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FEDERAL REGULATION OF THE OVER- THE-COUNTER SECURITIES MARKET

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I. INTRODUCTION

Throughout this Article¹ the term "over-the-counter securities market" refers to transfers of securities other than through the medium of a stock exchange and in which brokers or dealers² are participants

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1. This Article is a revision and compression of an unpublished monograph that I prepared as one of a series of studies of the over-the-counter securities market made by the Securities Research Unit of the Wharton School at the University of Pennsylvania under the sponsorship of the Merrill Foundation. In the preparation of this essay I have tried to explore the writings of all those who have published any relevant material. These authors are too numerous for me to thank individually, but I take this opportunity to express my gratitude to all those who have preceded me in this field for the ideas and information that I have derived from them. To Louis Loss, however, I wish to acknowledge a signal indebtedness. His volume on *Securities Regulation* is so comprehensive and so thorough that it is virtually impossible for one to write extensively on any portion of this subject without impinging upon some area of his monumental work. I have profited greatly from Loss' pioneering treatise and I welcome this opportunity to express my especial thanks.

2. The Securities Exchange Act of 1934 defines the terms "broker" and "dealer" as follows: The term "broker" means "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." 48 STAT. 883 (1934), 15 U.S.C. § 78(C) (1952). The term "dealer" means "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business." *Ibid.*

Throughout this Article the terms "broker" and "dealer" are used as above defined. The term "broker-dealer" is used where a person combines the activities of both broker and dealer, or where there is uncertainty as to whether a person is acting in the one capacity or the other.

either as agents or as principals. This study is confined to an inquiry into the regulations affecting the purchase and sale over the counter of *existing* securities. Hence, original issues of securities, either through public offerings or private placement, are not within the scope of this paper. As a major part of the activity of the Securities and Exchange Commission relates to the regulation of original issues and of stock exchange transactions, only those portions of the work of the SEC will be analyzed that are concerned directly or indirectly with over-the-counter transactions in existing securities.³

The basic concept of "regulation" is herein employed not in a narrow but in an inclusive sense. Securities are a species of property and all transfers of property are subject to some form of regulation. Buyers and sellers of property are generally conceived of as acting "at arm's length": if after negotiations they agree upon the terms of a purchase and sale, the transaction is binding upon each, even though one of them may thereby benefit at the expense of the other from his superior knowledge or astuteness. There is, however, an important exception to this generalization. The law may be invoked to set aside or modify the results of transactions deemed to be tainted by fraudulent conduct. Such governmental interventions, whether by legislative enactment, judicial decision or administrative ruling, constitute "regulation" in the broad sense in which that term is used in this Article. With respect to the purchase and sale of securities, regulation has been addressed principally to four types of misconduct: misrepresentation, manipulation, non-disclosure, and malpractices on the part of brokers and dealers. The major parts of this Article will be devoted to an examination of federal legislation relating to each of these categories.

From the fact that the purpose of this Article is to present a study of regulation of the over-the-counter securities market it must not be inferred that there is a substantial body of regulations peculiarly applicable to over-the-counter transactions. Actually there are very few regulatory measures that have such limited application. Over-the-counter securities transactions are but a segment of the entire area of securities transactions. Many of the rules that in the aggregate constitute "federal regulation of the over-the-counter securities market" are nothing more than an application of rules that relate generally to sales of securities whether over the counter, or through an exchange, or by direct dealing between buyer and seller.

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3. To be sure, the over-the-counter market, as well as the stock exchange, is incidentally affected by the character and extent of original issues that may provide material for subsequent transfers of securities, but the gestation period is deemed too remote for inclusion within the limits of this Article.

II. THE NEED FOR FEDERAL REGULATION

The need and the justification for federal legislation dealing with malpractices in securities transactions arise from the fact that the remedies developed by the common law and by state legislatures are so inadequate.

A. *The Common-Law Remedies*

Literally interpreted, the maxim *caveat emptor* imposes severe risks upon the buyer. But the common law has devised three causes of action applicable to the plight of a buyer who has been deceived or defrauded. These are warranty, rescission and deceit.

It might seem that an action for damages based upon a breach of warranty would provide a deceived or defrauded purchaser of a security with as much protection as a purchaser of goods. But this is not the case. A defect in a commodity can usually be discovered quickly, but false representations as to a security are not easily ascertainable. A security may pass through many hands before the "defect" is discovered and the ultimate loss may fall upon a purchaser having no knowledge of the representation that proved to be false. Moreover, in ascertaining and measuring the buyer's loss a defective commodity may generally be compared to a similar commodity minus the defect. But each issue of securities is unique, and there is no same security minus the misrepresentation with which to compare it. Furthermore, there are a multitude of factors that may influence the value of a security, and when a price decline occurs it is extremely difficult to demonstrate that this loss resulted directly from the discovery that a particular representation was false. In reality the law of warranty has had very little application to the sale of securities. The late Dean Harry Shulman explains this as follows:

"Only a warranty of title and that the stock or bond is a general security of the kind which it purports to be on its face is imposed on the seller by implication from the mere sale. No warranty is implied as to the quality or value or that the security was not issued in contravention of constitution, law or corporate charter. The buyer is held to have, and exercise, his own judgment as to value; and he is charged with knowledge of legal defects in the security. The liberality in treating representations in the sale of goods as warranties is absent in the security cases. Affirmations, no matter how positively made, are not warranties unless an intent to warrant is shown. There has not been any tendency to extend the reach of warranty to remote seller or issuer. And the doctrine seems not to differentiate between sales by individual investors and sales by dealers or issuers."⁴

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4. Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 230 (1933).

The second common-law remedy which may be available to a defrauded buyer of goods, that of rescission, likewise has many shortcomings when securities are the subject-matter of the sale. Rescission based upon misrepresentation is available only to the person who bought directly from the misrepresenter. Hence the remedy of rescission cannot be invoked by buyers of securities induced to make stock market purchases on the strength of false representations in circulars or prospectuses, because such misrepresentations are not those of the immediate seller. This limitation obviously excludes a very substantial group of investors in securities. The common law places other obstacles in the path of the buyer who seeks to rescind on the ground of misrepresentation: he must return to the seller the subject-matter of the sale; he must act promptly; he must avoid all conduct that can be construed as a ratification or as inconsistent with a desire to rescind; he must show that the seller misrepresented a material fact; and he must show that he relied on the truth of this false statement. In the case of securities transactions these hurdles are so difficult to surmount that the common-law action of rescission is seldom an adequate remedy for the misled purchaser of stocks or bonds.⁵

According to legal dogma the elements of the third common-law remedy, an action for deceit, are a false representation of a material fact, plus scienter on the defendant's part and plaintiff's reliance on the representation, as a result of which he is damaged. The buyer is obviously confronted with many pitfalls: the difficulty of demonstrating the falsity of a partial truth, or of an ambiguity, or of a statement literally true but nevertheless misleading to the average person; the necessity of identifying that which is material rather than inconsequential or irrelevant; the burden of distinguishing between expressions of fact and statements of law or opinion or forecast or assurance; and the buyer of securities has the especially difficult problem of proving that it was not a tip sheet or the general market condition, but a false representation upon which he relied, and that this reliance was the proximate cause of damage that he actually incurred.

The impact of the common law upon fraudulent sellers of securities is realistically summarized by Dean Shulman as follows:

"In the ideal of the law, then, issuers and sellers of securities have lived under very great risks of liability, at least to their immediate vendees. But they have lived well because the reality was not so harsh. Reality was sporting: very few investors brought suit. Reality was indulgent: the men empowered to decide cases made many allowances for the practices of the times.

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5. *Id.* at 231.

And reality recognized that the ideal required only truth in statements made, not that full statement be made; that sales could be promoted with only scant statement; that troublesome questions could be avoided by omitting mention of a variety of matters and confining circular and prospectus to truthful descriptions of the show window without taking the investor through the store behind it.”⁶

This tolerant attitude of the common law toward non-disclosure is based upon the theory that each of the parties has equal access to pertinent information and that, as if bargaining were a game, he who is shrewder or more industrious in gathering facts is entitled to the better score. But in the sale of securities there are transactions in which the initial knowledge of the parties is quite disparate, or in which but one of the parties has access to the only source of additional information. A typical example is that of a corporate director or other insider withholding his inside knowledge while engaging in transactions for the purchase or sale of the corporation's securities. The common law, however, has been slow to impose any duty of disclosure upon a director trading in shares of the corporation; and the duty which it does impose is quite limited in scope.⁷

With respect to certain types of misconduct by a broker, such as striving to serve both buyer and seller in a securities transaction or concealing his status as one of the parties in such a transaction, the common-law rules of principal and agent are applicable. But a broker may resort to other malpractices such as inducing a customer to trade excessively in order to increase commissions, improperly utilizing information obtained as a result of the confidential relationship between broker and customer, or favoring an important customer at the expense of one whose account is deemed by the broker to be of less value, and as to such abuses relief available at common law is highly inadequate.

Furthermore, one of the greatest temptations of a dealer is that of extracting an exorbitant profit for himself from a given transaction with a customer, and against this the common law provides little or no protection if the status of the dealer as such was clearly revealed, although it may not have been understood or appreciated by the customer. A dealer may resort to high-pressure tactics in merchandising his wares and if his conduct is not “misrepresentation” or “fraud,” the customer has no redress at common law, although the dealer's acts may be unethical or even immoral.

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6. *Id.* at 242.

7. For example, directors have been said not to be under a duty to disclose facts that appear upon the corporation's books. See STEVENS, *PRIVATE CORPORATIONS* 697 (2d ed. 1949).

Most persons—in fact the great majority—engaged in the securities business in the United States combine the functions of broker and dealer, and from this hybrid status of broker-dealer stem many conflicts. A broker-dealer may serve a given customer in one transaction as a broker and in another as a dealer. He may act as a broker in relation to some customers, and as a dealer in relation to others. He may have transactions with non-customers in his business as a dealer, while at the same time engaging in similar transactions as an agent for customers of his brokerage business. Misunderstandings and disputes are stimulated by this overlapping of functions and the common-law rules of principal and agent do not present an effective antidote.

B. *State Legislation*

Every state except Nevada has enacted some form of legislation regulating or affecting the sale of securities. Such statutes, collectively known as "Blue Sky" laws, are of three major types. Although the regulatory device adopted by a specific legislature often combines the features of several types, and a given state may frequently effect drastic changes in its legislation.⁸

First, there are licensing statutes. Practically all states require brokers, dealers, securities salesmen and investment counselors to obtain licenses from the state, or at least to register with the state. These laws are based upon the theory that honest brokers will not engage in dishonest practices and that honest dealers will not trade in dishonest securities. In applying for a license the broker-dealer is required to supply information as to his business operations and financial status upon the basis of which a designated official is supposedly enabled to form a judgment as to the applicant's professional standing.

Secondly, there are registration statutes. About forty states provide for the registration of securities with a regulatory commission before they may lawfully be sold or offered for sale. Each state administrative agency is empowered to deny or to revoke registration if in its judgment the issue does not conform to statutory standards designed to curtail the sale of fraudulent or unsound securities. The impact of these laws is greatly diminished by provision for numerous exemptions. The great majority of states exempt securities in the following categories: securities of national and state banks, securities of building and loan associations, commercial paper issued in the ordinary

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8. The Wisconsin law, for example, has been completely re-written at least four times.

course of business, securities of corporations organized under acts of Congress, securities of foreign governments, isolated sales by owner or for owner's account, judicial sales, securities of non-profit organizations, securities issued by political subdivisions of states, securities of public utilities under federal or state control, real property mortgage bonds or notes, sales of securities to banks, brokers, dealers, corporations, insurance companies, savings institutions or trust companies, stock dividends to security holders, securities of trust companies, and securities of the United States, states, or territories. A dozen or more states exempt securities issued by cooperative associations, domestic corporations, insurance companies, personal property mortgage bonds or notes, as well as securities issued upon merger or consolidation or pursuant to stock subscriptions when no commissions were paid nor expenses incurred prior to incorporation.

Thirdly, there are fraud statutes. Considered generally, "Blue Sky" laws provide five types of remedies for fraudulent practices in connection with the sale of securities: (1) prosecution resulting in fine and/or imprisonment, (2) injunction, (3) stop order, (4) suspension or revocation of license or registration, and (5) civil liability. The former Delaware statute⁹ merely authorized the Attorney General to seek injunctions against those engaging in the fraudulent sale or exchange of securities. Unless at least coupled with a provision for investigation or criminal prosecution, such a statute has little or no remedial value.

The task of administering "Blue Sky" laws is entrusted in most states not to a separate securities commission but to some other state agency that performs this work only as a subsidiary function. In such states, more likely than not, attorneys general, corporation commissioners, insurance commissioners or comparable administrative officials are those who administer the laws. The 1938 report of the State Legislation Committee of the Investment Bankers Association contains this statement:

"Records disclose that the average tenure in office by a securities commissioner is but little more than two years. This, of course, is occasioned by the exigencies of our political system and the failure to place such highly specialized administrative positions on the merit system. The success of any securities law, both as to workability and effectiveness, depends almost wholly upon its administration, and administration is dependent upon experience as well as ability. It all too frequently happens that about the time the requisite experience is acquired, the turn of the

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9. SEE LOSS, SECURITIES REGULATION 32 (Supp. 1955).

political wheel of fortune forces a change. As a consequence, both the investor and legitimate industry are liable to suffer for a time."¹⁰

On the whole, "Blue Sky" laws have proved to be of limited effectiveness in counteracting malpractices in the distribution and sale of securities. This can be ascribed in large measure to the fact that these statutes, almost without exception, are based upon a philosophy of control rather than disclosure. The state agency undertakes to decide whether a given security conforms to specific statutory standards which typically are very broad. Hence the state agency has, in effect, discretion to determine whether or not a security is so unsound that it should not be sold within the state. This excessive governmental invasion of the free enterprise system, like the eighteenth amendment, encourages evasion and subterfuge, thus causing administration and enforcement of the law to be impracticable. Moreover, the generous and oftentimes illogical exemptions that are to be found in many of the "Blue Sky" laws promote confusion, dissatisfaction and general disrespect for the statute, thereby complicating the problem of enforcement. Furthermore, one who seeks to avoid impact with the "Blue Sky" law of a given state has no great difficulty in achieving this result by merely remaining physically outside of that state and conducting operations within the state solely through media of interstate commerce. Not being a "fugitive," he is in little danger of extradition. Finally, it should be noted that many state legislatures have been niggardly in appropriating funds for the administration and enforcement of the law, and inadequate budgets and personnel have hopelessly handicapped state agencies in the performance of their allotted tasks.

III. FEDERAL REGULATION OF MISREPRESENTATION IN OVER-THE-COUNTER TRANSACTIONS

Misrepresentation is as old as barter, and in the sale of any kind of property it is the most common form of misconduct. To falsify in the hope of thereby achieving more favorable terms is a temptation that besets both buyers and sellers, although in the sale of securities the chief offender is the seller. Sales of securities over the counter afford more scope for misrepresentation than those consummated through a stock exchange because over-the-counter transactions involve direct dealings between the principals or their agents and are less exposed to public scrutiny.

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10. STATE LEGISLATION COMMITTEE, REPORT OF PROCEEDINGS OF THE TWENTY-SEVENTH ANNUAL CONVENTION OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA 305 (1938).

In over-the-counter trading, a customer may buy from or sell to a dealer directly or through the medium of a broker or he may, with a broker as his agent, buy from or sell to a non-dealer who may or may not be represented by a broker. Ordinarily, misrepresentation in over-the-counter transactions is that of a broker or dealer and not of a customer, but certain types of customers, such as promoters seeking to unload watered stock, may deceive their own brokers. Hence, if misrepresentation is involved in an over-the-counter transaction, the wrongdoer may be either a broker, a dealer, or a customer.

As heretofore indicated, common-law principles evolving from a succession of judicial decisions have failed to provide purchasers and sellers of securities with adequate protection against misrepresentation. In general, the function of a court is to decide controversies presented to it through the medium of established procedures and concerning the interests of specific litigants. A court has little independent investigating power, and although it may be mindful of a broad public policy and desirous of preventing, as contrasted with only correcting, a given abuse, it has very little power to innovate; hence such prophylactic rules as it may devise will seldom prove to be completely effective. This is particularly true in the realm of fraud and kindred forms of misconduct. The malpractices of unscrupulous promoters and dealers in securities are rarely brought to the attention of a court until after the event, and the common-law remedies available to the court after the horse has been stolen do not always enable it to return the steed, or its equivalent, and seldom to bolt the stable-door against renewed chicanery.¹¹

A. *The Mail Fraud Statute*

Prior to the passage of the Securities Act of 1933, the Mail Fraud Statute¹² was the major source of the federal government's power to curtail wrongdoing in the sale of securities. This statute has had

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11. The significant development of administrative agencies in recent decades may be traced, in large measure, to the expanded marketing of securities and Congress' attempt to remedy malpractices with which the common law and state legislation had proved incapable of dealing adequately. The stock crash of 1929-30 and resultant depression precipitated a widespread demand for reform in stock trading, both on the exchanges and over the counter.

12. In its present form this statute provides substantially as follows: "Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell . . . any . . . security or other article . . . for the purpose of executing such scheme or artifice or attempting to do so, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Post Office Department . . . shall be fined not more than \$1,000 or imprisoned not more than five years or both." 18 U.S.C. § 1341 (1952).

only limited effectiveness in combatting fraudulent practices in securities transactions. Its sanctions are confined to criminal proceedings, and the clever swindler has been able readily to stay beyond its reach, if only by completely avoiding the use of the mails. Moreover, the cumbersome procedure for enforcement of the Mail Fraud Statute enables many real offenders to go unpunished.

B. *The SEC Statutes*

In 1920 Congress had added section 20a to the Interstate Commerce Act,¹³ making it unlawful for any carrier by railroad to issue securities without the authorization of the Interstate Commerce Commission, but the Securities Act of 1933¹⁴ was the first permanent federal securities legislation of general application. It represents a middle of the road policy of full disclosure, rejecting two other opposing philosophies: (1) the die-hard attitude that no preventive legislation was feasible, and that Congress should go no further than to enact an after-the-fact fraud type of statute, and (2) the pro-regulation viewpoint that Congress should provide for federal incorporation of interstate business, and pass legislation similar to the provisions of many state "Blue Sky" laws requiring the registration of securities by qualification.

In addition to the Securities Act of 1933 the Securities and Exchange Commission administers the Securities Exchange Act of 1934,¹⁵ the Public Utility Holding Company Act of 1935,¹⁶ the Trust Indenture Act of 1939,¹⁷ the Investment Company Act of 1940,¹⁸ and the Investment Advisors Act of 1940;¹⁹ it also has some significant functions with respect to corporate reorganization proceedings under chapter X of the Bankruptcy Act.²⁰ Moreover, the Commission has express powers to make, alter and rescind rules and regulations deemed by it to be necessary to enable it to carry out the purposes of the several statutes. Many of the rules thus promulgated have a practical significance comparable to that of the statutory provisions themselves.

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13. 41 STAT. 493 (1920), 49 U.S.C. § 20(a) (1952).

14. 48 STAT. 74 (1933), 15 U.S.C. § 77(a) (1952).

15. 48 STAT. 881 (1934), 15 U.S.C. § 78 (1952).

16. 49 STAT. 838 (1935), 15 U.S.C. § 79 (1952).

17. 53 STAT. 1149 (1939), 15 U.S.C. § 77(a) (1952).

18. 54 STAT. 789 (1940), 11 U.S.C. §§ 72, 107 (1952), 15 U.S.C. §§ 80(a)-(1) to 80(a)-(52) (1952).

19. 54 STAT. 847 (1940), 15 U.S.C. § 80(b) (1952).

20. 52 STAT. 883 (1938), 11 U.S.C. §§ 501-676 (1952).

1. Disclosure Provisions

One who has knowledge of the actual facts is difficult to mislead by a false representation as to such facts, and it is at least less likely that misrepresentation will be attempted if the facts are known to be readily available. Consequently, to the extent that the federal securities laws require disclosure and widespread dissemination of information relevant to the worth of securities traded over the counter, they minimize the likelihood of effective misrepresentation in such transactions. Through this legislation Congress sought in two major respects to induce disclosure of detailed information as to specific securities.

Section 5 of the Securities Act provides that no person may lawfully sell or deliver a security, not exempt under sections 3 and 4, through the use of the mails or in interstate commerce unless a registration statement has been filed with the SEC and is in effect, and a prospectus meeting the requirements of section 10 is delivered to the purchaser.²¹ Reference to the definition and exemption sections of the act reveals that section 5, despite its all-embracing language, is confined essentially to the issuing and underwriting of new securities. In short, it relates primarily²² to the original distribution of a security issue and not to subsequent trading in such securities. Nevertheless, when the distribution is complete, and trading in the securities occurs on a stock exchange or over the counter or both, the highly detailed information in the registration statement, being available to investors and their professional advisers, tends to dissuade those who might otherwise be tempted to misrepresent. Moreover, the information contained in a registration statement may have significance with respect to other outstanding classes of securities of the issuer.

The required information is both financial and non-financial. Typical items are: a balance sheet as of a date not more than ninety days before filing, certified profit and loss statements for the last three fiscal years, and similar financial statements of any business that is to be bought in whole or in part with any portion of the proceeds of the issue, copies of the issuer's articles of incorporation and by-laws, the names and addresses of all directors, principal officers, promoters, underwriters and ten per cent shareholders, together with the amount of securities they hold or have manifested an intention to acquire, the

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21. 48 STAT. 77 (1933), 15 U.S.C. § 77(e) (1952).

22. Section 4 of the Securities Act, as amended in 1954, which defines exempted transactions, causes some of the provisions of § 5 to be applicable to transactions in registered securities by a "dealer" within forty days of the effective date of the registration statement affecting such securities. 68 STAT. 684 (1954), 15 U.S.C. § 77(d) (Supp. III, 1954).

general character of the issuer's business, copies of the agreements or indentures underlying any securities offered or to be offered, the proposed public offering price, underwriters' commissions or discounts and other expenses of the offering, the estimated net proceeds of the issue, the purpose of the issue, remuneration of officers and directors, payments made within the preceding two years, or to be made, to promoters, property to be acquired through the proceeds of the sale and the interest of any director or officer or ten-percenter in such property, and the financial history of the issuer and of any business to be acquired through the proceeds of the issue.

By virtue of section 13(a) of the Securities Exchange Act the Commission has authority to require a limited number of issuers to keep the information set forth in their registration statements up to date by filing current and annual reports.²³

The other major provision promoting disclosure of detailed information as to specific securities is to be found in the Securities Exchange Act of 1934. Section 12(a) of that statute declares that "It shall be unlawful for any member, broker or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title, and the rules and regulations thereunder."²⁴ The fact that a security when issued, may have been registered with the SEC under section 5 of the Securities Act does not obviate the necessity of complying with section 12(a) of the Exchange Act, although it does facilitate compliance.

Although under section 12(b) duplicate originals must be filed with the SEC, the theory of the section is that to achieve registration of a security on a national exchange the issuer shall file *with the exchange* an application for listing, and the exchange may at its discretion accept or reject the application, subject to the qualification that the exchange may not validly accept an application unless it conforms to the registration procedures prescribed by the Commission. These procedures are set forth in subsections (b), (c) and (d) of section 12 and regulation X-12B.²⁵ The information which is required of the issuer for registration under section 12 is very similar to that required for registration under section 5 of the Securities Act. Section 13 of the Exchange Act requires the issuer to keep this information up to date by filing current and annual reports on forms prescribed by

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23. 48 STAT. 894 (1934), 15 U.S.C. § 78(m) (1952).

24. 48 STAT. 892 (1934), 15 U.S.C. § 78(1) (1952).

25. *Ibid.*

the Commission,²⁶ and failure to comply with this requirement may result in the security being "de-listed" by the Commission pursuant to section 19(a)(2) of the Exchange Act.²⁷

The efforts of Congress to combat misrepresentation in the sale of securities by enforced disclosure of information are not confined to the above-mentioned sections of the Securities Act and the Securities Exchange Act. There are comparable provisions in the Investment Company Act²⁸ and in the Public Utility Holding Company Act.²⁹ Moreover, section 14(a) of the Exchange Act gives the Commission broad rule-making power with respect to the solicitation of proxies "in respect to any security (other than an exempted security) registered on any national securities exchange."³⁰ The rules promulgated by the Commission are designated as regulation X-14.³¹ They require, *inter alia*, that proxy solicitations by management in connection with meetings for the election of directors must be accompanied or preceded by an adequate annual report of the company for the last fiscal year. Similar financial statements are required to be included with the proxy solicitation in conjunction with the authorization, issuance, modification or exchange of securities, or a merger or consolidation.

Although the information required to be disclosed in proxy literature is not generally related to a specific security, nevertheless the data are of value to investors in arming them against misrepresentations. Moreover, this information goes directly to security holders, whereas the information in registration statements and similar instruments gets to investors after termination of the public offering only if they seek it out. The general rule (subject to certain exceptions with respect to confidential matter) is that documents filed with the Securities and Exchange Commission are available to the public, and photocopies may be purchased from the Commission.

2. General Anti-Fraud Provisions

Fortunately, however, the congressional approach to the problem of misrepresentation in the sale of securities is not confined to the disclosure principle. Misrepresentation occurring willfully, or resulting from gross carelessness as to truth, is a species of fraud. In the SEC

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26. 48 STAT. 894 (1934), 15 U.S.C. § 78(m) (1952).

27. 48 STAT. 898 (1934), 15 U.S.C. § 78(s) (1952).

28. 54 STAT. 803, 838 (1940), 15 U.S.C. §§ 80(a)-(8), 80(a)-(30) (1952).

29. 49 STAT. 812, 827 (1935), 15 U.S.C. §§ 79(e), 79(m) (1952).

30. 48 STAT. 895 (1934), 15 U.S.C. § 78(n) (1952).

31. 17 C.F.R. § 240.14a-3 (1939).

statutes there are three general anti-fraud provisions that may be a basis for injunctive or administrative action or criminal prosecution, or that may entitle defrauded buyers or sellers of securities to maintain civil suits for rescission or damages. These are section 17(a) of the Securities Act,³² rule X-10B-5³³ under section 10(b) of the Exchange Act,³⁴ and section 15(c)(1) of the latter Act³⁵ (amplified by rule X-15C1-2³⁶ thereunder).³⁷

a. *Section 17(a) of the Securities Act*

This section enumerates three distinct offenses:

"It shall be unlawful for any person in the sale of any securities by the use of any means or instrument 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 the 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."³⁸

One of the weaknesses of section 17(a) is that it is applicable by its terms only to *sellers* of securities, and while it is arguable that it is also applicable to frauds by purchasers, the fact is that the SEC has never sought to apply it to purchasers.

b. *Rule X-10B-5*

Section 10(b) of the Exchange Act reads as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce

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32. 48 STAT. 84 (1933), 15 U.S.C. § 77 (1952).

33. 17 C.F.R. § 240.10b-5 (Cum. Supp. 1944).

34. 48 STAT. 891 (1934), 15 U.S.C. § 78(j) (1952).

35. 52 STAT. 1075 (1938), 15 U.S.C. § 78(o) (1952).

36. 17 C.F.R. § 240.c1-2 (Supp. 1940).

37. In addition, § 206 of the Investment Advisers Act makes it unlawful for any registered adviser, by use of the mails or interstate facilities, directly or indirectly, "(1) to employ any device, scheme or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." 54 STAT. 852 (1940), 15 U.S.C. § 80(b)-(6) (1952).

38. 48 STAT. 84 (1933), 15 U.S.C. § 77(q) (1952).

or of the mails or of any facility of any national securities exchange—

(b) To use or employ in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”³⁹

This section expressly applies to over-the-counter as well as to stock exchange transactions, to purchasers as well as sellers of securities, and is not limited, as is section 15(c)(1), to transactions by brokers and dealers. But the section is not self-operative, for by its terms it can be invoked only with respect to “such rules and regulations as the Commission may prescribe,” and it was not until 1942 that the Commission adopted the now famous rule X-10B-5. This rule, which imports the prohibitions of section 17(a) of the Securities Act into the Exchange Act, provides as follows:

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

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.”⁴⁰

Since its adoption rule X-10B-5 has increasingly been relied upon as the basis for civil actions for rescission or damages, as well as for other forms of litigation.

c. *Section 15(c)(1) of the Exchange Act*

This section is confined to over-the-counter transactions and affects only brokers and dealers. It reads as follows:

“No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any

³⁹ 17 C.F.R. § 240.10b-5 (Cum. Supp. 1944); 48 STAT. 891 (1934), 15 U.S.C. § 77(q) (1952).

⁴⁰ 17 C.F.R. § 240.10b-5 (Cum. Supp. 1944).

transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent." ⁴¹

Despite the concluding authorization to the Commission to promulgate rules and regulations, this section differs from section 10(b) in that its first sentence is self-operative; but it is like section 10(b) in that it relates to fraudulent purchasers as well as sellers of securities.

3. Sanctions Available to the Commission

One of the reasons that the foregoing anti-fraud sections are more effective than the Mail Fraud Statute is that Congress has given the SEC the long-range weapon of injunction with which to combat threatened or continuing violations of the various acts administered by it. Section 20(b) of the Securities Act provides as follows:

"Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, it may in its discretion bring an action in any district court of the United States, United States court of any Territory, or the Supreme Court of the District of Columbia, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. . . ." ⁴²

There are comparable provisions in the Exchange Act,⁴³ the Public Utility Holding Company Act,⁴⁴ the Trust Indenture Act,⁴⁵ the Investment Company Act,⁴⁶ and the Investment Advisers Act.⁴⁷ Moreover, all of the SEC statutes make it a criminal offense "wilfully" to violate any of their provisions, or any of the Commission's rules thereunder ⁴⁸ (except, as to the rules of the Investment Advisers Act).

41. 52 STAT. 1075 (1938), 15 U.S.C. § 78(d) (c) (1) (1952).

42. 48 STAT. 86 (1933), 15 U.S.C. § 77(t) (1952).

43. 48 STAT. 881 (1934), 15 U.S.C. § 78 (1952).

44. 49 STAT. 838 (1935), 15 U.S.C. § 79 (1952).

45. 53 STAT. 1149 (1939), 15 U.S.C. § 77(a) (1952).

46. 54 STAT. 789 (1940), 11 U.S.C. §§ 72, 107 (1952); 15 U.S.C. §§ 80(a)-(1) to 80(a)-(52) (1952).

47. 54 STAT. 847 (1940), 15 U.S.C. § 80(b) (1952).

48. 48 STAT. 87 (1933), 15 U.S.C. § 77(x) (1952); 48 STAT. 904 (1934), as amended, 15 U.S.C. § 78(ff) (1952).

4. Civil Liabilities

In addition to injunction and criminal prosecution, another form of sanction for the anti-fraud statutes is that of civil liability, *i.e.*, a private suit by the defrauded party against the wrongdoer for rescission or damages. Such suits, as noted above, have frequently been based upon rule X-10B-5, although neither this rule nor section 10(b) of the Exchange Act, which it implements, expressly authorize such litigation. Section 12(2) of the Securities Act does, however, specifically create civil liability on the part of a defrauding seller. This section reads as follows:

"Any person who sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." ⁴⁹

To the defrauded purchaser of securities this statute is in several respects an improvement over the common-law action of rescission. In the first place, he does not have to prove that he actually relied upon the misrepresentation, although he must prove unawareness of the truth. Secondly, tender back of the purchased security is not a *sine qua non* of his statutory cause of action, and if he has sold the security, he may nevertheless sue for the monetary equivalent of the rescission, *i.e.*, damages. Thirdly, he may maintain his action in the federal courts without a requirement of diversity of citizenship or of a jurisdictional amount, and without being deprived of his right, in the alternative, to maintain a state court action.

A broker guilty of misrepresentation may be sued under section 12(2), for the statutory language "any person who sells a security" applies not only to the seller but also to those who represent him.

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49. 48 STAT. 84 (1933), 15 U.S.C. § 77(i) (1952).

In the Exchange Act there are two civil liability sections applicable to misrepresentations. Section 9(a)(4) declares it to be unlawful for any person, including a dealer or broker, knowingly to make a false or misleading statement as to any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security,⁵⁰ and section 9(3) gives any person injured thereby a right to sue in law or in equity in any court of competent jurisdiction to recover the damages resulting therefrom.⁵¹ The period of limitations set forth in this section is one year after discovery and three years after the violation. Section 18 provides, in effect, that any person, who shall have purchased or sold a security in reliance upon any false or misleading statement contained in an application, report or document filed pursuant to the Exchange Act, or any rule or regulation thereunder, shall have a cause of action for resulting damages against anyone responsible for the misrepresentation.⁵² Such suit may be at law or in equity and may be brought in any court of competent jurisdiction. The statutory period of limitations is one year from discovery and three years after the cause of action accrued.

5. Implied Liability

The presence or absence of an express statutory provision for rescission or damage suits against those who violate SEC legislation has been less important during recent years because of the judicial development of a far-reaching doctrine. Section 29(b) of the Exchange Act stipulates, in effect, that all contracts in violation of the statute or any rule thereunder are "void" as to the violator or any other person who acquired any right under the contract with actual knowledge of the violation.⁵³ Although this section does not spell out the legal relations arising out of such a "void" transaction, the courts have held that the language of section 29(b) is sufficient not only for a cause of action for rescission but also for companion causes of action for money damages. This is a specific application of a common-law doctrine, which has been finding increasing favor with the judiciary, to the general effect that a private action may be brought for violation of a statute, if the interest invaded is one which the statute is intended to protect.⁵⁴

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50. 48 STAT. 889 (1934), 15 U.S.C. § 78(i) (1952).

51. *Ibid.*

52. 48 STAT. 897 (1934), 15 U.S.C. § 78(r) (1952).

53. 48 STAT. 903 (1934), 15 U.S.C. § 78(cc) (1952).

54. One of the most important applications of this doctrine to securities transactions occurred in the case of *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). It will be recalled that there is no express provision for civil liability either

IV. FEDERAL REGULATION OF MANIPULATION IN OVER-THE-COUNTER TRANSACTIONS

Manipulation is the process of artificially causing the price of one or more securities to be above or below that which otherwise would result from the normal operation of supply and demand. The methods of manipulators are legion but certain patterns frequently emerge.

Manipulation is seldom encountered today, but when attempted it is usually a pool operation. First, the pool selects a stock to which public attention may easily be directed by rumors of merger, stock split-up, new discoveries, government contracts, etc. Then, such rumors are deliberately spread through the media of touting, tip-sheets, financial publications, radio commentators and newspaper columnists susceptible to bribery, and similar channels. Sometimes the pool will first depress the price of the stock to be manipulated by selling short on a scale down accompanied by unfavorable rumors, in order to acquire a supply of the stock at a low price level from which to start the artificial stimulation. The pool may resort to options to buy the stock at a fixed price or at graduated prices close to the market.

Next the appearance of active trading is created. Brokers and dealers are sent market letters calculated to interest them and their customers in the stock in question. With the aid of professional publicity agents, supposedly unbiased market analyses of the stock are widely circulated. A program of active trading by the members of the pool is launched.

When through this unrealistic activity the price of the stock has risen substantially, the pool will circumspectly dispose of its holdings. This will be accomplished by a continuation of active trading in the stock with a preponderance of sales by the pool. Even after the pool has profitably liquidated its long position, it may continue active trading during which it effects a volume of short sales. It will then stop trading and with the withdrawal of the support a sudden decline in the price of the stock will probably occur, enabling the pool to cover its short sales at a low price, thus profiting both ways from the manipulation.

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in § 10(b) of the Exchange Act or in rule X-10B-5, and in this case the federal court had jurisdiction only if the Exchange Act was applicable. The court, however, upheld the plaintiffs' right of action against the defendants saying that "the disregard of the command of a statute is a wrongful act and a tort," and "in view of the general purpose of the Act, the mere omission of an express provision for civil liability is not sufficient to negative what the general law implies." Many courts have followed this doctrine and none have reached a contrary result under rule X-10B-5. *But see* Howard v. Furst, 238 F.2d 790 (2d Cir. 1956), 105 U. PA. L. REV. 1016, 70 HARV. L. REV. 493 (1957), in which the court held a civil remedy was not implied under section 14(a) for violation of the proxy rules.

Although manipulation is facilitated by the mechanics of the stock exchange, it is by no means confined to stock exchange transactions. The over-the-counter market has frequently been the scene of manipulative practices, and to the extent that listed securities are traded over the counter, stock exchange manipulations can have a direct impact upon over-the-counter traders. During 1929 alone, members of the New York Stock Exchange participated in pool operations involving 105 listed issues, and during the period 1929-1933 pool profits were shared by 175 member firms.⁵⁵ The effect of manipulation may be devastating upon small investors, especially those poorly financed or trading on a relatively narrow margin. Furthermore, manipulation is a social evil in that it undermines public confidence in the relationship between market prices and market values.

Elimination of manipulation was a major concern of Congress in enacting the program of federal securities legislation, and happily this has been one of the most successful portions of the program. As the terms of over-the-counter transactions in listed securities obviously can be affected by stock exchange manipulations, the statutory regulations with respect to manipulation on the stock exchange as well as over the counter will be examined.

A. *Wash Sales and Matched Orders*

The statutory attack upon manipulation of securities prices is spearheaded by sections 9 and 10 of the Exchange Act. Section 9 makes it illegal to effect any wash sale (*i.e.*, one in which the same party is both buyer and seller) or matched order (*i.e.*, an order placed with knowledge that a confederate will place a corresponding order to buy or sell the same security at the same time and price).⁵⁶ The success of a pool operation to manipulate the price of a security upward depends upon the extent to which an increased demand for the security can be artificially stimulated. The purpose of wash sales and matched orders through an exchange is to cause the ticker tape and newspaper quotations to record an appearance of activity in the security, and thus to lead the unwary investor to act on the belief that others regard the security as underpriced. If the pool is seeking to manipulate the price downward, comparable activities may ensue. There may be non-manipulative wash sales or matched orders (*e.g.*, in the hope of achieving a tax benefit), but the overwhelming preponderance of such transactions are associated with planned securities manipulations, and

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55. S. REP. NO. 1455, 73d Cong., 2d Sess. 32-33 (1934).

56. 48 STAT. 889 (1934), 15 U.S.C. § 78i (1952).

the resulting harm from such machinations is so great that Congress felt justified in outlawing them.

The statutory prohibitions and Commission regulations with respect to manipulation are supported by the same sanctions as those discussed in the preceding section on misrepresentation, *i.e.*, injunctive, administrative and criminal proceedings, and civil liability.

B. Dissemination of False and Misleading Information

In the preceding section the regulation of misrepresentation in general was considered. Misrepresentation is a favorite device of those seeking to manipulate securities prices, and from that standpoint it will be discussed in the present section. Section 9(a)(3) of the Exchange Act declares it to be unlawful for

“ . . . a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.”⁵⁷

Section 9(a)(5) makes it unlawful for anyone, for a consideration, to engage in the activities forbidden in section 9(a)(3).⁵⁸

Taken together the foregoing two subsections prohibit a pool operator from “touting” a security or hiring someone to do his “touting” for him. In connection with manipulative operations it was a common practice for the pool to employ publicity agents and publishers of “market services” and tipster sheets to give slanted opinions while purporting to be unbiased.

Section 17(b) of the Securities Act makes it unlawful for anyone, for a consideration received from an issuer, underwriter or dealer, to circulate information about a security without disclosing the receipt of such consideration;⁵⁹ and section 9(a)(4) of the Exchange Act contains a general prohibition against any person knowingly making a false or misleading statement concerning a security registered on a national securities exchange for the purpose of inducing its purchase or sale.⁶⁰

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57. 48 STAT. 889 (1934), 15 U.S.C. § 78i(a)(3) (1952).

58. 48 STAT. 890 (1934), 15 U.S.C. § 78i(a)(5) (1952).

59. 48 STAT. 85 (1933), 15 U.S.C. § 77q(b) (1952).

60. 48 STAT. 889 (1934), 15 U.S.C. § 78i(a)(4) (1952).

C. *Manipulative Pool Operations*

Apart from the use of a particular device, manipulative operations are in general prohibited by section 9(a)(2) of the Exchange Act, which declares it to be unlawful "To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others."⁶¹

By its express terms section 9(a) of the Exchange Act relates only to securities registered on a national securities exchange, and therefore this section does not prohibit manipulative practices on the over-the-counter market with respect to unlisted securities. But to some extent section 15(c)(1) of the Exchange Act plugs this gap: This section declares it to be unlawful for any broker or dealer to induce the purchase or sale of any security "otherwise than on a national securities exchange" by means of any manipulative device.⁶² This section is confined to brokers and dealers, but inasmuch, as, by definition, an over-the-counter transaction always involves a broker or dealer, manipulative practices on the over-the-counter market almost of necessity result in a violation of the section. As a matter of fact, the Commission has often ruled that conduct which would be a violation of section 9(a)(2) in the case of a listed security is a violation of section 15(c)(1) if effected in an unregistered security.

An administrative division of the SEC follows the price movements of about 3,500 securities traded on the exchanges and about 5,000 of the most active over-the-counter securities; hundreds of securities are kept under special scrutiny when public offerings of related securities are pending. Thus the Commission is frequently able to nip in the bud manipulative activities which otherwise might be conducted for the purpose of "facilitating" the new offering.

D. *Puts and Calls*

A put is a negotiable document giving the holder the right to sell to the maker a given security at a stated price within a specified period of time; a call gives the holder a converse right to buy. A "spread" or "straddle" is a similar option to buy or sell or both. The holder of a put hopes that the market price will decline so that he can buy the security at less than the fixed price at which he holds a selling option,

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61. 48 STAT. 889 (1934), 15 U.S.C. § 78i(a)(2) (1952).

62. 48 STAT. 895 (1934), 15 U.S.C. § 780(c)(1) (1952).

and the holder of a call will profit if the market price advances so that he may sell the security at a price greater than that at which he has an option to buy. These instruments may be legitimately acquired as a hedge against adverse future market movements or as an inexpensive form of speculation. But they may also serve as aids to manipulative pool operations, for they enable the manipulators to enter the market at a minimum of risk with a large potential supply of the security to be manipulated.

Because of possible legitimate uses of puts, calls and other securities options, Congress did not ban these devices, but in section 9(b) and (c) of the Exchange Act it was declared to be unlawful, through the facilities of a national securities exchange, to acquire any interest in or to guarantee performance of any put, call, straddle, etc., in contravention of rules and regulations prescribed by the Commission.⁶³ In its early years the Commission studied proposed rules to govern trading practices and other matters concerning puts and calls, but it has never adopted any rules on this subject, apparently preferring to combat these devices, if used for manipulative purposes, by resort to its other anti-manipulation powers.

E. Short Sales and Stop-Loss Orders

Section 10(a) makes it unlawful for any person "to effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe. . . ." ⁶⁴

A short sale occurs when a broker carries out a customer's order to sell a given security for the customer's account and to make delivery by borrowing the security for the customer. Usually the seller's broker borrows the security from another broker and deposits with the latter a dollar amount equal to the market value of the stock at the time it is borrowed. The customer hopes that the market price will thereafter decrease, and that he can profit by purchasing stock with which to cover his loan at a price lower than that which he received when the short sale was executed. If instead the market rises, the customer will suffer a corresponding loss when he buys stock with which to repay the loan.

There are those who maintain that the stock market derives some economic benefit from the short sale; others insist that short-selling is mainly a speculative device and that it serves few useful economic func-

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63. 48 STAT. 890 (1934), 15 U.S.C. § 78i(b)-(c) (1952).

64. 48 STAT. 891 (1934), 15 U.S.C. § 78j(a) (1952).

tions. Without doubt, however, as a tool of those seeking by manipulation to depress the market in a given security, short sales can result in positive harm. So strenuous was the controversy over the merits of short-selling that Congress decided not to ban this practice, but to delegate to the Commission power upon investigation to make appropriate rules and regulations.

During 1937 the Commission made a thorough study of short selling rules as a result of which it prescribed a comprehensive system of regulations, the heart of which is rule X-10A-1(a).⁶⁵ That rule now permits short sales at (rather than above) the last "regular way" sale price if that price was itself higher than the last different "regular way" price that preceded it. On the New York Stock Exchange a "regular way" sale is one which is made for delivery on the third full business day following the day of the transaction. There are a number of exemptions among which are odd-lot sales. In consequence of the Commission's regulations, short-selling on a scale-down, for the purpose of depressing the market price of a security, is effectively prohibited.⁶⁶

A stop-loss order is a direction given by a customer to his broker to buy (or to sell) a given security if the market price rises (or declines) a stipulated number of points, *i.e.*, when a transaction occurs at the designated price. If the market reaches the stated price, the stop-loss order becomes an order to buy (or to sell) at the market and the broker must promptly execute the order at the best price obtainable. Stop-loss orders to buy will minimize the losses of those who have sold short if the market rises, and stop-loss orders to sell will enable those who have a long position to limit loss or protect profit in the event of a market decline.

Stop-loss orders are not exactly a manipulative device, but their existence may be a considerable aid to pool operators, especially if the pool includes a "specialist"⁶⁷ in the security to be manipulated. If there is a large volume of stop-loss orders at or near the same price, the

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65. 17 C.F.R. § 240.10a-1 (1939).

66. Unfortunately, there is no explicit safeguard with respect to over-the-counter dealings in unlisted securities against the impact of short sales on a down scale. Due to differences in over-the-counter and exchange transactions, a different formula for regulation would have to be devised for short selling over the counter.

67. At each stock exchange trading post there is a member who has been granted permission by the exchange to "specialize" in a particular stock or stocks traded at that post, and who remains constantly at the post during trading hours. Other brokers who have limited orders, *i.e.*, not at the market but at a fixed price, to buy or to sell a full lot (usually 100 shares) incline to place such orders with the appropriate specialist to be filled when the market reaches the customer's stated price. The specialist keeps a book in which such orders are recorded in accordance with the stated price. "Stop loss" orders, being a form of limited order, are likewise generally executed through a specialist, if and when the occasion arises.

market may be flooded with selling offers when the security reaches this price. Since these orders must be executed at the best price obtainable, even though this is substantially below the price stipulated in the stop-loss order, a precipitous price decline may result. If a "bear" pool can learn from a specialist the level of such a volume of stop-loss orders, it can drive the price down to this level by short sales, and then the desired further decline will follow automatically.

Since stop-loss orders have economic justification and their aid to manipulators is circumstantial, Congress decided not to prohibit their use, but to leave this matter also to Commission regulation. To date, however, the Commission has issued no regulations on this subject and, in view of the general acceptance of the legitimacy of stop-loss orders, the likelihood that the Commission will alter its present course is remote.

F. Manipulative Devices

Section 10(b) declares it to be unlawful for any person, in connection with the purchase or sale of any security, listed or unlisted, to employ "any manipulative or deceptive device or contrivance" in contravention of Commission rules.⁶⁸ Pursuant to this authorization the Commission has adopted five anti-fraud rules (one of which it subsequently repealed) implementing this section. No one of these rules relates exclusively to manipulation, but since manipulation is a species of fraud, the general anti-fraud sections and rules, heretofore discussed in connection with the topic of misrepresentation, are applicable and have been applied to manipulative practices on the over-the-counter market as well as on stock exchanges.

G. Stabilization

A form of securities manipulation that has provoked considerable controversy is known as "stabilization." This occurs most frequently during the period of flotation of a new issue, and usually consists of purchases of the security being distributed for the account of the underwriting syndicate in order to maintain the initial offering price or to prevent a decline. A brief resumé of investment banking practices will contribute to an understanding of the stabilization problem.

Many corporations that seek additional capital by marketing their securities directly to the public, contract for these services with an investment banker or underwriter. This contract contains the agreed terms of the issue as well as the approximate price to the issuer and the "spread" (*i.e.*, the difference between the price realized by the issuer

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68. 48 STAT. 891 (1934), 15 U.S.C. § 78j (b) (1952).

and the price charged to the public by the underwriter). The originating underwriter then forms an underwriting syndicate, the other members of which proportionately share the risk and the potential profit. The members of the underwriting group sell at least half of the issue to their own customers, and the balance is sold for their account by a selling group which they form and with whom they split commissions on this latter amount of the total issue. Shortly before the effective date of the registration statement, which the originator has previously submitted to the Securities and Exchange Commission, the actual contract between the issuer and the originator is signed, and the offering price is decided upon and communicated to the SEC by way of an amendment to the registration statement, which the Commission almost invariably accepts.

Sound public demand for a security is based upon its known merits and upon the record of the issuer. There may, however, be a time lag between the offering of an issue at a stated price and public awareness of its worth, during which period the market price may sag. But the underwriters, if they have already provided the issuing corporation with the capital represented by the price to them, can ill afford to have this amount of their assets immobilized while they wait for the public to develop a realization that the offering price is fair and reasonable. So they at times purchase blocks of the very issue they are trying to sell, in order to create artificially an appearance of real demand at the offering price, and thus to induce prompt public interest in purchasing the securities at that price. If the issue proves to be excessively unpopular, or if it coincides with a general price decline, stabilization may prove to be ineffective or the cost prohibitive.

Section 9(a)(6) of the Exchange Act declares it to be unlawful for any person "to effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing or *stabilizing* the price of such security in contravention of such rules and regulations as the Commission may prescribe. . . ." ⁶⁹ (Emphasis added.)

Section 9 applies only to securities listed or admitted to listed privileges on a national exchange. Section 9(a)(6) specifically authorizes the Commission to make rules distinguishing between stabilization and unlawful manipulation with respect to such securities. The only federal legislation relative to manipulation and stabilization in over-the-counter transactions is to be found in the general anti-fraud provisions of the Exchange Act, namely sections 10(b) and

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69. 48 STAT. 890 (1934), 15 U.S.C. § 78i(a)(6) (1952).

15(c)(1),⁷⁰ together with section 17 of the Securities Act. With respect to securities traded solely over the counter, these general anti-fraud sections of the Exchange Act have been interpreted as having the same impact upon fraud as section 9(a) has within its field. These anti-fraud statutes proscribe "manipulative" practices, but do not contain the express authorization to the Commission, found in section 9(a), to make rules permitting a limited use of stabilizing devices.⁷¹ But there is no evidence justifying the assumption that Congress intended the law as to stabilization to be more lenient with respect to stock exchange than over-the-counter transactions. Hence it would seem that in interpreting the term "manipulative" in sections 10(b) and 15(c)(1), the Commission has the power to exclude stabilizing devices similar to those that it sanctions pursuant to its express rule-making authority in section 9(a)(6) with respect to registered securities. In both situations the congressional policy is to entrust to the SEC the duty of distinguishing between stabilization and unlawful manipulation. The Commission, however, has exercised this discretion to only a very limited extent.

In 1939 the Commission adopted a rule under section 17(a) of the Exchange Act requiring daily reports of stabilizing activities with relation to any offering of an issue registered under the Securities Act.⁷² These reports are not open to public inspection. The Commission also adopted rule 426 under the Securities Act, which requires that a statement of intention to stabilize be conspicuously indicated on the front cover page of the prospectus whenever the registrant or any of the underwriters has reason to believe that the price of the security may be stabilized.⁷³ In 1940 the Commission adopted regulation X-9A6-1 under section 9(a)(6) of the Exchange Act.⁷⁴ This regulation is confined to primary or secondary distribution "at the market" (*i.e.*, at the price represented as being related to the market price and not expressed in terms of a fixed number of dollars) of securities of a class already registered on a national securities exchange. With respect to such "at the market" offerings, it precludes, *inter alia*, stabilization

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70. 48 STAT. 891, 895 (1934), 15 U.S.C. §§ 78j(b), 78o(c)(1) (1952).

71. "No broker or dealer shall . . . effect any transaction in, or . . . induce the purchase or sale of, any security . . . otherwise than on a national securities exchange, by means of any manipulative, deceptive, or fraudulent device or contrivance. The Commission shall . . . by rules and regulation define such devices or contrivances as are manipulative, deceptive or otherwise fraudulent." 48 STAT. 895 (1934), 15 U.S.C. § 78o(c)(1) (1952). Although the Commission has not defined "such devices or contrivances" as are mentioned in the second sentence, the first sentence is self-operative. See text following note 41 *supra*.

72. 48 STAT. 897 (1934), as amended, 15 U.S.C. § 78q(a) (1952).

73. 17 C.F.R. § 230.426 (Supp. 1947).

74. 17 C.F.R. § 240.9a6-1 (Supp. 1940).

purchases at a price above the last legitimate sale price on the designated exchange. The effect of this regulation has been the virtually complete elimination of new offerings "at the market." The present practice is to offer new issues at a fixed price, and stabilizing activities in relation to "fixed price" offerings are subject to no special rules or regulations of the Commission except the reporting rule and the disclosure rule mentioned above.⁷⁵

The absence of a body of formal rules and regulations concerning stabilization should not be construed as indicating that the Commission has drawn no lines between stabilization and manipulation. The concern of the SEC and its staff with this subject has resulted in thousands of rulings and opinions. In 1948, in summarizing its position as to permissible stabilizing transactions in "fixed price" offerings, the Commission publicly stated that

"... stabilization for the sole purpose of preventing or retarding a decline . . . does not of itself violate Section 9(a) (2) or any other section of the Securities Exchange Act of 1934 so long as the stabilizing purchases are effected at whichever is the lower of two figures—(1) a bona fide independent market price for the security being stabilized or (2) the public offering price of the issue once the offering is made—and that within these restrictions there is no limit under existing statute and rules on the amount of securities which may be purchased in the stabilizing process."⁷⁶

From this statement it clearly appears that transactions raising the price of the security being offered, or creating excessive trading therein, are not protected and are subject to the various anti-manipulation procedures and penalties heretofore discussed.

If the security being stabilized is traded exclusively over the counter, the propriety of the initial stabilizing bid is tested not by the last sale (since there is no systematic reporting of transactions), but by the highest truly independent bid in the market, *i.e.*, the highest price that a dealer has indicated his willingness to pay to another dealer, which may or may not be the highest price appearing in the current quotation sheet.

V. FEDERAL REGULATION OF NON-DISCLOSURE IN OVER-THE-COUNTER TRANSACTIONS

Those who manage the affairs of a corporation or who own large blocks of its stock often obtain advance information as to facts bearing

75. Since the promulgation in 1940 of regulation X-9A6-1, the Commission has adopted no other regulation under § 9(a) (6) of the Exchange Act.

76. See 13 FED. REG. 5659 (1948).

upon the probable value of its securities. If this information is not shared with others trading in these securities, the insiders are in a position, through stock market transactions, to profit from their undisclosed knowledge. In time this practice became widespread, and it produced one of the major problems confronting Congress in the enactment of securities legislation, for, as pointed out heretofore, the common law treated such inequitable conduct with extreme tolerance.⁷⁷

A. Report Requirement

Not unnaturally, Congress sought in its disclosure philosophy an antidote for these "sure thing" speculations. Section 16(a) of the Exchange Act provides that every officer or director of a corporation with an equity security listed on a national exchange, or any person who owns more than ten per cent of any registered equity security, shall report to the Commission and to the exchange his holdings of such securities, and shall further report each month any change in his holdings.⁷⁸ Section 3(a)(11) defines "equity security" as "any stock or similar security," or any right to obtain such securities, or any other security which the Commission may deem it necessary, by such rules and regulations as it may prescribe, to treat as an equity security.⁷⁹ Voting trust certificates and certificates of deposit of equity securities are themselves deemed to be equity securities. If a corporation has several classes of shares outstanding and one class is listed, section 16(a) applies as well to its other classes of shares.⁸⁰ But if the corporation has only a bond issue registered, this not being an equity security, section 16(a) would not apply to any of the corporation's securities, even its common and preferred stocks.

The reports required by section 16(a) are made available to the public both by the Commission and the exchange, and the Commission summarizes the reports in a monthly pamphlet that is widely distributed. For failure to comply with the requirements of section 16(a) the act provides no specific penalty other than the general sanctions of criminal prosecution and administrative injunction.

B. Loss of Short-Swing Profits

In addressing itself to the potential inequities of insider trading in securities, Congress did not confine itself to the requirements of enforced disclosure. Seeking to discourage such practices by minimizing the possibility of profit resulting therefrom, Congress created, in section

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77. See text at note 7 *supra*.

78. 48 STAT. 896 (1934), 15 U.S.C. § 78p(a) (1952).

79. 48 STAT. 884 (1934), 15 U.S.C. § 78c(a)(11) (1952).

80. 48 STAT. 896 (1934), 15 U.S.C. § 78p(a) (1952).

16(b) of the Exchange Act, a right in the issuing corporation to any profits resulting to insiders from short-swing transactions in equity securities. This section provides as follows:

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of the beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."⁸¹

Since the intent of this section is prophylactic, *i.e.*, to prevent rather than to cure, an absence of actual unfair use of inside information is no defense to the issuer's action to recover profits. On the other hand, no matter how unfairly he may have profited from undisclosed information, an insider is not liable under this section if the swing of his transactions extended beyond the arbitrary six months limit established by Congress. Although the profits with which section 16(b) is concerned must arise out of transactions in *equity* securities, the section applies to unlisted securities as well as those registered on an exchange, and to transactions over the counter or even by private transfer as well as on a stock exchange.

C. Prohibition of Short Sales by Insiders

In dealing with the problem of insider trading, Congress supplemented subsections 16(a) and (b) by prohibiting short sales by insiders. This provision is set forth in subsection 16(c) as follows:

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81. 48 STAT. 896 (1934), 15 U.S.C. § 78p(b) (1952).

"It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer [other than an exempted security], if the person selling the security or his principal (1) does not own the security sold, or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause him undue inconvenience or expense."⁸²

Clause (1) relates to ordinary short sales. Clause (2) is intended to prevent "sales against the box," *i.e.*, transactions by possessors of inside information whereby they sell their holdings, but keep the stock registered in their names so that their changes of position do not become known until delivery is made at a later date.⁸³

The insider trader provisions of section 17 of the Public Utility Holding Company Act⁸⁴ are comparable to those of section 16 of the Exchange Act, but section 17 does not apply to ten-percenters, and it does not prohibit short sales by insiders; it is not, however, confined to equity securities. Related to these two sections is section 30(f) of the Investment Company Act which regulates insider trading in any securities issued by a registered closed-end investment company.⁸⁵

D. SEC Proxy Rules

In the case of most of the larger American corporations the ownership of voting shares is held in comparatively small blocks by a vast number of shareholders scattered over a wide geographical area. Under these conditions the factors of expense, inconvenience and inertia combine to dissuade all but a handful of shareholders from attending shareholders' meetings in person; without provision for voting by proxy even a quorum is unattainable. In these large-scale corporations the practice has developed of management soliciting the shareholders to appoint as their proxies one or more persons designated by management. Almost invariably enough shareholders sign these printed "management" proxies and return them to the corporation in the conveniently enclosed addressed and stamped envelope, so that management exercises a majority of the voting power and thus controls the

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82. 48 STAT. 897 (1934), 15 U.S.C. § 78p(c) (1952).

83. See H.R. REP. No. 1383, 73d Cong., 2d Sess. 25 (1934).

84. 49 STAT. 830 (1935), 15 U.S.C. § 79q (1952).

85. 54 STAT. 836 (1940), 15 U.S.C. § 80a-29(f) (1952).

forthcoming "shareholders" meeting. In many instances those responding to such proxy solicitation have practically no idea of what matters management will bring before the meeting or of how management will exercise its proxy voting power. This use of the proxy machinery has thus given rise to management rather than stockholder control of the most influential corporations, and the resulting decline in corporate democracy has become a matter of congressional concern.

At first sight there might appear to be no connection between regulation of the over-the-counter securities market and regulation of management solicitation of shareholders' proxies. But here again Congress and the Commission have utilized the disclosure philosophy, and curtailment of illicit insider trading has been an interesting by-product. Section 14(a) of the Exchange Act states that

"It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."⁸⁶

Comparable provisions are to be found in section 12(e) of the Public Utility Holding Company Act⁸⁷ and section 20(a) of the Investment Company Act.⁸⁸

The proxy rules promulgated by the Commission require that each person solicited must be or have been furnished with a written proxy statement containing various specified items of information. Copies of these proxy statements must be filed with the Commission. In connection with the election of directors the proxy statement must reveal the securities of the corporation held by each nominee, and every person solicited by management must receive an annual report containing financial statements that adequately reflect the financial position and operations of the corporation. Moreover, if proxies are solicited with respect to such matters as merger, consolidation or re-arrangement of the share structure, every solicited shareholder must be supplied with financial statements substantially similar to those which are required in connection with a registration statement. Under varying circumstances, many more items of information are required to be contained

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86. 48 STAT. 895 (1934), 15 U.S.C. § 78n(a) (1952).

87. 49 STAT. 823 (1935), 15 U.S.C. § 791(e) (1952).

88. 54 STAT. 822 (1940), 15 U.S.C. § 80a-20(a) (1952).

in the proxy statements, and all of this data is of value to investors in enabling them to arrive at informed opinions as to the corporation's securities. This proxy literature, unlike registration statements and reports to the Commission, goes directly into the hands of investors. The net result is that a device primarily aimed at securing greater corporate democracy has incidentally narrowed, although by no means eliminated, the opportunities for illicit profit from insider trading. For the same reasons, it would seem desirable to extend the proxy disclosure requirement to all securities subject to federal jurisdiction.

E. Rule X-10B-5

This rule, previously set forth,⁸⁹ specifically declares it to be unlawful for any person, *inter alia*, "to omit to state a material fact necessary in order to make the statements made . . . not misleading" in connection with the purchase or sale of any security.⁹⁰ Accordingly, this rule, too, has an important part in the legislative program for combatting non-disclosure by officers, directors and controlling persons. Violations of the rule have resulted in about a dozen injunction actions by the Commission and a considerable number of private actions for rescission or damages. A corporation buying in its own securities has under this rule a duty to disclose similar to that of an officer, director or controlling person.

The first case holding section 10(b) of the Exchange Act and rule X-10B-5 to be applicable to non-disclosure by an insider was *Kardon v. National Gypsum Co.*⁹¹ In his opinion in this case Chief Judge Kirkpatrick stated: "Under any reasonably liberal construction, these provisions apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction."⁹² In the case of *Speed v. Transamerica Corp.*,⁹³ the court, in arriving at a comparable holding, stated that the rule requiring disclosure by insiders "is an attempt to provide some degree of equalization of bargaining position in order that the minority [shareholders] may exercise an informed judgment in any such transaction."⁹⁴

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89. See text at note 40 *supra*.

90. 17 C.F.R. § 240.15b-5 (Cum. Supp. 1944).

91. 73 F. Supp. 798 (E.D. Pa. 1947).

92. *Id.* at 800.

93. 99 F. Supp. 808 (D. Del. 1951).

94. *Id.* at 829.

Rule X-10B-5 applies not only to transactions on the exchanges and in the over-the-counter market, but also to all transactions in securities between any two persons. If an insider engages in a short-swing transaction, he may subject himself to a dual liability: he may be liable to the corporation under section 16(b) for any resulting profit, and he may be subject to an action by the other party to the transaction under rule X-10B-5 for rescission or damages.

VI. FEDERAL REGULATION OF MALPRACTICES OF BROKERS, DEALERS AND BROKER-DEALERS IN OVER-THE-COUNTER TRANSACTIONS

A. *Registration*

Congress has given the Commission great power over the activities of brokers, dealers and broker-dealers by requiring such persons to register with the Commission as a condition precedent to engaging lawfully in over-the-counter transactions, and authorizing the Commission to revoke registration for violation of its rules and regulations. Section 15 of the Exchange Act⁹⁵ is the key statute. As originally enacted in 1934, it provided for the registration of all brokers or dealers who make or create an over-the-counter market and also for the registration of all such over-the-counter securities; and this section further declared it to be unlawful for brokers and dealers to make or create an over-the-counter market in violation of rules and regulations prescribed by the Commission. This was an effort to assimilate the over-the-counter market to a national securities exchange, and to provide investors with comparable protections. But in 1936, before the Commission had progressed very far, even with the registration of brokers and dealers, section 15 was amended to eliminate the necessity of registering every security for which an over-the-counter market was created, and to substitute a requirement of periodic supplements to registration statements filed under the Securities Act of 1933. This, of course, meant that many over-the-counter securities would be wholly unregistered, and that as to such securities no public source of information might be available to investors. But the 1936 amendment strengthened the section by codifying the rules and regulations of the Commission concerning the registration of brokers and dealers and by clearly establishing the power of the Commission to deny or revoke registration; and section 17 of the Exchange Act was amended to give the Commission power of inspection over registered brokers and dealers. Moreover, by a further amendment of section 15 in 1938 the rule-making power of the Commission was broadened to afford protec-

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95. 48 STAT. 895 (1934), as amended, 15 U.S.C. § 78o (1952).

tion against fictitious quotations in the over-the-counter market and safeguards with respect to financial responsibility of over-the-counter brokers and dealers.

As amended in 1936, section 15(a) provides:

"No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section."⁹⁶

This section is confined to over-the-counter transactions, and a broker need not register if he conducts his business exclusively on a national exchange, either through his own membership or that of another acting as his agent. Most stock exchange firms, however, do some over-the-counter business and hence are registered. If a broker or dealer and his customers are all in the same state, he will be regarded as doing solely an intrastate business and need not register, even though the securities in which he deals may have been issued by corporations not within the state.

The registration requirement applies only to brokers and dealers, and not to traders. A trader resembles a dealer in that he, too, aims to profit from the purchase or sale of securities, but not as a business. He does not handle other people's money or securities; he does not "make a market"; he does not supply market quotations or render incidental investment advice, etc.

B. Denial and Revocation of Registration

Section 15(b) of the Exchange Act authorizes the Commission to deny registration to or to revoke the registration of any broker or dealer if it finds that such denial or revocation is in the public interest, and if such broker or dealer (1) has wilfully included any false or misleading statement as to a material fact in his application for registration, or (2) has been convicted within ten years preceding the filing of any such application, or at any time thereafter, of any felony or misdemeanor involving the purchase or sale of any security or arising out of the conduct of the business of a broker or dealer, or (3) is enjoined by any court from engaging in any conduct or practice in connection with the purchase or sale of any security, or (4) has

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96. 49 STAT. 1377 (1936), 15 U.S.C. § 78o(a) (1952).

wilfully violated any provision of the Securities Act or of the Exchange Act or of any rule or regulation thereunder.⁹⁷

By specific provision in this section a broker or dealer may also be denied registration, or have his registration revoked, if "any partner, officer, director, or branch manager" of, or "any person directly controlling or controlled by," said broker or dealer is himself subject to one of the aforesaid four disqualifications.⁹⁸ The Commission holds that any employee is a controlled person; hence a broker-dealer firm cannot escape responsibility for a subordinate's misconduct even though the firm may not have been specifically aware of his actions. Moreover, if a person whose registration has been revoked *subsequently* becomes employed by another broker or dealer, the latter's registration will be subject to revocation unless prior clearance is obtained from the Commission.

As indicated above, section 15(b) expressly authorizes the Commission to revoke the registration of any broker or dealer who has wilfully violated *any* portion of the Securities Act or the Exchange Act or of the rules and regulations thereunder. This provision in effect enables the Commission, if it so desires, to supersede the courts and to constitute itself a quasi-judicial forum for processing violations of these acts, revocation being a speedier and more decisive penalty than the common-law or statutory remedies that might be invoked through judicial proceedings. This administrative jurisdiction is limited, however, to cases of "willful" violation.

If a person has had registration denied or revoked for a willful violation, he cannot obtain a re-examination of this decision by the simple expedient of filing another application for registration, for the first determination will be regarded by the Commission as having a continuing and conclusive effect. The term "willfully" does not necessarily imply intent to violate the statute or any evil motive. A broker or dealer will be held by the Commission to have acted "willfully" if the proof indicates that he in fact knowingly did the acts with which he is charged, although he may not have appreciated that these acts constituted a statutory violation.

In exercising its authority to act "in the public interest," the Commission may decree a conditional withholding of revocation, conditioned, for example, upon a firm and an individual broker or dealer becoming disassociated. Moreover, in exercising its "public interest" discretion, the Commission has on occasions determined to visit upon a violator some lesser penalty than revocation; it may, for example,

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97. 49 STAT. 1378 (1936), 15 U.S.C. § 78o(b) (1952).

98. *Ibid.*

require merely suspension from membership in a stock exchange or in the National Association of Securities Dealers.

Revocation hearings may be public or private at the discretion of the Commission, but it is the inveterate practice of the Commission to conduct a public hearing if the respondent so requests. The Commission favors public hearings and hence it does not always accede to a respondent's desire for a private hearing.

C. *Withdrawal and Cancellation of Registration*

If a registered broker or dealer files a specified notice with the Commission, he may withdraw his registration. Section 15(b) of the Exchange Act expressly provides for such withdrawal "upon such terms and conditions as the Commission may deem necessary in the public interest or for the protection of investors."⁹⁹ Normally, in the absence of a revocation proceeding, a withdrawal notice becomes effective on the thirtieth day after its filing. But if revocation proceedings are pending against a registered broker or dealer, the Commission may, at its discretion, refuse to permit him to withdraw his registration. An application for registration not as yet acted upon may be withdrawn at any time.

Section 15(b) also authorizes the Commission to cancel a registration or application upon a finding that the registrant or applicant "is no longer in existence or has ceased to do business as a broker or dealer."¹⁰⁰ Except in the case of physical or corporate death, it is not the practice of the Commission to cancel registration by *ex parte* proceedings, although the act does not specifically require notice and opportunity for hearing.

D. *Post-Registration Requirements*

One of the most important controls of the Commission over brokers and dealers is to be found in that portion of section 17(a) of the Exchange Act which requires registered brokers and dealers to keep such accounts and records and to file such reports as the Commission may prescribe.¹⁰¹ This section also authorizes the Commission, by its examiners and other representatives, to make such periodic inspections of these accounts and records as it may deem appropriate. These inspections serve not only to disclose violations, and to familiarize the brokers and dealers with the applicable rules

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99. *Ibid.*

100. *Ibid.*

101. 48 STAT. 897 (1934), as amended, 15 U.S.C. § 78q(a) (1952).

and regulations, but also to bring to the Commission's attention conditions which may indicate a need for new regulations or for amendments of existing rules.

E. Capital Requirements

Although the federal securities legislation does not impose any bonding requirement upon brokers and dealers, the Commission has utilized its authority under section 15(c)(3)¹⁰² to accomplish a related result. The Commission has put into effect a rule that requires brokers and dealers, whether or not registered, to maintain a twenty-to-one ratio between aggregate indebtedness and net capital.¹⁰³ The only exemptions relate to brokers who do not extend credit to customers or who are members of certain specified exchanges whose requirements are, in this respect, more stringent than those of the Commission.

F. Special Anti-Fraud Provisions Applicable to Brokers and Dealers

Misconduct by brokers and dealers was often facilitated by the fact that the customer had no clear understanding as to whether he was doing business with a dealer or being represented by a broker, and also that he had no accurate indication of the extent of the profit or commission accruing to the broker-dealer from the transaction. This situation has been remedied to some degree by applicable provisions of the federal securities legislation and by rules and regulations prescribed by the Commission. Section 11(d)(2) of the Exchange Act makes it unlawful for a broker-dealer to effect a transaction without making a written disclosure to the customer as to whether he is acting as a dealer for his own account or as a broker for either buyer or seller.¹⁰⁴

G. Confirmation Requirement

Under section 15(c)(1) of the Exchange Act the Commission has promulgated a number of rules. One of them, rule X-15C1-4, is the confirmation rule.¹⁰⁵ It requires a written confirmation to be given or sent to the customer at or before the completion of every over-the-counter transaction. The confirmation must not only disclose in which capacity a broker-dealer is acting and for whom, but also, if he is acting as a broker, it must set forth the amount and source of his commission, the name of the person buying from or selling to the customer, and the

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102. 52 STAT. 1075 (1938), 15 U.S.C. § 78o(c)(3) (1952).

103. 17 C.F.R. § 240.15c3-1 (Supp. 1944).

104. 48 STAT. 892 (1934), 15 U.S.C. § 78k(d)(2) (1952).

105. 17 C.F.R. § 240.15c-4 (1939).

date and time of the transaction. If the confirmation indicates that the broker-dealer is engaged in the transaction as a principal, *i.e.*, as a dealer, there is no rule explicitly requiring him to disclose the amount and source of his profit. But one may not escape the status of a fiduciary by merely declaring himself to be a principal, and an excessive profit of a dealer (or commission of a broker), even though disclosed, may be actionable as a violation of a fiduciary standard.

H. "Churning"

The general anti-fraud provisions, as indicated heretofore,¹⁰⁶ are section 17(a) of the Securities Act,¹⁰⁷ rule X-10B-5¹⁰⁸ under section 10(b) of the Exchange Act,¹⁰⁹ and section 15(c)(1) of the Exchange Act.¹¹⁰ These provisions are particularly applicable to misconduct by brokers and dealers, and most of the regulations aimed at curbing the major temptations of broker-dealers stem from these provisions and the rules developed thereunder. For example, in the case of a discretionary account a broker may be tempted to augment his commissions by "churning" the account, *i.e.*, buying and selling securities for the account more frequently than exclusive concern for the customer's interests would justify. Rule X-15C1-7 seeks to check this by providing that transactions for a discretionary account may not be "excessive in size or frequency in view of the financial resources and character" of the account.¹¹¹ "Churning" is not limited to discretionary accounts; it may occur whenever a customer is accustomed to follow a broker's or dealer's suggestions, and the latter induce him to engage in excessive trading. Such procedure, while not expressly covered by rule X-15C1-7, is a violation of section 17(a)(3) of the Securities Act¹¹² and also of rule X-15C1-2, which defines "manipulative, deceptive, or other fraudulent device or contrivances"¹¹³ as used in section 15(c)(1) of the Exchange Act.¹¹⁴

J. Excessive Spreads

Probably the major temptation with which a dealer is beset is that of seeking an unreasonable profit from an over-the-counter trans-

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106. See pages 13-16 *supra*.

107. 48 STAT. 897 (1934), as amended, 15 U.S.C. § 78q(a) (1952).

108. 17 C.F.R. § 240.10b-5 (Cum. Supp. 1944).

109. 48 STAT. 891 (1934), 15 U.S.C. § 78j(b) (1952).

110. 48 STAT. 895 (1934), 15 U.S.C. § 78o(c)(1) (1952).

111. 17 C.F.R. § 240.15c-7 (1939).

112. 48 STAT. 85 (1933), 15 U.S.C. § 77q(a)(3) (1952).

113. 17 C.F.R. § 240.15c-2 (1939).

114. 48 STAT. 895 (1934), 15 U.S.C. § 78o(c)(1) (1952).

action. In deciding the case of *Duker v. Duker*,¹¹⁵ a revocation proceeding, the Commission evolved the principle that it is a fraud on the part of a dealer to consummate a transaction with a customer at a price not reasonably related to the current market. This has come to be known as the "shingle" theory, because it is based upon the idea that when a dealer hangs out his shingle he impliedly represents that he will not impose upon the public, even in those transactions where technically he is acting "at arm's length" and not as an agent or broker. The theory assumes, furthermore, that one of the details of this implied representation is that the dealer's prices will approximate the current market unless he unmistakably indicates that this is not so.

This doctrine was upheld in 1943 by the Court of Appeals, Second Circuit, in the case of *Charles Hughes & Co. v. SEC.*¹¹⁶ In this case the court affirmed an order of the Commission revoking the petitioner's registration as a broker and dealer, on the ground that petitioner had wrongfully sold securities to customers at prices ranging from sixteen to forty-one per cent above the market price at which petitioner subsequently bought the securities for delivery to the customers. This was held to be a willful violation of section 15(c)(1) of the Exchange Act and section 17(a) of the Securities Act. In reaching its decision the court said:

"An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those which petitioner charged here must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level. Even considering petitioner as a principal in a simple vendor-purchaser transaction (and there is doubt whether, in several instances at least, petitioner was actually not acting as broker-agent for the purchasers, in which case all undisclosed profits would be forfeited), it was still under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions. The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in its customers. Once that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device. When nothing was said about market price, the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. . . . The essential objective of securities legislation is to protect those who do not know market conditions from the

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115. 6 S.E.C. 386 (1939).

116. 139 F.2d 434 (2d Cir. 1943).

overreachings of those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities.”¹¹⁷

If a dealer does not have in his portfolio the securities his customer desires to purchase, he may buy them at the market from another dealer and then resell them to the customer at a profit. So long as this spread is reasonable in relation to the current market, the “shingle” theory is not violated. The important question is how great may this spread legitimately be. A 1943 survey conducted by the National Association of Securities Dealers revealed that in seventy-one per cent of the over-the-counter transactions of its members the gross spread has not exceeded five per cent. But in determining “reasonableness” of spread, consideration should be given not only to the results of this survey but also to such factors as market activity of the security in question, price range, and total monetary size of the transaction.

A dealer who is also in the business of an investment adviser is held to a higher fiduciary standard than that discussed above in relation to a dealer who counsels his customers merely as an incident of his business as a dealer. The dealer-investment adviser, although avowedly acting as a principal, has placed himself in a position of trust and confidence in relation to his customer, and is therefore subjected to a stricter obligation than merely to avoid taking a price that is not reasonably related to the current market price. He must make a full and complete disclosure of every item in the transaction that relates to the fact that his interest is adverse to that of his customer. In 1949 the Court of Appeals of the District of Columbia ratified this doctrine in the case of *Hughes v. SEC.*¹¹⁸

The *Hughes* case involved an appeal by petitioner from an order of the Commission revoking her registration as a broker-dealer. She was also registered as an investment adviser under the Investment Advisers Act,¹¹⁹ and had about 175 clients to whom she sold advice or “service” pursuant to a schedule or rates and charges. When a client placed a buying order with petitioner, she filled it either by supplying the security from her own inventory or by purchasing it for her own account and then as a principal selling it to the client. The Commission ruled that she had willfully violated the general anti-fraud provisions of the Securities Act and of the Exchange Act by not “fully disclosing to such clients the nature and extent of her adverse interest, including, among other things, (1) the best price at which such securities could

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117. *Id.* at 436-37.

118. 174 F.2d 969 (2d Cir. 1949).

119. 54 STAT. 850 (1940), 15 U.S.C. § 80b-3c (1952).

be purchased for such clients in the open market in the exercise of reasonable diligence, and (2) the cost to registrant of the securities sold to such clients.”¹²⁰ In affirming the Commission’s order the court, after referring to the statutory provisions making unlawful “any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading,” said:

“These quoted words as they appear in the statute can only mean that Congress forbid not only the telling of purposeful falsity but also the telling of half-truths and the failure to tell the ‘whole truth.’ These statutory words were obviously designed to protect the investing public as a whole whether the individual investors be suspicious or unsuspecting. The best price currently obtainable in the open market and the cost to registrant are both material facts within the meaning of the above-quoted language and they are both factors without which informed consent to a fiduciary’s acting in a dual and conflicting role is impossible. . . . It is not enough that one who acts as an admitted fiduciary proclaim that he or she stands ever ready to divulge material facts to the ones whose interest she is being paid to protect. Some knowledge is prerequisite to intelligent questioning. This is particularly true in the securities field. Readiness and willingness to disclose are not equivalent to disclosure. The statutes and rules discussed above make it unlawful to omit to state material facts irrespective of alleged [or proven] willingness or readiness to supply that which has been omitted.”¹²¹

A general anti-fraud provision, modelled after section 17(a) of the Securities Act but applicable specifically to investment advisers, is set forth in section 206 of the Investment Advisers Act.¹²² This act also requires registration with the Commission by persons who are engaged in the business of selling advice, reports, or analyses concerning securities.¹²³

VII. SELF-REGULATION OF THE OVER-THE-COUNTER SECURITIES MARKET (HEREIN OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS)

In requiring registration of new securities to be offered to the public, and in regulating stock exchanges and their members, Congress obliquely affected the over-the-counter market to the extent that listed securities are traded over the counter and that stock exchange firms

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120. 174 F.2d at 971.

121. *Id.* at 976.

122. 54 STAT. 852 (1940), 15 U.S.C. § 80b-6 (1952).

123. 54 STAT. 850 (1940), 15 U.S.C. § 80b-3 (1952).

engage in over-the-counter transactions. But aside from the previously discussed statutory provisions for the registration of broker-dealers and for combatting fraud, there have been only a few items of federal legislation *directly* affecting the conduct of the over-the-counter market. Thus far the national policy has been in general to minimize direct statutory intervention with respect to over-the-counter operations and to encourage supervised self-regulation.

The business ethics of those who engage in stock exchange transactions are regulated to a considerable degree by the national stock exchanges. Moreover, in two important respects the Exchange Act supplements such regulation: section 6(b) provides that an exchange may not register with the Commission if it has not adopted rules providing for "the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade";¹²⁴ section 19(a)(3) authorizes the Commission to suspend or expel from an exchange any member or officer thereof who violates the act or the Commission's rules.¹²⁵ But the original Exchange Act, as enacted in 1934, gave the Commission no comparable power in relation to the over-the-counter market, and although the act was materially amended in 1936, it was not until enactment of section 15A (the Maloney Act) in 1938¹²⁶ that the Commission acquired specific power to combat unethical practices in the over-the-counter market.

After enactment of the National Industrial Recovery Act, over-the-counter brokers and dealers began to organize for self-regulation and a Code of Fair Competition applicable to them, although primarily for investment bankers, was evolved, and approved by President Roosevelt in November of 1933. Although this development was halted by the Supreme Court's determination in 1935 that NIRA was unconstitutional,¹²⁷ these first steps towards self-regulation were not wasted. Birth of an organization to aid in policing the industry was impeded by fear of violation of the anti-trust statutes. But unofficial committees were active and effective in settling disputes within the industry by arbitration and mediation. These efforts at self-regulation finally culminated in the enactment of section 15A of the Exchange Act, effective in June of 1938.

A. Section 15A of the Exchange Act

The primary purpose of section 15A is to provide for the establishment of a mechanism for more direct and effective regulation of brokers

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124. 48 STAT. 886 (1934), 15 U.S.C. § 78f (1952).

125. 48 STAT. 898 (1934), 15 U.S.C. § 78s (1952).

126. 52 STAT. 1070 (1938), 15 U.S.C. § 78o-3 (1952).

127. *Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935).

and dealers than the registration provisions of the Exchange Act supply. As section 15A is extremely comprehensive and detailed, considerations of space bar its verbatim inclusion in this Article. But its substance is so vital to the matter under discussion that its major provisions must at least be summarized. At the outset section 15A states that "Any association of brokers or dealers may be registered with the Commission as a national securities association,"¹²⁸ under terms and conditions thereafter provided. To be eligible for registration an association's rules must admit to membership *any* reputable broker or dealer who uses instrumentalities of interstate commerce to engage in an over-the-counter securities business, unless the Commission gives the association permission to confine its membership on a geographical, type of business, or other basis specified by the Commission. Moreover, the rules of the association must assure internal democracy in the administration of its affairs, must in enumerated respects promote just and equitable principles of trade, and must provide that pursuant to a fair procedure its members shall be appropriately disciplined for violation of its rules. The section also authorizes the Commission to review the action of any registered association in disciplining a member or in refusing admission to a broker or dealer seeking membership, and the Commission is empowered to modify or set aside the action of the association.

One of the most important portions is subsection (i)(1) which authorizes a registered association to prohibit a member from dealing with any non-member "except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such members accorded to the general public."¹²⁹ The consequence is that members may grant dealers' discounts, allowances, commissions or special terms only to other members, and thus from a practical standpoint over-the-counter brokers and dealers find membership in a registered association to be virtually mandatory.

Not only is a registered securities association required to supply the Commission with detailed information as to itself at the time of registration, but it is also obligated to keep this information up to date by periodic supplements filed with the Commission. For example, the Commission must be notified of any change in the rules of a registered securities association. The Commission may overrule the proposed change by entering an order disapproving thereof, but if it takes no such action, the proposed rule will automatically take effect on the thirtieth day after being filed with the Commission. The Commission

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128. 52 STAT. 1070 (1938), 15 U.S.C. § 78o-3 (1952).

129. 52 STAT. 1073 (1938), 15 U.S.C. § 78o-3 (1952).

may, however, subsequently abrogate any rule of a registered securities association, if after an appropriate hearing it appears to the Commission that such abrogation is necessary to protect investors or otherwise to insure fair dealing. The Commission may furthermore compel a registered securities association to adopt any specified alteration of or supplement to its rules that appears to the Commission to be necessary or appropriate in the public interest, provided such rule relates to (1) the denial of membership or the disciplining of members, (2) the method of amending the association's rules, (3) the method of choosing officers and directors, and (4) affiliation between registered securities associations.

Finally, section 15A empowers the Commission, after appropriate hearing, (1) to suspend or revoke the registration of a registered securities association for conduct tending to defeat the purposes of the section, (2) to suspend or expel any member from a registered securities association for violation of the statute or any rules or regulations thereunder, and (3) to remove from office any officer or director of a registered securities association who willfully refuses to enforce the rules of the association or who abuses his authority.

The primary purpose of the Maloney Act (section 15A) was to encourage over-the-counter brokers and dealers to form one or more associations through which they might engage in effective self-regulation comparable to the self-regulation of members of organized exchanges, subject only to a degree of governmental supervision in the public interest.

B. The National Association of Securities Dealers

Whatever may have been the expectation of Congress, the fact remains that since the enactment of section 15A only one securities association has registered with the Commission. This is the National Association of Securities Dealers, Inc., more familiarly known as the NASD, whose application for registration was accepted by the Commission in August, 1938.

The NASD is a private non-profit corporation incorporated in Delaware. Its certificate of incorporation states "the nature of the business or objects or purposes to be transacted are to promote through cooperative enterprise the investment banking business, to standardize its principles and practices, to promote therein high standards of commercial honor and to encourage and promote among members the observance of federal and state securities laws." Membership is open to any broker or dealer authorized to transact an investment banking or a securities business under state and federal laws. The current member-

ship of the NASD includes approximately ninety-five per cent of all eligible dealers and brokers. The management of the association is vested in a board of governors elected by the members. This board has wide powers especially in relation to the adoption, amendment and interpretation of rules and the disciplining of members.

The NASD is nation-wide in scope, and for purposes of administration the country is divided into fourteen districts similar to those of the Federal Reserve System. Each district, although represented on the national board of governors, has considerable regional autonomy. For example, each district may adopt local rules so long as they are not in conflict with the rules of the national association, and in each district there is a business conduct committee which has original jurisdiction of complaints originating in its area. Such proceedings must, however, be conducted pursuant to a code of procedure adopted by the national board of governors and insuring a fair hearing.

A significant activity of the NASD is the establishment and enforcement of rules of fair practice relating to the professional conduct of its members. The rules that most frequently invoke disciplinary proceedings are 1, 4 and 19. Rule 1 is very general in its terms: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."¹³⁰ Rule 4 requires that a member shall buy or sell at a fair price in relation to the market at the time of the transaction.¹³¹ Rule 19 concerns the use of a customer's securities or funds, and provides:

"(a) No member shall make improper use of a customer's securities or funds. (b) No member shall lend, either to himself or to others, securities of any customer unless such member shall first have obtained a separate written authorization from such customer permitting the lending of securities held for his account by such member. (c) No agreement between a member and a customer authorizing the member to pledge securities carried for the account of the customer either alone or with other securities, either for the amount due thereon or for a greater amount, shall justify the member in pledging more of such securities than is fair and reasonable in view of the indebtedness of said customer to said member."¹³²

In each district there is a District Business Conduct Committee composed of not more than twelve members. These committees,

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130. NATIONAL ASSOCIATION OF SECURITIES DEALERS, RULES OF FAIR PRACTICE rule 1 (1939).

131. *Id.* 4.

132. *Id.* 19.

augmented by Local Business Conduct Committees, are the agency by which the Association's rules of fair practice are administered and enforced. Any person (not necessarily a member of the Association) may file a complaint with an appropriate committee, or a committee may institute a complaint on its own motion. A copy of the complaint is sent to the respondent which he is required to answer. If either the complainant, the respondent, or the committee so desire, a hearing will be held at which complainant and respondent may appear in person or by counsel and present relevant testimony. If the committee concludes that the respondent has violated one or more of the rules, the sanctions to which it may resort are various: It may be content to accept from the respondent a pledge of future compliance; it may censure or fine him; or it may suspend or expel him from the Association. In any event, the judgment of the committee is subject to review by the board of governors, which may either decrease or increase the severity of the penalty. Moreover, section 15A of the Securities Exchange Act authorizes either the complainant or the respondent to apply to the SEC for review of any disciplinary action approved by the board of governors. Such appeals, however, have been very infrequent. Decisions of the Commission are, of course, subject to judicial review.

This joint responsibility of the NASD and the SEC for policing the over-the-counter market is heightened by the fact that the Commission has original jurisdiction to determine the eligibility of certain applicants for membership in the Association, and that it can, on its own initiative, bring about the termination of a dealer's membership in the Association. Moreover, exercise by the Commission of its power to revoke the registration of a broker-dealer with the SEC will automatically end his eligibility for membership in the NASD.

One of the most difficult problems faced by the Association is the matter of mark-ups: What constitutes a fair profit or spread on transactions with the public investor which are not made as part of a public offering or underwriting? On the basis of the results of a questionnaire and of years of experience, the board of governors indicated in 1943 that mark-ups in excess of five per cent would be regarded unfavorably in the absence of special, justifying circumstances. In May of 1949 the Board issued a statement indicating that the five per cent policy was not applicable to sales in which the member fully and fairly disclosed, by way of prospectus or otherwise, the mark-up to his customer. The board added that "A reasonable relationship of price to customer to the current market is, of course, assumed."¹³³

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133. NASD News, June 1949, p. 2.

In each of the fourteen districts the Association engages in periodic spot-checks of the records of its members in order to ascertain financial condition, methods of doing business, and possible violations of the Association's rules. This may be undertaken either through visitation by an examiner or field secretary, or by questionnaire at times followed by verifying check-up by an accountant.

VIII. CONCLUSION

The free enterprise system operates through a nation-wide bargaining process, and one of the functions of government is to maintain this process. There is a marked disparity of bargaining power between the average investor in securities on the one hand and professional brokers and dealers and corporate officials and insiders on the other. Justification for governmental regulation of the securities markets is based mainly upon this fact.

The present federal program of securities legislation is consistent with the preservation of the free enterprise system, because Congress has not sought to supersede the bargaining process by dictating to buyers and sellers of securities the terms of their transactions. The effort of Congress has been principally to bring about greater equality of bargaining power. To achieve this, Congress has relied primarily upon enforced publicity of the facts, knowledge of which is requisite to bargaining equality. Secondarily, Congress has sought to protect the investor by recognizing the activities of brokers and dealers as having the ethical standards and obligations of a profession, thereby virtually eliminating the concept of an "arm's length" transaction between broker-dealer and customer. Thus, it is only the standards attending the bargaining process and not the terms of the consummated transaction that Congress has sought to influence, a proper exercise of governmental power within the framework of a capitalist democracy.

These forms of federal regulation are a marked improvement over the situation as it obtained under the common law and the "Blue Sky" laws. But there are still areas of the over-the-counter securities market where equality of bargaining power has not been achieved.

A. Inadequacy of Disclosure Requirements

The disclosure requirements embodied in the SEC statutes fall far short of an adequate program of public information about securities such as would render misrepresentation virtually futile. It is only in connection with public offerings of new securities that the SEC can elicit information under section 5 of the Securities Act—and within

this narrow area there are many exemptions. Even large corporations can readily avoid the impact of section 5 by obtaining additional working capital through bank loans, undistributed earnings, or private placement of new securities, rather than through public offerings.

Information gleaned through the operation of section 12(a) of the Exchange Act is confined to securities listed on a national securities exchange. It must not be overlooked that the listing of a security on an exchange and registration by the issuer under this section are entirely voluntary. Many corporations prefer to forego having their securities traded on an exchange rather than to comply with the listing and registration requirements. Other companies are too small, too unsound, or their securities are too inactive to be acceptable by an exchange for listing. All such securities may be traded over the counter, and section 12(a) furnishes no source of information to the unwary purchaser.

Similarly, the proxy solicitation provisions of section 14(a) of the Exchange Act are applicable only to securities registered on a national exchange; and issuers can conceivably avoid the necessity of supplying stockholders with the stipulated information by the device of not soliciting proxies.

Both listed and unlisted securities are traded over the counter, but with the exception of government bonds, which in any event are exempted from the federal securities legislation, the great bulk of over-the-counter transactions is in unlisted securities. Hence the disclosure philosophy embodied in the federal program of securities legislation has failed to serve as a complete antidote to misrepresentation in the over-the-counter securities market. Unless the registration, reporting, and proxy requirements are extended to all securities within the jurisdiction of the federal government, the effort to check misrepresentation by enforced dissemination of pertinent information will continue to be to some extent ineffectual.

B. Shortcomings of the Anti-Fraud Provisions

The concept of a legal right is illusory unless it is accompanied by an effective remedy. Similarly, the significance of the declaration of a duty depends upon the character of the sanctions that may be invoked if the duty is transgressed. In endeavoring to cope with malpractices in securities transactions, the most effective portions of the SEC statutes have been the anti-fraud provisions. But even here there is room for improvement.

The most important sanction against fraud is the imposition of civil liability upon the wrongdoer. If, however, a defrauded purchaser

elects to seek rescission under section 12(2) of the Securities Act, rather than at common law, he encounters some disadvantages. The seller's statutory right to defend on the ground of lack of awareness of his misrepresentation or omission practically limits the purchaser's cause of action to *intentional* deceits by the seller, which was not the case at common law. Moreover, even as to intentional misrepresentations the statute requires the plaintiff buyer to prove their *materiality*, a burden that the common law did not impose upon him. Furthermore, section 13 of the Securities Act establishes a shorter period of limitation (one year after discovery of the wrong or three years after the purchase, whichever occurs sooner) than that applicable to a common-law action for rescission.

Sections 9(c) and 18 of the Exchange Act impose upon the plaintiff the almost impossible task of showing that the price he paid or received for the security was "affected" by the defendant's misrepresentation, and for this reason the civil liability provisions of these sections are seldom invoked.

The SEC statutes should be amended so as to broaden the civil liability provisions and expressly to include civil liability as a remedy in all appropriate situations, thus eliminating the necessity of relying on a judicial holding of implied civil liability.

C. Stabilization

Many courts have held that stabilization is legal if its purpose is in fact to provide support against unusual market conditions in a sincere effort to protect the interests of shareholders and investors. But this is not necessarily a sound doctrine. To create a false impression as to the degree of real interest in a security is a form of deception, regardless of sincerity of purpose. Alleged stabilization may be used to disguise illicit manipulation. Moreover, stabilization, if unsuccessful, may magnify loss to investors. That a given offering of new securities may prove initially unpopular or "sticky" is a risk inherent in the business of underwriting, and the law should not condone efforts to avoid this risk by creating an unreal appearance of demand for the security at the expense of unsuspecting investors thus induced to pay artificially inflated prices. The Commission should re-examine and reconsider its present exercise of the power that Congress has given it to regulate or prohibit stabilization.

D. Broker-Dealers

The functions of broker and dealer are usually combined in the same person or firm. There are many sound arguments in favor of

the retention of this practice, but there are also some dangers to investors inherent in the combination. Effective measures must be found for counteracting these dangers without requiring complete separation of the businesses of broker and dealer. This is not an easy task but it can be done, and it would be preferable for it to be done through self-regulation by the industry rather than by governmental decree. But one way or another it must be accomplished, if the goal of substantial equality of bargaining power in the over-the-counter securities market is to be achieved.