165.

dustry. First, the NASD, which polices the over-the-counter market, is required by the Exchange Act to pass rules designed to prevent fraudulent practices.[339] Pursuant to this provision the NASD has passed rules of fair practice. The basic philosophy of these rules is that "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."[340] Also, specific rules make the following practices violations of the rules of fair practice: unreasonable mark-ups,[341] excessive transactions in a discretionary situation,[342] and the recommending of unsuitable securities.[343] Upon a finding of a violation of the rules of fair practice, the NASD has certain sanctions available.[344]

Those broker-dealers who are members of the New York Stock Exchange are subject to specific NYSE sanctions for fraudulent selling practices. The Exchange Act requires that the rules of the Exchange, like those of the NASD, provide for expulsion, suspension, or discipline for violations of "just and equitable principles of trade."[345] The constitution of the Exchange provides for sanctions against any member or allied member who is adjudged guilty of "fraud or of fraudulent acts,"[346] or willful violation of the Exchange Act.[347] The Board of Governors of the Exchange has also adopted rules governing conduct of members and employees in their selling activities.[348] Violation of these rules subjects a member to certain sanctions. However, few disciplinary proceedings concerning selling practices are instituted by the Exchange, and the value of this potential sanction is at present subject to considerable doubt.[349] The other national exchanges have similar anti-fraud provisions, but enforcement there is of even less significance because either the volume of sales is so low as to have little impact on the industry, or the detection procedures are very poor.[350]

D. *Investor Remedies*

In addition to the various disciplinary actions which may be brought by the Commission and the self-regulatory agencies, a broker or dealer may also be subjected to certain sanctions available to the investor. The securities acts explicity state that the remedies therein exist in addition "to any and all other rights and remedies that may exist at law or in equity."[351] Thus, a common-law deceit action is available, and a defrauded investor

339 52 Stat. 1070 (1938), 15 U.S.C. § 70*o*-3(b)(7) (1958).
340 NASD, Rules of Fair Practice art. III, § 1.
341 *Id.* § 4; see Nat'l Ass'n of Security Dealers, Inc., 17 S.E.C. 459 (1944).
342 NASD, Rules of Fair Practice art. III, § 15(a).
343 *Id.* § 2.
344 *Id.* art. V.
345 48 Stat. 885 (1934), 15 U.S.C. § 78f(b) (1958).
346 NYSE Constitution art. XIV, § 1.
347 NYSE Constitution art. XIV, § 7.
348 NYSE Rule 401 ¶ 2401, at 3695.
349 *Special Study* pt. 1, at 320.
350 *Id.* pt. 1, at 321-22.
351 48 Stat. 84 (1933), 15 U.S.C. § 77p (1958); 48 Stat. 903 (1934), 15 U.S.C. § 78(bb) (1958).

may retain the stock and sue for damages.[352] However, because of the *scienter* requirement, this remedy, in most jurisdictions, is not as favorable as the civil liabilities created by the securities acts.[353] The investor may instead decide to return the stock and rescind the contract, receiving back his consideration.[354] Rescission is generally available where there has been misrepresentation of a material fact relied upon by the purchaser, but this remedy is fraught with difficulties, such as the requirement at law of tender of the stock to the seller before the suit is brought.[355] While a successful damage action will usually give the investor his loss-of-bargain remedy,[356] rescission allows the investor to recover only his purchase money. An investor might also seek to pursue a breach of warranty action.[357] In fact, under the Uniform Commercial Code, there is a built-in suitability requirement in the implied warranty of fitness for particular purpose.[358] The problem is that investment securities are not "goods" as defined by the Code,[359] and the warranty provision applies only to goods. However, the warranty provision might be applied by analogy to securities, as is suggested in a drafter's comment.[360] The uncertainty of this remedy, however, makes it of doubtful value. In addition to the common-law remedies, a defrauded investor may also have a statutory cause of action under the applicable Blue Sky law.[361]

Section 12(2) of the Securities Act provides for civil liability in the case of any person who sells a security making an untrue statement of a material fact or who omits to state a material fact without being able to show that he was not at fault in making or failing to make the statement.[362] This section has its drawbacks because it is available only against the seller, and not against others who may have induced the investor to buy. Also, the seller may avoid liability by showing that he did not know and in the exercise of reasonable care could not have known of the untruth or the omission. The statute of limitations is short and no recovery for attorney's fees is allowed. Finally, the out-of-pocket damage measure is used, while in a fraud action

352 See generally Shulman, *Civil Liability and the Securities Acts*, 43 YALE L.J. 227 (1933).

353 *Scienter* is an element of common-law deceit, but it is generally conceded that no such requirement exists under the civil liabilities imposed by the securities acts. See RESTATEMENT, TORTS § 526 (1934). On the absence of a *scienter* requirement under the federal civil liability provisions, see Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962).

354 See Shulman, *supra* note 352, at 231.

355 See E.T.C. Corp. v. Title Guar. & Trust Co., 271 N.Y. 124, 2 N.E.2d 284, 286 (1936).

356 The majority of courts grant loss-of-bargain damages in a deceit action, while a minority confine damages to out-of-pocket losses. See PROSSER, TORTS 568, 571 (2d ed. 1955).

357 See Shulman, *supra* note 352, at 228.

358 UNIFORM COMMERCIAL CODE § 2-315.

359 For the definition of "goods," see UNIFORM COMMERCIAL CODE § 2-105(1).

360 The comment follows § 2-105(1) and cites Agar v. Orda, 264 N.Y. 248, 190 N.E. 479 (1934), as authority for applying the warranty provision by analogy to securities.

361 See 3 Loss 1631, 1682.

362 48 Stat. 84 (1933), 15 U.S.C. § 77*l*(2) (1958). See generally Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under the S.E.C. Statutes*, 18 LAW & CONTEMP. PROB. 505 (1953).

at common law the measure of damages is usually based on the loss-of-bargain rule.[363]

The Exchange Act includes no provision for civil liability comparable to section 12(2) of the Securities Act. However, Rule 10b-5, enacted pursuant to section 10 of the Exchange Act, has been interpreted by the courts as giving rise to an implied civil liability for violation of its antifraud provisions. Because the securities acts provide for several express civil liabilities, it is difficult to infer the legislative intent necessary to imply a civil liability where none exists in the express language of the statute. Nevertheless, since the defrauded seller was not protected by the securities acts, an implied cause of action was thought desirable by the courts.[364] The Supreme Court has declined to hear cases questioning the propriety of this implied liability, and it now seems clear that implied civil liability under Rule 10b-5 has complete judicial acceptance.

The elements necessary to support a 10b-5 action are: (1) violation of 10b-5 in connection with either the sale or purchase of a security and (2) the direct or indirect use of interstate commerce, the mails, or a national securities exchange in connection with the sale or purchase.[365] It is generally conceded that recovery under 10b-5 is broader than a common-law deceit action, but to what extent depends upon the jurisdiction. The element of *scienter* is not necessary for a 10b-5 action, but in those states with a broad disclosure duty in deceit actions 10b-5 may merely be a codification of the common law.[366] The element of reliance, necessary in deceit, has also been held to be an indispensable element of a 10b-5 action,[367] but there is authority to the contrary.[368]

An interesting aspect of the implied civil liability embodied in 10b-5 is that, since this rule applies to "any person," it has been used to remedy misuse of corporate insider information. In the landmark case of *Cady, Roberts & Co.*[369] an obligation was imposed on insiders not to take advantage of nonpublic information disclosed for a corporate purpose. This seems far removed from fraud in the ordinary sale of securities, but arguably necessary because few jurisdictions require corporate insiders to disclose confidential information when dealing with existing shareholders.[370] Recent judicial developments extending the scope of 10b-5 in connection with corporate insiders and dominant shareholders give reason to believe that

363 *E.g.*, Repass v. Rees, 174 F. Supp. 898 (D. Colo. 1959).

364 See, *e.g.*, Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

365 See generally White, *From the Frying Pan into the Fire: Swindlers and the Securities Acts*, 45 A.B.A.J. 129 (1959).

366 See Connelly v. Balkwill, 174 F. Supp. 49, 60 (N.D. Ohio 1959).

367 See Reed v. Riddle Airline, 266 F.2d 314 (5th Cir. 1959); Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962); Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955).

368 See Connelly v. Balkwill, 174 F. Supp. 49, 59 (N.D. Ohio 1959); Kardon v. National Gypsum Co., 83 F. Supp. 613 (E.D. Pa. 1947).

369 CCH FED. SEC. L. REP. ¶ 76803 (S.E.C. Nov. 8, 1961).

370 See generally BALLANTINE, CORPORATIONS § 80 (rev. ed. 1946); Annot., 84 A.L.R. 615 (1933).

the role of this rule as a remedy in the corporate setting will be extended.[371]

Another problem existing under 10b-5 is that there is no federal statute of limitations applicable, and the courts have utilized the statute of limitations applicable to fraud actions of the state in which the federal court is sitting.[372] This gives rise to lack of uniformity from state to state, although the cause of action is federal. Also, since the courts have been willing to apply 10b-5 civil liability to both buyers and sellers,[373] this means that the restrictions which exist under section 12(2) of the Securities Act, applicable to a suit by a defrauded purchaser, are rendered nugatory because 10b-5 encompasses all possible section 12(2) causes of action. The result is that the courts, in order to give a defrauded seller a federal cause of action, have by judicial legislation made section 12(2) of negligible importance.

As a final remedy, the federal courts are empowered under the securities acts to grant ancillary relief, such as temporary injunctions.[374] Section 12(2) of the Securities Act sets up certain legal consequences, but does not restrict the procedure or form of action the claimant must use. While it appears that the securities acts provide the defrauded investor with comprehensive relief, it is interesting to note that investors have made relatively infrequent use of the remedies provided by the federal securities acts.[375]

E. *Special Study Findings and Recommendations*

The Special Study devoted considerable attention to selling practices.[376] After a thorough study of the present law, the evolution of the Commission's theories of fraudulent practices, detection problems, and the role of the self-regulatory agencies, the Study concluded that "some segments of the industry appear to be earnestly promoting high standards of selling while others seem only to be earnestly promoting sales."[377] It was also made clear that no quantitative measurement of the extent of fraudulent practices was intended, but these practices were found to exist throughout the industry, from the boiler-rooms to the well-known brokerage firms.[378]

The Special Study made several specific recommendations. It urged that the large broker-dealer firms strengthen supervision of the selling activities of their personnel by greater use of electronic data processing equipment programmed to expose overtrading and other fraudulent practices. The basis of this recommendation was that even in the responsible firms indi-

371 See Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963), wherein a corporation succeeded in a cause of action against a corporate insider for fraudulently inducing the corporation to issue stock for worthless consideration even though questions of corporate mismanagement were involved. See 62 MICH. L. REV. 339 (1963). See also Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962), wherein failure of a dominant shareholder to disclose the reason for a change in the market price of the corporation's stock was held actionable under 10b-5.

372 See Errion v. Connell, 236 F.2d 447 (9th Cir. 1956).

373 See Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

374 See Deckert v. Independence Shares Corp., 311 U.S. 282 (1940).

375 See 3 Loss 1685.

376 See generally *Special Study* pt. 1, at 237-330.

377 *Id.* at 323.

378 *Id.* at 325.

vidual salesmen engage in fraudulent practices; thus closer supervision aided by electronic data processing would be valuable in detecting and curbing abuses. It was also recommended that the self-regulatory agencies strengthen their enforcement procedures and assure more effective supervision of firm selling practices. The NASD already has rules covering the major selling abuses, but detection of violations could be greatly improved. Likewise, the NYSE has rules governing fraudulent selling practices, but the limited number of disciplinary proceedings instituted suggested to the Study either a failure in the detection program or a reluctance to acknowledge selling abuses as a matter of concern. The self-regulatory agencies could play a key role in curbing fraudulent selling practices, and every attempt should be made to encourage this. To supplement these measures relating to control by firms and self-regulatory agencies, the Special Study suggested that the Commission pass rules requiring additional record-keeping to facilitate discovery of abusive selling practices.[379] Furthermore, it was recommended that the Commission and the self-regulatory agencies give more emphasis to suitability by promulgating statements of policy further elucidating what the concept means. The authors of the *Report* felt that the suitability concept is important and should be fully developed. Clearly, if suitability is to become a meaningful requirement in the securities industry, clearer standards are necessary so that the scope of this requirement can be ascertained.

The Study further advocated that wider and more prominent use be made of disclosures officially filed in connection with selling activities. For example, brokers and dealers should show reports and proxy statements to prospective customers or advise where they may be found. While some doubt may exist as to the ability of the average investor to interpret effectively such information, it should certainly be made available. Investor education is essential to the elimination of selling practice abuses. In order to eliminate some of the pressure and incentive now existing for large volume sales, it was recommended that the compensation of salesmen be less dependent on the volume of securities sold. The commission method of compensation may be inherent in the industry, but it encourages overtrading and the recommendation of securities on which the commission is highest, regardless of the merit of the securities. It is not very probable that the commission method of compensation will disappear, but implementation of this proposal would help eliminate such practices as churning and the charging of unreasonable prices.

Finally, it was urged that the sanctions available to the Commission be expanded so that disciplinary action might be taken against one or a few salesmen in a firm without involving the entire firm. The proposed legislation incorporates such a provision.[379a] Presently, to discipline one errant salesman the Commission must discipline the whole firm—a sanction which can be very harsh as compared with the violation.

379 *Id.* at 328.

379a S. 1642, H.R. 6789, 88th Cong., 1st Sess. § 6(b) (1963).

F. *Conclusion*

It is apparent that court and Commission proceedings of recent months have instituted highly significant changes in the level of integrity required in broker-dealer operations. Full realization of the importance of these developments may decrease to some extent the significance of the Special Study findings and recommendations. Nevertheless, the Study constitutes a highly constructive analysis of selling practices generally, and certainly deserves great attention for that reason. It is significant, however, that the Study conclusions are aimed primarily at continuing and increased emphasis on the traditional standards applicable to the securities industry. As such, they simply embody specific extensions of existing policy. Essentially, that policy is one of proscribing certain conduct peculiar to the sale of securities, primarily that which breaches concepts of fair dealing. It is too late to deny either the necessity for securities regulation or the efficacy of utilizing regulatory power to create a standard of professionalism throughout the industry. Elimination of many fraudulent sales practices could undoubtedly be accomplished by the imposition of a general duty of disclosure to the customer, thereby equalizing bargaining power.

An expansion of the methods of detecting sales fraud through requiring more complete records of transactions was recommended by the Special Study. Increased qualification requirements for personnel involved in the securities business[380] and greater control over sales practices through the use of electronic data processing were also recommended. Unquestionably, implementation of these recommendations would serve to reduce, directly or indirectly, the susceptibility of securities sales to fraudulent practices.

However, to increase duties of disclosure and investigation, and to widen the scope of conduct considered fraudulent is not to eliminate the conduct. Awareness that conduct is fraudulent and subject to sanction is not always an effective deterrent; nor can increased supervision alone eliminate deleterious practices. Fraud is a pervasive evil, whatever the context, and in a merchandising industry so rapidly expanding, with burgeoning sales posing so high a potential for fraudulent practice, many investors could continue to be irrevocably injured. Therefore, additional deterrents should be provided which would conform to Commission policy and at the same time provide redress for injured investors.

First, a strictly enforced net capital requirement, possibly accompanied by a bonding procedure, would help assure that defrauded investors could recoup their losses; this would also help discourage fringe operations, such as boiler-rooms, because bonding would be very expensive for this type of establishment. Second, a simple federal remedy available to defrauded investors should be enacted by Congress. A cause of action should arise out of any violation of the anti-fraud provisions. The provision should have a uniform statute of limitations, and a provision allowing recovery of reasonable attorney's fees. Third, in situations where willful disregard of estab-

380 See section I *infra*.

lished standards of conduct can be shown, the defrauded investor should be able to recover double damages. The purpose of this provision would be analogous to the treble damage action in the antitrust area in that removal of the economic incentive to operate fraudulently would serve as a deterrent, as well as provide relief for the investor.

Finally, more effort should be expended in the area of investor education. This could be accomplished to some degree with a publicity campaign calculated to illustrate such practices as churning, wild and extravagant claims of profits, and the customary unreliability of information received from boiler-room operators. The campaign should also make more apparent the functions of the Securities and Exchange Commission and the self-regulatory agencies. Alerting the public to the potential areas and methods of fraud is a logical and necessary component of the present selling practice regulations. An informed general public would provide a deterrent to fraud and implement present policy in several ways. It would greatly facilitate detection of frauds through timely complaint. It would reduce the effectiveness of high pressure sales campaigns and other sales practices which are presently aided by the purchaser's ignorance and susceptibility to innuendo. It would complement the full disclosure requirements now imposed on the securities industry by creating greater equality of bargaining power. Above all, an educated public might demand the same standards of performance of their broker-dealers as is now required by the Commission and the self-regulatory agencies.

V. CONCLUSION

Although it is apparent that there is room for improvement in the practices of many segments of the securities industry, the *Report* of the Special Study has demonstrated that the approach of the government to regulation of the industry should continue to be based on the same philosophy with which federal securities regulation originated in the 1930's. It is significant that Mr. Justice Douglas, then chairman of the Commission, indicated that it was the intent of his agency to let self-regulation play the key regulatory role. In his words, "Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never have to be used."[381] This approach is certainly consistent with recognition by the Study, that the securities industry has for the most part shown itself to be imbued with a considerable sense of public responsibility. Chairman Cary, in speaking of a Special Study, has stated:

> "[I]t is not a picture of pervasive fraudulent activity and in this respect contrasts markedly with the hearings and findings of the early Thirties

381 Quoted in The Wall Street J., Oct. 8, 1963, p. 14, col. 4. After noting the fact that reference to firearms has never been particularly pleasant to securities men, the *Journal* also pointed out that, notwithstanding the Study's emphasis on a government-securities industry partnership, many in the securities industry fear that the government intends to shrink sharply the industry's role in the partnership.

> preceding the enactment of the Federal securities laws. *The Study confirms the strength of those laws and the heightened sense of obligation of the financial community.*"[382]

Keeping this in mind, the writers of this comment have attempted no comprehensive coverage of the problems attending the function of the securities industry; rather, the four topics discussed represent specific areas of operation in which the need for reform does in fact seem clear. While no claim is made to having devised a panacea for the problem areas dealt with, it is submitted that the recommendations herein articulated should be considered as solutions for the complex problems involved. Certainly, if the level of competence of securities personnel is raised, if corporate publicity is confined to the *facts* of corporate life, if investment advisers assume a fiduciary responsibility with respect to those whom they advise, and if more effective efforts are made to eliminate undesirable selling practices, no one can deny that strength will have been added to the securities industry and in turn to the entire economy.

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Ira J. Jaffe
Rolfe A. Worden
James C. Lockwood
Willoughby C. Johnson

382 Excerpt from a letter of Chairman Cary, printed in the New York Times, April 4, 1963, p. 40, col. 1. (Emphasis added.)