CUSTOMER PROTECTION UNDER THE FEDERAL SECURITIES LAWS

A Report to the Inter-Agency Task Force

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Prepared by the staff of the Securities and Exchange Commission

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Foreword

In early January 1979, the General Counsel of the Treasury Department asked the Policy Group on Financial Instrument Futures ("Policy Group") to undertake a study to compare and contrast the regulatory objectives and programs in the securities area, as administered by the SEC and the FRB, with those in the commodity futures area, as administered by the CFTC. Several preliminary meetings of staff members of the four interested agencies (Treasury, FRB, SEC and CFTC) who had been asked to work on the study were thereafter held to discuss the nature of the study. It was then agreed at a meeting of the Policy Group in late June that, as an initial step, the staff would prepare working papers outlining the various regulatory requirements relating to customer protection, margin, and reporting and recordkeeping requirements applicable to securities options and commodities futures.

These initial papers were to be used as a basis for a second phase of the study which would consist of a comparative analysis of the regulatory schemes described in the papers. The objectives of the subsequent analysis would be to determine whether there were material differences in the regulatory schemes, whether the differences were significant in terms of capital allocation decisions of market professionals and investors, whether any significant differences found could be justified on public policy grounds, and whether and to what extent the two regulatory schemes could be better coordinated to avoid undesirable regulatory gaps or unnecessary duplication of effort. To aid the analysis respecting coordination of efforts, the staffs were also asked to prepare a paper describing the various enforcement and surveillance programs of the CFTC and SEC.

The SEC staff was asked to prepare the initial paper on customer protection and reporting and recordkeeping in the securities options area. Following is the product of that effort. A paper on surveillance and enforcement systems is being prepared and will be submitted separately.

In planning the carrying out of our assignment, we made several decisions as to the nature and scope of our report which should be noted at the outset.

First, we have not attempted to present the pertinent provisions of the federal securities laws and regulations in depth. 1/ However, in the course of our general review of those laws and regulations we did attempt to locate situations where, based on our less thorough acquaintanceship with the realm of futures, it appeared that important similarities or differences between regulatory schemes were likely to reside. Such situations, when we found them, are highlighted, but by no means exhaustively treated, in this report.

In light of the purposes of this study, as indicated at the June meeting of the Policy Group, we have also not attemped to deal with a very substantial number of securities regulatory requirements not impacting directly on the relationship between the retail broker and his public customer. This means

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1/ Earlier this year, the Commission published the Report of the Special Study of the Options Markets (herein "the Options Study") to the Commission (see House Committee on Interstate and Foreign Commerce, Committee Print 96-IFC3, 96th Congress, 1st Session, (December 22, 1978)). We have attempted to refer to that report in this paper, where pertinent. As of this writing, a task force composed of representatives of exchanges trading options, the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD") ("the SRO task force") is reviewing and working on proposals to implement many of those recommendations. A summary of the Study's recommendations and the Commission's preliminary views on that report can be found in Securities Exchange Act Release No. 15575 (February 22, 1979), 16 SEC Docket No. 17, at pp. 1163-1175. References herein to those recommendations are denoted by their assigned numbers in that release.

that such subjects as specialist-market maker regulation, priority and precedence of orders, last sale and quotation dissemination, market manipulation (except peripherally), and other largely market center-related matters are not treated here. 2/

On the other hand, in approaching the subjects designated at the June meeting as germane for this phase, it became clear to us that in order to place the statutory and rule provisions in their proper perspective, particularly for purposes of aiding future analysis, it was necessary to go beyond a mere recitation of those provisions. Accordingly, this paper includes brief statements of some of the principal assumptions and underlying concepts, as reflected in legislative history, of the federal securities laws which seemed particularly pertinent here. In addition, the nature and scope of particular provisions which are set out in very broad terms, such as the anti-fraud provisions, can only be fully grasped by an examination of the case law applying those provisions to specific kinds of factual situations. For that reason, the discussions of those types of provisions in this paper include major principles and standards of professional behavior derived from those sources.

2/ Their inclusion obviously would have lengthened this paper considerably. In addition, we have omitted discussion of the (1) functions of clearing agencies and the Muncipal Securities Rulemaking Board as self-regulatory organizations; and (2) the activities and regulation of clearing agencies (except as "issuer" of listed options) and transfer agents, as such.

The area of financial responsibility regulation (i.e. the net capital rules) has been the subject of intensive SEC-CFTC coordinating efforts during the past year and substantial strides have already been made toward harmonizing the relevant rules. A separate paper summarizing the results of that work is in preparation and will be furnished shortly.

I. Regulatory Philosophy

As the Supreme Court has noted, a fundamental purpose of the the Securities Act of 1933 and its companion legislative enactments is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor." 3/ Underlying this change in the standards governing the relationship of securities buyers and sellers was the Congressional desire to restore investor confidence following the market collapse of 1929. 4/ The essential theme therefore is investor protection. This objective also is to be accomplished by providing, through one of the companion enactments (the Securities Exchange Act of 1934), "fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors . . . and to provide, to the maximum degree practicable, markets that are open and orderly." 5/

A further fundamental ingredient was added to the federal regulatory philosophy by the 1934 Act — the idea of self-regulation and its underlying premise, the need for securities industry professionalism. 6/ In advocating

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3/ Securities and Exchange Commission v. Capital Gains Bureau, Inc., 375 U.S. 180, 186 (1963).

4/ See, Loss, Securities Regulation 119-128(1961).

5/ Conference Report, H.R. Rep. No. 94-229, 94th Cong., 1st Session (1975) 91-2. The special problems of regulation in this field were exacerbated by the circumstance, recognized at the very beginning, that securities were "intricate merchandise." H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933)8. As we will observe below, this circumstance is of particular importance in connection with options.

6/ See, generally, Report of the Special Study of the Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. (1963), Pt. 1, Chap. III.A.

passage of the 1938 amendments to that Act — i.e., the amendments which led to the creation of the National Association of Securities Dealers, Inc. ("NASD") in the following year — William O. Douglas, then SEC Chairman, expressed this philosophy as follows: 7/

> Quite clearly the protection of the investor and the public generally requires that the important segment of the financial life of the country represented in the over-the-counter markets must be placed on a highly professionalized plane. It is essential to protect the investor and constructive element in the business alike from the unfair competitive practices of those who do not seem to realize that one who handles the funds of the public is a fiduciary and under a duty to act with the highest good faith . . .
>
> Perfection of a regulatory process of the required scope can conceivably be accomplished in two ways. The first and most obvious method would be to expand our present licensing process for brokers and dealers to include a proscription not only of the dishonest but also of those unwilling or unable to conform to rigid standards of financial responsibility, professional conduct and technical proficiency . . . The prospect of such an undertaking is no more agreeable to our Commission than to the brokers and dealers of the country . . .
>
> But there is, I think, a preferable course of action. I refer to effective self-government among the brokers and dealers of the country . . . I mean groups organized under federal auspices and operated under federal supervision with ample contractual powers over members to enable them to take a hand in enforcing the law . . . The pattern is simply that provided by Congress for the exchanges in the Securities Exchange Act of 1934. . .
>
> By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach.

7/ Address before the Bond Club of Hartford, Conn. (Jan. 7, 1938).

II. Statutory Framework

A series of statutes, four of which are of particular significance here, were enacted to prescribe the means for carrying out the above regulatory philosophy. 8/ The resulting regulatory framework is summarized, in the chronological sequence of those enactments, in the succeeding sections.

It will be noted that, as with many such regulatory statutes, each of the relevant federal securities laws has the following elements;

(1) A recitation of substantive standards of conduct and/or the provision of administrative rulemaking authority to further define those standards.

(2) A prescription of administrative procedures for monitoring compliance with the substantive standards.

(3) A setting out of judicial and quasi-judicial procedures for remedying violations of the standards when detected through the monitoring system or otherwise.

A. The Securities Act of 1933

At the heart of this statute, which has been known historically as the "truth-in-securities" act, is the general requirement that the introduction of securities into commerce, through public sale, be accomplished by the seller's furnishing to the buying investor a contemporaneous written prospectus. 9/ The prospectus is required to disclose affirmatively financial

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8/ The four statutes dealt with in this paper and their respective United States Code citations and Code of Federal Regulations citations for the rules under each act, are listed below:
Securities Act of 1933, 15 U.S.C. 77a-77aa, as amended; 230CFR
Securities Exchange Act of 1934, 15 U.S.C. 78a-78jj, as amended; 240 CFR
Investment Company Act of 1940; 15 U.S.C. 80a-1-80a-52, as amended; 270 CFR
Investment Advisers Act of 1940, 15 U.S.C. 80b-1-80b-21 as amended; 275 CFR
We have not used those citations in this paper, except in Sections B and H of Part III.

9/ Sec. 5(b)(2).

and other significant information relating to the issuer of the security and its business, the plan and purposes of the distribution, and other facts and circumstances that would permit the investor to make an informed judgment as to the merits of the offered investment. 10/ The Act calls for the inclusion of the prospectus (among other disclosure documents) in a registration statement to be filed with the Commission. 11/

No sales can be effected by the distributors of the securities until that registration statement has become "effective" by lapse of a prescribed post-filing period of twenty.days or pursuant to an earlier Commission order accelerating the effective date. 12/ It is also unlawful to offer or sell securities subject to the registration requirements 13/ by use of a prospectus which does not contain the disclosures required by the Act or governing Commission rules. 14/ Additionally, the statute prohibits such offers and sales through use of a prospectus which contains any untrue statement of a material fact or omits to state any material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading. 15/

10/ Sec. 10, Schedule A.

11/ Sec. 10(a)(1).

12/ Sec. 8.

13/ There are a number of exemptions from the registration requirements. See Sec. 3 and 4.

14/ Sec. 5(b).

15/ See, e.g., Sec. 17(a).

While the Act contains considerable detail as to the categories of information which must be set forth in the registration statement and prospectus, 16/ it grants to the Commission broad rulemaking authority (under public interest and protection of investors standards) to prescribe additional or different disclosures, to permit omission of information called for by the Act, and to classify those documents in respect of their form and content according to their use, the nature of the security or issuer, "or otherwise." 17/

These powers are conferred as part of the Commission's overall rulemaking authority under the Act — which has counterparts in the other statutes 18/ — as follows:

> Sec. 19 (a). The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this [Act] . . .

The statute also contains the first federal antifraud provision relating to securities transactions and although limited in scope to protection of the buyer, extends to all communications, including the prospectus, utilized in the offer or sale of securities by interstate facilities, whether or not the sale occurs in connection with a registered offering. 19/

16/ See Schedule A under the Act.

17/ See Sec. 7, 10(a)(4), 10(c), 19.

18/ See Securities Exchange Act Sec. 23(a), Investment Company Act Sec. 38(a); Investment Advisers Act Sec. 211(a).

19/ Section 17(a). These and other general anti-fraud provisions of the federal securities laws are discussed in greater detail in Part III.B. infra.

As will be seen, the coverage of federal antifraud concepts introduced by this provision was greatly expanded in subsequent enactments. 20/

Compliance with these "full disclosure" requirements is accomplished through various statutorily prescribed administrative procedures and judicial and quasi-judicial remedies. First, the registration process, and its associated pre-effective period, is intended to afford the Commission staff an opportunity to review the registration statement and to communicate to the registrant its views concerning any apparent material inaccuracies or omissions in the filed documents, including the proposed prospectus. This gives the registrant an opportunity to amend its filing to conform to applicable requirements.

If the Commission is not successful in these informal efforts or if for any reason it decides (as a discretionary matter) not to pursue them, it has formal statutory authority, after hearing, to issue a refusal or stop order, denying or suspending the effectivness of any registration statement that "includes any untrue statement of material fact . . ." etc. 21/

The Commission may also seek injunctive relief, or through the Attorney General, criminal proceedings, in a federal district court for any conduct made unlawful by the Act or Commission rules under the Act:

> 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 [Act], 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 United States District

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20/ See Part III.B, infra.

21/ Sec. 8(b), (d), (e); see Sec. 5(a).

> Court for 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. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General who may, in his discretion, institute the necessary criminal proceedings under this title. Any such criminal proceeding may be brought either in the district wherein the transmittal of the prospectus or security complained of begins, or in the district wherein such prospectus or security is received. 22/

It is important to bear in mind that while the filing and examination process is expected to contribute to the general reliability of registration disclosures, it does not give positive assurance of the accuracy or completeness of the facts reported. For that reason, the Act provides that it is unlawful to represent to a prospective purchaser that the fact that a registration statement has been filed or is in effect indicates that the statement is true or complete. 23/ Moreover, under the latter section of the Act it is also unlawful to represent that the Commission "has in any way passed upon the merits of the security."

In order to ascertain whether it should pursue any of these administrative and judicial remedies, the Commission is given investigative functions, and in that connection is vested with subpoena power as well as the ability to require written statements, without subpoena, from persons suspected of violating the statute or Commission rules. 24/

22/ Sec. 20(b).

23/ Sec. 23.

24/ Sec. 19(b), 20.

It should also be noted here that provisions in the other federal securities laws afford various additional types of administrative remedies which may be invoked by the Commission to aid in enforcing the 1933 Act as against various kinds of securities professionals. 25/

Finally, the Act affords the investing public various express and implied civil remedies where violations of the law or Commission rules are discovered. These are considered in Section H of Part III below.

B. Securities Exchange Act of 1934

1. Introduction

"Whereas the 1933 act is concerned primarily with the distribution process, the 1934 act has to do with post-distribution trading. It has four basic purposes: to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation's credit which goes into those markets." 26/

It will be noted that the means adopted by Congress to achieve the first two objectives are largely extensions of the basic 1933 Act concepts to the regulation of the so-called "secondary" (trading) markets. As observed previously, the statutory approaches to the realization of the other two objectives, while similarly focused, ultimately, on the public interest in well-functioning capital markets and the protection of investors through

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25/ See, e.g., pp. 22, 30, infra.

26/ 3Loss, Securities Regulation, 130-131 (2nd ed. 1961).

the maintenance of honest markets, contain several elements of a quite different character from those in the 1933 Act. This Act, including its post-1934 amendments, goes beyond improved disclosure about securities being offered and prevention of fraud. It envisions the upgrading and maintenance of high ethical standards applicable to professional participants in their relationships with public investors and with one another. 27/

2. Substantive Standards

More specifically, in the 1934 Act, Congress extended the "full disclosure" doctrine of the 1933 Act to securities listed and registered for trading on national securities exchanges and to equity securities of companies traded on an unlisted basis (e.g., over-the-counter issues) if their assets exceed $1 million and their shareholders number 500 or more. 28/ Under these provisions, issuers are required to file with the Commission, 29/ and (if listed) the exchange where there securities are traded, a registration document similar in content to the 1933 Act registration statement. 30/ Following registration, they must file annual and other periodic reports to keep current the information contained in the original filing. 31/

27/ See pp. 4-5, supra.

28/ Sec. 12(g).

29/ Banks and insurance companies are generally exempt from these requirements because they are subject to similar requirements of other regulators. See Sections 12(g)(2)(G) and 12(i). There are also certain other limited exemptions. See Section 12(g)(2)(C)-(F), (H).

30/ Sec. 12(b), (c).

31/ See, e.g., Sec. 13, which also empowers the Commission to prescribe the form and content of those reports "as necessary or appropriate for the proper protection of investors and to ensure fair dealing in the security." Also, see Sections 13(e) and 14 with respect to disclosure requirements applicable to tender offers and proxy solicitations. The latter two provisions are not discussed here.

Since trading by and between public investors, whether in listed or over-the-counter securities, involves transactions between holders of outstanding securities (not an offer of securities for sale by the issuing company), there is no provision for dissemination of the reported data to investors through use of a prospectus or similar medium. However, the reported information is available for public inspection and reproduction, both at the Commission and the exchanges. It is also used extensively by publishers of securities manuals, securities advisory services, investment advisers, trust departments, brokers and dealers in securities, and similar agencies, and thus obtains widespread dissemination.

The fraud concepts under the 1933 Act were also broadened in certain key respects by the 1934 Act. Section 10(b) of the latter Act was more generally worded to protect any "persons" (including sellers as well as buyers) and gave the Commission direct rulemaking power to define such practices. In addition, Congress added Sections 15(c)(1) and (2) to cover specifically deceptive and manipulative practices of brokers and dealers, with equally broad (and perhaps broader) rulemaking authority vested in the Commission. The Commission's power to "prescribe means reasonably designed to prevent" as well as its power to define such practices was made explicit in the Section 15(c)(2) provisions. 31/

In post-1934 amendments to the Act, 32/ Congress also codified a long-held Commission view that broker-dealers and their supervisory employees may

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31/ See Part III B., infra.

32/ P.L. 88-467, Aug. 20, 1964.

themselves be charged with violations of law committed by persons subject to their supervision if they fail reasonably to supervise such persons. 33/ One may comply with the duty of reasonable supervision if:

(1) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(2) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with. 34/

Under their respective rulemaking (as well as adjudicatory) powers, the Commission and the industry self-regulatory organizations ("SROs") may, of course, spell out the requirements for "such procedures and system". 35/ As will be seen, they have exercised that authority.

Of special significance in the statutory scheme are Sections 9(b) and (c) of the 1934 Act, relating to options trading. Like the antifraud provisions, the standards of conduct depend on the adoption of implementing Commission rules with the statute providing only general guidance as to the content of the rules; but there is even less guidance in the case of Sections 9(b) and (c) where the only specified considerations for rulemaking are the

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33/ See n. 34, infra.

34/ Section 15(b)(4)(E). Under Section 3(a)(39), a violation of this standard is a "statutory disqualification," thus enabling SROs to exclude violators from membership or association with members. See, e.g., Sections 6(c)(2), and 15A(g)(2). While the Act does not directly make such violations subject to the injunctive or criminal provisions, case law seems clear that such liability attaches. See e.g., 3 Loss, Securities Regulation 1476 (1961), and 5 Loss 3374-3377 (1969 Supp.)

35/ See pp. 15-16, infra.

public interest and protection of investors. 36/ There is no delimiting reference to deception or manipulation.

As embodied in the 1934 Act, the Congressional plan to bring about securities industry professionalism is built principally on the idea of self-regulation. That regulation is to be carried out, under government supervision, by self-governing institutions composed of such professionals (i.e., as "members") and equipped with quasi-governmental powers to adopt and enforce standards of member conduct reaching to areas well beyond those (such as the areas of fraud and manipulation) ordinarily dealt with directly by government. Under the Act, these institutions must have rules:

> [D]esigned to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulation, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . 37/

These SROs may also deny membership or association with members to firms and other "persons" who are subject to specified "statutory disqualifications" 38/ or who do not meet "such standards of training, experience and competence" and of "financial responsibility or operational

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36/ It will be noted that, as with some other areas within the Commission's regulatory jurisdiction, it has done little directly to utilize this broad authority to prescribe substantive standards of conduct in the options area, preferring instead to leave the immediate regulatory task to the SROs.

37/ Sec. 6(b)(5) and 15A(b)(6).

38/ Sec. 3(a)(39), 6(c)(2), 15A(g)(2).

capability as are prescribed by the rules of the SRO." 39/

In light of the breadth of these mandates and associated authority given to industry institutions to set norms of member behavior, it is not surprising that the Act also contains a number of safeguards against inappropriate anti-competitive conduct or other misuse of power by the SROs. Among these protections are requirements that SRO rules provide (1) fair procedures for imposing disciplinary sanctions for violations of its conduct rules; 40/ (2) fair representation of the membership in the adoption of rules and in other affairs of the organization; 41/ (3) equitable allocation of dues and fees levied for defraying reasonable expenses of SRO administration. 42/ The Act also requires that regulatory actions of each SRO not erect impediments to free and open markets 43/; permit unfair discrimination between members, issuers, or customers 44/; or "regulate by virtue of any authority conferred by [the Act] matters not related to the purposes of [the Act] . . ." 45/ In a similar vein, the Act prohibits the SROs from imposing "any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]." 46/

39/ Sec. 6(c)(2), 15A(g)(3).

40/ Sec. 6(c)(3), 15A(b).

41/ Sec. 6(b)(7), 6(d), 15A(b)(4), 15A( ).

42/ Sec. 6(b)(4), 15A(b)(5).

43/ Sec. 6(b)(5), 15A(b)(6).

44/ Ibid.

45/ Ibid.

46/ Sec. 6(b)(8), 15A(b)(9). Also, see Sec 6(e), restricting exchanges' fixing of commissions and other charges by members, and Sec. 15A(b)(6), barring registered associations from fixing those charges.

Perhaps more importantly, Congress provided for close oversight by the Commission of virtually all aspects of the self-regulatory process. The Commission is vested with powers, among others, to:

(1) Review, including power of approval or disapproval, proposed SRO rule changes. 47/

(2) Modify or supplement SRO rules. 48/

(3) Review, either on appeal or on the Commission's own motion, SRO disciplinary actions or denials of membership (or association with members) or of access to SRO or member facilities. 49/

All of these powers, in effect, make the Commission an active participant both in the formulation and application of SRO conduct and other standards. In carrying out its functions under (1) and (2), the criterion for Commission action on SRO rules is consistency with the requirements of the Act, which would, of course, include all of the affirmative requirements for such rules (e.g., "in general, to protect investors and the public interest") as well as the safeguards listed previously.

In reviewing SRO disciplinary and other adjudicatory actions, the statute requires the Commission independently to examine the SRO record (which the Commission may, in its discretion, supplement) and to make specific findings with respect to the bases for the sanction or other action taken by the SRO. 50/ This means that if the matter reviewed involves the application of SRO rules, the Commission is not bound by an SRO's interpretation of

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47/ Sec. 19(b).

48/ Sec. 19(c).

49/ Sec. 19(d)-(f).

50/ Sec. 19(e)-(f).

those rules nor does it necessarily afford any special weight to the SRO's interpretation.

3. Enforcement of Standards

The 1934 Act makes extensive use of registration and filing procedures as a primary monitoring tool to help assure compliance with the substantive standards of the Act and the rules thereunder. As previously noted, issuers with securities traded in the markets register those securities and file periodic reports to keep them up-to-date.

In addition, brokers and dealers are required to register with the Commission in order to do an interstate business. 51/ The SROs are to have similar procedures for screening applicants for membership and for association by individuals with members of their respective organizations to determine their compliance with applicable entry qualifications. And the Act empowers the Commission to review SRO determinations respecting the admission of such applicants. 52/

SRO conduct standards are, of course, enforced primarily by the SROs themselves. They also have the responsibility of enforcing the Act and the rules thereunder. The Act provides in this regard that an SRO may not be registered unless the Commission determines that the organization "is so organized and has the capacity to carry out the purposes of [the Act] and to comply, and . . . to enforce compliance by its members and persons

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51/ Sec. 15(a)-(b).

52/ Sec. 19(d), (f).

associated with its members, with the provisions of (the Act)," the rules thereunder, and the rules of the SRO. 53/ Its continuing compliance duties are made explicit in Section 19(g)(1) of the Act. 54/

Although without direct authority to seek the aid of the courts to carry out their enforcement mandates, the SROs are given statutory powers to employ administrative procedures, subject to Commission review, for that purpose. The Act requires each SRO's rules to provide that "its members and persons associated with its members shall be appropriately disciplined for violation of any provision of the act, the rules . . . thereunder, . . . or the rules of the [SRO], by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction." 55/ It is also clear that these enforcement directives, as well as other general powers 56/ contained in the Act, require, and hence authorize, the SROs to maintain appropriate monitoring and investigative systems to detect such violations.

53/ Sec. 6(b)(1), 15A(b)(2).

54/ With respect to the Commission's authority to relieve SROs of particular duties, see Sections 17(d) and 19(g)(2).

55/ Sec. 6(b)(6), 15A(b)(7). Under Section 19(e), the Commission, on review of an SRO disciplinary action may set aside, reduce, or require the remission of the sanction; but it may not increase the sanction. It may, however, institute its own proceeding under Section 15 or pursue other remedies in its "arsenal" (discussed below) if the respondent in the SRO action has violated the federal securities laws or rules thereunder.

56/ See, e.g., n. p. 15, supra.

While the Commission's enforcement arsenal under the 1934 Act also includes quasi-judicial administrative remedies with respect to violative conduct of SRO members, associated persons, as well as non-member professionals, it has a substantially larger variety of available remedies, including quasi-judicial ones, than the SROs.

As under the 1933 Act, the Commission can, with respect to professional and non-professional violators, apply to the courts for injunctive and other equitable relief and refer matters to the Justice Department for criminal prosecution. 57/ The Commission's 1934 Act authority to apply for, and district courts to issue, injunctions is particularly noteworthy. Among other things, the Commission can initiate court enforcement of SRO rules; and it has two ways to go about it. Section 21(e) of the latter Act provides, in pertinent part:

> Upon application of the Commission the district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any territory or other place subject to the jurisdiction of the United States shall also have jurisdiction to issue writs of mandamus, injunctions, and orders commanding (1) any person to comply with the provisions of this [Act], the rules, regulations, and orders thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or person associated with a member, . . . (2) any national securities exchange or registered securities association to enforce compliance by its members and persons associated with its members with the provisions of this [Act], the rules, regulations, and orders thereunder, and the rules of such exchange or association, . . .

57/ Sec. 21(d)-(g).

In short, the Commission can seek the court's aid in obtaining compliance with SRO rules by proceeding against either the member (or associated person) or the SRO, or both. 58/

The 1934 Act also makes available to the Commission certain added administrative remedies. Like the SROs, the Commission may, after hearing, issue orders censuring or suspending or expelling members and their employees from SRO membership or association with a member. 59/ But, in addition, the Commission alone has power to deny, suspend or revoke the broker-dealer registration of a securities firm; 60/ or it may bar individuals (temporarily or permanently) from employment with any registered firm. 61/

Further, in order to assure that SROs and their officials obey their own rules and carry out their enforcement obligations, the Commission may conduct proceedings to:

> (1) censure an SRO, suspend or revoke the registration of an SRO, or impose limitations on an SRO's activities and functions if it finds that the SRO has violated or is unable to comply with its rules, the Act, or rules under the Act, or has failed, without reasonable justification or excuse, to enforce compliance with any of those provisions. 62/

58/ Under Sec. 21(f), the Commission must make certain findings before initiating such court action.

59/ Sec. 19(h)(2)-(3).

60/ Sec. 15(b)(4).

61/ Sec. 15(b)(6).

62/ Sec. 19(h)(1).

(2) censure or remove from office, any (SRO) officer or director that has similarly failed to enforce compliance or has willfully violated the Act, rules under the Act, or the SRO's rules, or willfully abused his authority. 63/

It should be noted that the bases for Commission sanctions against broker-dealers (including SRO members) and their associated persons are largely identical to those of the SROs except that:

(1) the Commission may not base an administrative sanction directly 64/ upon charges of violations of SRO rules; but

(2) the Commission may base such a sanction upon violations of the 1933 Act, the Investment Advisers Act of 1940, or the Investment Company of 1940, and the rules thereunder, as well as the 1934 Act and rules.

The Commission's enforcement tools with respect to securities issues and issuers are also extensive. To protect investors, it may conduct administrative proceedings to deny or withdraw or suspend the exchange or over-the-counter registration under the Act of any security subject to such registration requirements on a finding that the issuer has failed to comply with any provision of the Act or rules thereunder. 65/ And it is unlawful for any broker or dealer to effect or induce any transaction in a security whose registration has been so suspended or revoked. 66/ In addition —

> If in its opinion the public interest and the protection of investors so require, the Commission is authorized summarily to suspend trading in any

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63/ Sec. 19(h)(4).

64/ A court injunction obtained by the Commission based upon SRC rule violations (see p. 20, supra) might form a basis for a proceeding under Section 15(b)(4) or (6).

65/ Sec. 12(j).

66/ Ibid.

> security (other than an exempted security) for a period not exceeding ten days or with the approval of the President, summarily to suspend all trading on any national securities exchange or otherwise, in securities other than exempted securities, for a period not exceeding ninety days. No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in which trading is so suspended. 67/

The Commission also has one further obligation with regard to the enforcement of SRO rules. In the case of exchange listed securities, the Commission, upon application of the exchange or an issuer whose securities are listed on the exchange, is required to order the delisting of any such security if the Commission finds that such action is in accordance with exchange rules concerning delistings. 68/ This function, together with its powers over exchange rules in this area and its review of denials of access to exchange facilities, 69/ rounds out the Commission's authority with respect to the listing and delisting rules and their application in particular cases.

The Commission's specific investigative authority stems principally from Section 21 of the Act which provides:

> (a) The Commission may, in its discretion, make such investigations as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of this [Act], the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member,

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67/ Sec. 12(k).

68/ Sec. 12(d). As to securities with unlisted trading privileges on exchanges, see Sec. 12(f).

69/ P. 17, supra.

> . . . and may require or permit any person to file with it a statement in writing, under oath or otherwise as the Commission shall determine, as to all the facts and circumstances concerning the matter to be investigated. The Commission is authorized, in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this [Act], or in securing information to serve as a basis for recommending further legislation concerning the matters to which this [Act] relates.
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> * * * * *
>
> (b) For the purpose of any such investigation, or any other proceeding under this [Act], any member of the Commission or any officer designated by it is empowered to administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing.

To facilitate the conduct of its investigations with respect to the activities of securities professionals and SROs and, respectively, their customers and members, Section 17 of the Act provides, among other things, that:

> (a)(1) Every national securities exchange, member thereof, broker or dealer who transacts a business in securities through the medium of any such member, registered securities association, registered broker or dealer, . . . shall make and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this [Act].

* * * * *

> (b) All records of persons described in subsection (a) of this section are subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission . . . as the Commission . . . deems necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this [Act]:

There are, as we have seen, a number of 1934 Act substantive provisions, such as the general anti-fraud and manipulation provisions of Sections 9 and 10, which apply not only to securities professionals, industry institutions, and issuers, but also to other participants in the markets, including in most instances investors themselves. As to such other persons, governmental type enforcement authority resides solely in the hands of the Commission or, for criminal prosecution purposes, the Attorney General.

Investors also have a variety of civil remedies under the Act. As in the case of the 1933 Act, these remedies perform a vital role in achieving the compliance objectives of the 1934 Act. They are discussed at greater length in Section H of Part III, below.

C. Investment Company Act of 1940

"Investment companies," as defined in this statute, take a variety of forms. 70/ They are (except for face-amount certificates companies) basically companies, trusts, or other organizational entities which provide a medium for public investment in pools of corporate or other types of securities.

70/ Sec. 3-5.

To the extent that an investment company raises the capital its uses for acquiring pool assets through public offering(s) of interests in the pool entity, it is normally subject to the registration (including prospectus) requirements of the 1933 Act. 71/ In addition, the antifraud and various other provisions of both the 1933 and 1934 Acts apply generally to the offer and sale of securities issued by an investment company. Thus, as with other non-exempt securities, the activities of brokers and dealers transacting business in investment company securities are generally covered by those two statutes.

However, the Investment Company Act contains a number of additional and unique substantive standards for investment companies subject to that Act. Those special requirements include additional disclosure requirements, particularly disclosures in this Act's registration statement (filed with the Commission) with respect to specified subjects such as diversification of portfolio risk, issuance of senior securities, borrowing and lending of monetary assets, engaging in underwriting, and investing in real estate and commodities. 72/ Moreover, the Act contains many provisions of a regulatory character which, while still stressing investor protection as a primary objective, sharply depart from the 1933 and 1934 Acts' "full disclosure" patterns. For example, the 1940 Act prohibits such companies from changing the nature of their business or their investment policies without

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71/ See Sec. 24 of the 1940 Act.

72/ Sec. 8.

the approval of the stockholders; 73/ prevents underwriters, investment bankers or brokers from constituting more than a minority of the directors of such companies 74/; requires a specified minority of the board to be independent; 75/ requires management contracts (and material changes therein) to be submitted to security holders for their approval; 76/ prohibits transactions between such companies and their directors, officers, or affiliated companies or persons, except with the permission of the Commission; 77/ forbids the issuance of senior securities by such companies except under specified conditions; 78/ and prohibits pyramiding of such companies and cross-ownership of their securities. 79/

The rationale for these types of departures emanated from an in-depth study by the Commission, published in 1939-40, of the then investment company industry. 80/ The report of this study led Congress to conclude that the "completely liquid, mobile, and readily negotiable" assets of investment companies offered unusual opportunities for abuse to unscrupulous company management and that disclosure alone was an inadequate safeguard for investment company shareholders. 81/

73/ Sec. 13.

74/ Sec. 10(b).

75/ Sec. 10(a).

76/ Sec. 15.

77/ Sec. 17.

78/ Sec. 18.

79/ Sec. 20(a).

80/ SEC, Report on Investments Trusts and Investment Companies.

81/ S.R. No. 1775, 76th Cong., 3d Sess. (1940)

The device of issuer registration is again used, this time to help to assure, through Commission review and public scrutiny, compliance with both the "regulatory" and disclosure requirements. Investment companies are prohibited from engaging in interstate commerce and from using the mails unless the company is registered with the Commission. 82/

The Act also requires registered companies to make periodic reports to the Commission and to their stockholders. 83/ In addition to the 1933 Act administrative and judicial remedies (previously discussed) — which are available because of the applicability of that act to the public financing aspects of investment company operations — the 1940 Act empowers the Commission to:

(1) Institute administrative proceedings to suspend or revoke the company's registration for violation of the registration provisions. 84/

(2) Seek court injunctions for violations of the Act and rules thereunder. 85/

(3) Sue in the courts to enjoin or bar from affiliation with the company any officers, certain principal underwriters of investment company-issued shares, or affiliated persons found to have engaged in a "breach of fiduciary duty involving personal misconduct;" 86/

(4) Refer evidence of violations of the Act and rules thereunder to the Attorney General with a view to criminal prosecution. 87/

82/ Sec. 7. Exemptions from registration are contained in Sec. 6.

83/ Sec. 7(e).

84/ Sec. 30.

85/ Sec. 42(e).

86/ Sec. 36.

87/ Sec. 42(e).

Finally, the Commission's powers in this act to require records and reports by registrants and to investigate possible violations of the law are basically parallel to those in the 1933 and 1934 Acts. 88/

D. Investment Advisers Act of 1940

This law establishes a pattern of regulation of investment advisers, including advisers to registered investment companies, which is similar in many respects to Securities Exchange Act provisions governing the conduct of brokers and dealers. It requires, with certain exceptions, that persons or firms who engage for compensation in the business of advising others about securities 89/ shall register with the Commission 90/ and conform their activities to statutory standards designed to protect the interests of investors.

The law contains antifraud provisions, similar to those in Sections 10(b) and 15(c)(2) of the 1934 Act. 91/ It also requires that investment advisers disclose the nature of their interest in transactions executed for their clients; 92/ and, in effect, it prevents the assignment of investment advisory contracts without the client's consent. 93/ Investment advisory

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88/ Sec. 31, 42(a)-(c).

89/ See Sec. 202(a)(11) (definition of "investment adviser").

90/ Sec. 203(a).

91/ Sec. 206.

92/ Sec. 206(3).

93/ Sec. 205.

contracts of registered firms which provide for compensation to the adviser on the basis of a share of capital gains of the client's funds (so-called "performance fees") are generally outlawed. 94/ The Act does, however, contain certain limited exceptions from this prohibition. Performance fees have been restricted largely because of a belief that such arrangements give advisers an incentive to take undue risks with clients' funds. 95/

The registration of investment advisers and association with them may be denied, suspended or revoked by the Commission if it finds that one or more types of disqualification exist and that such action is in the public interest. 96/ Disqualifications include a conviction for certain financial crimes or securities violations, the existence of injunctions based on such activities, a conviction for violation of the Mail Fraud Statute, the willfull filing of false reports with the Commission, and willfull violations of this act, the Securities Act, the Investment Company Act, or the Securities Exchange Act. 97/

In addition to the administrative sanctions of denial, suspension or revocation of registration, the Commission may obtain injunctions restraining violations of this law and may recommend prosecution by the Department of Justice for fraudulent misconduct or willfull violation of the law or rules of the Commission thereunder. 98/

94/ Sec. 205(1).

95/ P. 27, n. 80, supra.

96/ Sec. 203(i)(2), (e).

97/ Sec. 203(e).

98/ Sec. 209.

The law also imposes on investment advisers subject to the registration requirement the duty to maintain books and records in accordance with such rules as may be prescribed by the Commission, and it authorizes the Commission to make inspections of such books and records and to conduct other investigations into possible violations of the Act. 99/

III. Commission, SRO, and Judicial Implementation of the Statutory Scheme

While the basic statutory framework we have described affords considerable guidance respecting Congress' wishes, it leaves to the Commission, the SROs, and the courts a great deal of latitude to flesh out the details of the regulatory scheme. In this section, we discuss how that detail has been supplied, with specific reference to the area of listed securities options trading, the immediate subject of this paper.

A. The Disclosure Pattern

1. Options registration under the 1933 and 1934 Acts.

The put and call options proposed for exchange trading by the options exchanges in the early and mid-1970's were to be (and now are) publicly offered to investors on a continuing basis as trading/investment-related vehicles. One of their principal features is that the options clearing entity also acts as guarantor of the writer's performance obligation in the event of exercise. Largely because of these circumstances the Commission determined to require registration of the offering under the 1933 Act. And since these instruments were to be bought and sold in an exchange market, they were also considered to be subject to the registration requirements of the 1934 Act.

99/ Sec. 204.

In examining these registration questions, the main issues with which the Commission was confronted when listed options trading was initially proposed related to the nature and scope of the disclosures that were appropriate and to the degree to which those disclosures should be communicated to options investors at the time of their transactions. The Commission's conclusions on those questions ultimately were founded on the following considerations:

1. As short-term, highly leveraged instruments, options posed substantial as well as complex risks for investors.

2. The contemplated trading and settlement procedures and other features of these contracts, including tax consequences and margin treatment, were in many respects unique (or at least very unusual) and informed investor participation appeared to require substantial sophistication in these areas.

3. The traditional unlisted option markets had enjoyed rather limited investor participation, consisting mainly of sophisticated investors and specialized professional intermediaries. It was expected (by its proponents) that the listed, more liquid kind of vehicle proposed would have a wider investor base and that the "ordinary" registered representative and retail securities firms would inevitably be drawn into the new markets in increased numbers.

4. The listed option proposals were new and a great deal of experimentation in the development of these markets was anticipated.

5. One of the primary attractions of the proposed options contracts as a potentially more liquid investment was the mutualized guarantee of the clearing entity. From the investor's (option holder's) viewpoint, this suggested a need for the kind of disclosures about the financial and operational soundness of the obligor that has generally accompanied registered public offerings and trading of other issuers' obligations.

6. The market pricing mechanisms for the contemplated options contracts were likely to be interrelated to those for their underlying instruments. Defects in one could have significant impacts on the other.

In combination, these circumstances caused the Commission to conclude that the integrity and efficiency of the proposed markets called for a carefully drawn, informative basic disclosure document prepared, and kept current,

under close regulatory scrutiny. It was therefore felt that (1) the clearing agency, as a legal issuer of these securities and the "arm" of self-regulators (i.e., the exchanges on which they would be bought and sold), 100/ should be charged with the preparation of these documents and that (2) with some adjustments, the registration processes of the 1933 and 1934 Acts offered a suitable means for governmental oversight of the document and its utilization. It will be observed that the same considerations that led to this result have, individually or in combination, shaped much of the regulatory pattern that has emerged in the option area and should be borne in mind in connection with the succeeding sections of this Part of this paper.

2. Contents of registration statement and prospectus

The Options Clearing Corporation ("OCC"), the clearing entity servicing all of the five option exchanges, prepares and files with the Commission a registration statement under the 1933 Act as the "issuer" of all listed options traded on those exchanges. The statement includes a prospectus, currently about 56 pages in length, and is filed on Form S-1, the Commission's general registration form, which is used when no other specialized form has been designated by Commission rules. The prospectus provides considerable detail about OCC's own operations and financial condition and about the nature of listed options, their terms and risks, and the mechanics of option trading. The major subject headings in the OCC prospectus afford some idea as to the extent of the disclosures concerning those matters:

100/ Since passage of the 1975 amendments to the 1934 Act, P.L. 94-29 (June 4, 1975) clearing agencies are now themselves registered as SROs. See Section 17A.

1. Glossary of terms

2. Certain Risk Factors

3. Description of Options and Options Trading

   a. Terms of Options

   b. Adjustment in terms (i.e., during the life of an options contract)

   c. Limitations on Exercise

   d. Position Limits (i.e., under the rules of the exchanges)

   e. Certificateless Trading (i.e., confirmations and account statements as evidence of ownership interest)

   f. Underlying Securities (i.e., standards governing their selection for option trading and "delisting") 101/

   g. Hours of trading

   h. Order Placing and Execution

   i. Acceptance and Rejection of Transactions by Clearing Corporation

4. Purposes and Risks of Options Transactions (Under various sub-headings, many of the possible investor uses of options and options trading strategies are discussed. Consumes about 9 prospectus pages.)

5. The Secondary Markets in Options (Includes general discussion of exchange market procedures and the methods for closing positions acquired in the market.)

6. Exercise of Options

   a. General

   b. Tender of exercise notices

   c. Assignment of exercise notices

101/ Since listed options are, throughout their "life," convertible by exercise into the underlying security, the latter security would normally have to be fully registered under the 1933 Act ... i.e., the OCC registration statement and prospectuses could have been required, at least in
(footnote continued on next page)

d. Delivery and Payment

e. Remedies (i.e., when a clearing member fails to honor an exercise notice)

f. The Back-Up System (These are the rules, procedures, and financial arrangements to which the Clearing Corporation looks to hold it harmless when a clearing member does not perform his obligations on an assigned exercise notice.)

7. Margin Requirements

8. Federal Tax Aspects of Options Transactions

9. Transactional Costs

   a. Commissions

   b. Other charges

   c. New York State Transfer Tax

10. The Exchanges and the Clearing Corportion

    a. The Exchanges (Recites where options are traded, the handling of liquidations of positions in options traded on more than one exchange, etc.)

    b. The Clearing Corporation

       (1) Officers and Directors

       (2) Litigation Relating to the Clearing Corporation and the Exchanges

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(Footnote continued from previous page)

theory, to contain the usual information about the issuers of the underlying securities. But because the securities selected for options trading were already registered under the 1934 Act and were, for the most part, the most widely known and actively traded equities listed on the stock exchanges, the Commission (and the SROs) have required only minimal disclosures concerning them in OCC's filings and prospectuses. The option exchanges' uniform "listing and delisting" standards for underlying stocks, however, are themselves of major concern both from the viewpoint of disclosure and as protections against unfair and manipulative practices in the trading markets.

11. Legal Opinions and Experts (i.e., relating to preparation of the prospectus)

12. Additional Information (Calls attention to the fact that registration file includes certain documents not included in prospectus.)

13. Auditor's Opinion and Financial Statements (relating to OCC).

Under the Act and Commission and SRO rules, this prospectus, in a current form, must be delivered to each options customer at or prior to the time his broker approves his account for listed options trading and, thereafter, when the prospectus is amended or updated. 102/

As described in the Options Study, the nature and extent of the disclosure called for in the OCC prospectus and the resulting costs of, and potential liabilities for, its preparation and distribution, have been subjects of considerable debate. 103/ We merely note at this stage that although the Options Study itself made a number of recommendations for change in the format, style, and content of the registration statement, its proposals included the following:

> To provide investors with an appropriate disclosure document, a new document prepared by OCC [to replace the present prospectus] would be required under the Exchange Act to be delivered at or prior to the time . . . , an options customer opens an account. This document, designed for persons without financial training, would provide investors with a simple description of the risks and uses of put and call options. This new document should include a glossary of terms; a description of (i) the risks of options trading; (ii) the fundamental uses of options trading, (iii) the terms of options, and (iv) the mechanics of buying, writing and exercising options; and a simplified discus-

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102/ See, e.g., Section 5(b)(2) of the Securities Act; Rule 9.15 CBOE Guide (CCH) ¶ 2315.

103/ At pp. 377-383.

sion of transaction costs, margin requirements and tax consequences of option trading. 104/

The Study's recommendations are still undergoing Commission review.

3. 1934 Act broker-dealer disclosure rules

Principally in reliance on its anti-fraud powers under Sections 10(b) and 15(c)(1) and (2) of the 1934 Act, and its general rulemaking authority under Section 23(a), the Commission has adopted several of rules requiring securities broker-dealers to make a number of affirmative disclosures to their customers in connection with options and other securities transactions. These include:

a. Rule 10b-10, which governs the confirmation to customers of each of their securities transactions. This rule requires, among other things, disclosure of the price and identity of the securities bought or sold, the broker's capacity (principal or agent) in the transaction and his compensation (commission or service charge) in agency and "riskless" principal transactions. Such confirmations are to be sent to the customer at or before settlement of the transactions except in the case of a purchase of securities of some types of investment companies pursuant to certain individual retirement or pension plans or group purchase plans.

b. Rule 10b-16, the Commission's "truth-in-lending" regulation, which requires broker-dealers to make specified written disclosures to customers in connection with extensions of credit to the customer to finance securities transactions. At the time the customer opens his account he must be given information as to the conditions under which an interest charge will be

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104/ Id., at 381.

imposed, the rate of interest, its methods of computation, and other related matters. At least quarterly, the customer must receive information disclosing his beginning and ending debit balances; the debits and credits entered during the period; and interim changes in interest rates. Under the rule, increases in interest rates must be preceded by 30 days notice to the customer unless the change is required by law.

c. Rule 15c3-2, which provides that a broker-dealer may not use in his business 105/ any funds rising out of any free credit balance carried for the account of any customer unless he has established adequate procedures pursuant to which each customer for whom a free credit balance is carried will be given or sent, together with or as part of the customer's statement of account, whenever sent, but not less frequently than once every three months, a written statement informing the customer of the amount due to the customer by the broker-dealer on the date of the statement. The statement must contain a written notice that such funds (1) are not segregated and may be used in the operation of the broker-dealer's business, and (2) are payable on the demand of the customer. 106/

d. Rule 17a-5, which requires, among other things, that broker-dealers furnish to each customer semi-annually a balance sheet of the firm with appropriate notes, prepared in accordance with generally accepted

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105/ See Rule 15c3-3 and Section G, infra, for limitations on such use.

106/ Depending on the outcome of SRO task force responses to the Commission's Options Study recommendation, Rule 15c3-2 may be amended so as to conform to a revised account statement plan for options customers. See Options Study Recommendation I.A.2.a. and Section C, infra.

accounting principles. At least once a year this balance sheet must be an audited statement certified by an "independent" 107/ accountant. Both statements are required to be filed with the Commission and any SRO of which the firm is a member.

In addition, the SROs have adopted a number of disclosure requirements which have significance for the options businesses of their member firms. Several supplement the Commission's requirements. For example, options exchange rules calling for prospectus delivery apply to both buying and selling (writing) customers and, when a customer is a broker or dealer, require the member to "take reasonable steps" to see to it that the broker or dealer is furnished reasonable quantities of the current prospectus so as to enable that customer to comply with its own delivery obligations. 108/ In addition, exchange rules generally require that member firms send account statements to customers, showing security and money positions and entries -- (1) at least quarterly to accounts having such a position during the preceding quarter and (2) at least monthly to all accounts having an entry during the preceding month. 109/

Further, the SROs have assumed a lead role in setting industry disclosure standards governing the content of the advertising, sales literature, and related promotional activities of their members. The SROs have fairly comprehensive rules and policies on this subject. They deal with such subjects as the adequacy of the basis for recommendations respecting specific

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107/ For an explanation of this term, see Securities Exchange Act Rel. No. 9662 (July 5, 1972).

108/ See, e.g., Rule 9.15, CBOE Guide (CCH) ¶2315.

109/ See, e.g., Rule 9.12, CBOE Guide (CCH) ¶2312.

securities, disclosure of conflicts of interests and special risks of a recommended investment, past records of firm recommendations, testimonials, projections and predictions, claims for research, the dating and currency of sales literature, identification of sources, portfolio analysis, and other similar matters. 110/ While these provisions generally cover all such activities, including promotion of options investments, the SROs have recently proposed uniform industry-wide guidelines with particular applicability to options. 111/

4. Investment Advisers Act Disclosure

Until recently, the Commission had rather few special adviser-to-investor (client) disclosure requirements. As in the case of the broker-dealer registration rules under the 1934 Act, the 1940 Act adviser registration forms contained important information about such matters as registrant's business and principal officials; 112/ but this information had been available only in the Commission public files and, in general, no direct dissemination of it to investors was required. Under this Act's antifraud provision and grant of implementing rulemaking authority, the Commission also adopted some restrictions on advertising practices of investment advisers. 113/ The Commission's rule, Rule 206(4)-1, covers some of the same subjects as the SRO

110/ See, e.g., Rule 472, 2NYSE Guide (CCH) ¶2472; Rule 9.21, CBOE Guide (CCH) ¶2321.

111/ See, e.g., Securities Exchange Act Releases No. 16253-4(Oct. 5, 1979). SEC file Amex 79-18, MSE 79-18.

112/ Form ADV.

113/ Rule 206(4)-1.

rules on broker-dealer advertising, although the specific provisions differ in a few respects. Rule 206(4)-1, for example, prohibits all testimonials and requires disclosure of the limitations and difficulties involved in the use of any formulas or similar devices recommended by the adviser.

In the past year, the Commission added a rule of a disclosure nature which is noteworthy. In early 1979, it adopted Rule 204-3 (the "brochure rule") which requires advisers (a) to deliver to clients, prior to entering into an advisory contract, a written disclosure statement containing specified information concerning the background and business practices of such advisers and (b) annually to deliver, or offer in writing to deliver, without charge, an updated disclosure statement. 114/ These requirements are not applicable to advisory contracts with registered investment companies or the provision of "impersonal advisory services," except that there is a statement delivery requirement for entering into contracts for the latter type of services costing $200 or more.

The information to be included in the "brochure" relates to: the type of advisory services provided and the fees to be charged; the types of clients serviced and securities covered; methods of analysis employed; education and experience requirements for the adviser's associated persons; other business activities of the firm; adviser's participation in connection with clients' securities activities; conditions for opening and maintaining accounts; adviser's account review procedures; and provision of certified balance sheets to clients.

114/ See Investment Advisers Act Release No. 664 (Jan. 30, 1979), 16SEC Docket No. 14, at 901 ff.

B. Fraud Concepts Under Judicial and Administrative Decisions

As earlier observed, in enacting the federal securities laws, Congress adopted a number of broad anti-fraud and related provisions. Section 17(a) of the Securities Act of 1933 prohibits fraud in the offer or sale of securities; 115/ Section 10(b) of the Securities Exchange Act of 1934 prohibits, in connection with the purchase or sale of any security, the use of manipulative or deceptive devices in contravention of rules which the Commission is empowered to adopt; 115/ and Section 206 of the Investment Advisers Act of 1940 proscribes fraudulent practices by investment advisers, regardless of whether such

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115/ Section 17(a) of the Securities Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly --
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> (1) to employ any device, scheme, or artifice to defraud, or
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> (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.

116/ Section 10(b) of the Securities Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national seurities 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.

practices occur in connection with securities transactions. 116/ The federal securities laws also contain a host of other provisions aimed at more particular types of fraudulent or unfair dealing by securities professionals and certain other persons. 117/ Under the federal securities laws, moreover, controlling

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116/ Section 206 of the Investment Advisers Act provides:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, 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:
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> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;
>
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purpose of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

117/ See, e.g., Securities Exchange Act of 1934, Section 9, 15 U.S.C. 78i, (prohibition against manipulative and similar practices in the purchase and sale of securities on national securities exchanges); Section 13(e), 15 U.S.C. 78m(e), (prohibits fraud by issuer in purchasing its own securities); Section 14(a), 15 U.S.C. 78n(a), (prohibits proxy solicitations in contravention of Commission rules), Section 14(e), 15 U.S.C. 78n(e), (prohibits fraud in connection with tender offers), Section 15(c)(1),(2), 15 U.S.C. 78o(c)(1),(2), (prohibits fraud by broker-dealers in over-the-counter market transactions); Investment Company Act of 1940, Section 34(b), 15 U.S.C. 80a-33(b), (prohibits untrue statements, or omissions of material facts in documents filed with the Commission, or required to be kept, pursuant to the Act), Section 36(a), 15 U.S.C. 80a-35(a), (Commission authorized to bring action for certain breaches of fiduciary duty owed to investment company).

(Footnote continued)

persons of those who violate anti-fraud and other requirements may personally be liable for such actions. 118/

The broadest anti-fraud provision under the federal securities laws, in many respects, is Rule 10b-5, 119/ enacted under Section 10(b) of the Exchange Act. And, for purposes of this memorandum, the discussion which follows focuses upon this Rule. Our discussion first compares fraud concepts under the common law and under the federal securities laws, particularly Rule 10b-5. We then examine theories of liability arising from trading on inside corporate information, and from trading on non-public "market" information. Finally, we discuss the concepts of fraud as applied to broker-dealers and other securities professionals.

117/ (Footnote continued)

For a discussion of those provisions of the federal securities laws which create express rights of action on behalf of investors to redress, inter alia, fraudulent practices, see Section H, infra.

118/ Securities Act of 1933, Section 15, 15 U.S.C. 77o; Securities Exchange Act of 1934, Section 20, 15 U.S.C. 78t; Investment Company Act of 1940, Section 48(a), 15 U.S.C. 80a-47(a). See Section H, infra.

119/ 17 C.F.R. § 240.10b-5. Rule 10b-5 provides

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

1. Elements of securities fraud — comparison with common law

As the Supreme Court explained in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963), Congress enacted the federal securities laws to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." Thus, the Capital Gains Court instructed that the anti-fraud provisions of the securities laws are to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." 120/ In light of the Congressional purpose, courts have taken a broader and more flexible approach in construing securities law fraud, as compared to its common law antecedents. 121/

The basic elements of a cause of action for deceit under the common law are: 122/

(1) A false representation;

(2) Knowledge or belief, or a sufficient basis of information for such, on the part of the defendant that the representation is false;

(3) An intention to induce the plaintiff to act upon reliance on the misrepresentation;

120/ Capital Gains, supra, 375 U.S. at 195. See also Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971).

121/ Indeed, even under the evolving common law, courts have taken a more flexible approach where fraud is alleged in transactions involving intangibles, as compared with transactions involving land and other tangible items. Capital Gains, supra, 375 U.S. at 194.

122/ See, W.L. Prosser, The Law of Torts §105, at 685 (4th ed. 1971) ("Prosser"). See also, Broberg v. Mann, 213 N.E. 2d 89 (Ill. App. 1965); Suburban Properties Management v. Johnson, 204 A. 2d 326 (Md. 1964).

(4) Justifiable reliance by the plaintiff; 123/

(5) Damage caused by the representation.

As a general rule, under the common law, express misrepresentation is required; an action ordinarily will not lie for tacit nondisclosure. 124/ But as discussed infra, the federal securities laws, under appropriate circumstances, impose upon certain individuals an affirmative duty to disclose. 125/ Under common law, courts generally do not permit an action for deceit where expressions of opinion, as opposed to the misrepresentation of fact, are involved. 126/ Under the federal securities laws, however, liability may attach to expressions of opinion if the defendant, as a market professional, has no reasonable basis to support such opinion. 127/

123/ Justifiable reliance under the common law of deceit encompasses the concept of "materiality." One must not only justifiably believe that the representation is true, but one must also be justified in taking action on this basis. Prosser, supra note 122, § 108 at 718.

124/ Prosser, supra note, § 106 at 695. See Windram Mfg. Co. v. Boston Blacking Co., 131 N.E. 454 (Mass. 1921); Keates v. Earl of Cardogun, 10 C.B. 591, 138 Eng. Rep. 234 (1851).

125/ See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-95 (1963); Hughes v. Securities and Exchange Commission, 174 F.2d 969, 975-76 (D.C. Cir. 1945); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 278 (S.D.N.Y. 1972), aff'd, 495 F.2d 228 (2d Cir. 1974).

126/ See Prosser, supra note 122, § 109 at 720.

127/ See, e.g., Nees v. Securities and Exchange Commission, 414 F.2d 211, 219-20 (9th Cir. 1969); R.A. Holman & Co. v. Securities and Exchange Commission, 366 F.2d 446, 449-50 (2d. Cir. 1966), modified on other grounds, 377 F.2d 665 (2d. Cir.), cert. denied, 389 U.S. 991 (1967); Alexander Reid & Co., 40 S.E.C. 986, 990 (1962). See discussion at p. 58, infra.

Under the common law of deceit, scienter is an indispensable element. 128/ Similarly, in Ernst & Ernst v. Hochfelder, 129/ the Supreme Court held that, in a private action for damages under Rule 10b-5, a plaintiff must establish that defendant acted with scienter. The Court in Hochfelder explained that "scienter" is something more than mere negligence, and involves "a mental state embracing intent to deceive, manipulate or defraud." 130/ The Court, however, left open the question whether a reckless disregard for the truth or falsity of a statement is sufficient to establish scienter in a private action under Rule 10b-5. After Hochfelder, a number of lower courts have so held that reckless disregard is sufficient. 131/ The Court in Hochfelder also raised but did not resolve the question of whether scienter is a necessary element in an injunctive action by the Commission under Rule 10b-5, and there is presently a split in the circuits

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128/ Prosser, supra note 122, § 107 at 701.

129/ 425 U.S. 185 (1975).

130/ 425 U.S. at 193-94, n.12. (Emphasis added).

131/ 425 U.S. at 194 n.12. See Coleco Industries, Inc. v. Berman, 567 F.2d 569, 574 (3d Cir. 1977), cert. denied, 99 S.Ct. 106, rehearing denied, 99 S.Ct. 601 (1978); First Virginia Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Sanders v. John Nuveen & Co., 554 F.2d 790, 792 (7th Cir. 1977); Wright v. Heizer Corp., 560 F.2d 236, 251 (7th Cir. 1977); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46 (2d Cir.), cert. denied, 99 S.Ct. 642 (1978); Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 99 S.Ct. 464 (1978); Edward J. Mawod & Co. v. Securities and Exchange Commission, 591 F.2d 588, 596 (10th Cir. 1979); Mansbach v. Prescott, Ball & Turben, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,861, at 95,526 (6th Cir. 1979); McLean v. Alexander, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,879, at 95,601-05 (3d Cir. 1979).

on this question. 132/ The Supreme Court has recently granted certiorari in Securities and Exchange Commission v. Aaron, supra, to consider this issue.

As to the necessity of reliance in private actions under Rule 10b-5, the Supreme Court has held that independent proof of reliance is not a prerequisite to recovery in a case based on nondisclosure, as opposed to affirmative misrepresentation, so long as materiality of the nondisclosure is established. 133/ Because the Commission's injunctive actions seek to vindicate the public interest and protect investors at large, it is well-settled that the Commission need not demonstrate either reliance or causation in respect to any particular transaction. 134/

132/ Compare Securities and Exchange Commission v. Blatt, 583 F.2d 1325 (5th Cir. 1978); Securities and Exchange Commission v. Willis, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,712 (D.D.C. 1978); Securities and Exchange Commission v. Cenco, Inc., 436 F. Supp. 193, 200 (N.D. Ill. 1977); (scienter required), with, e.g., Securities and Exchange Commission v. Aaron, No. 77-6091 at 13, 47 U.S.L.W. 2605 (2d Cir., Mar. 12, 1979), cert. granted, 48 U.S.L.W. 3253 (Oct. 16, 1979). Securities and Exchange Commission v. Arthur Young & Co., 590 F.2d 785 (9th Cir., 1979); Securities and Exchange Commission v. World Radio Mission, 544 F.2d 535, 541 n.10 (1st Cir. 1976); Securities and Exchange Commission v. Geotek, 426 F. Supp. 715, 726 (N.D. Cal. 1976) (negligence is sufficient).

133/ Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972). However, this decision has been narrowly interpreted. See, e.g., Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 482 F.2d 880, 884-85 (5th Cir. 1973) (required general reliance). See also Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970) (proof of reliance not required where nondisclosure in proxy solicitation is material); Mader v. Armel, 402 F.2d 158, 162-63 (6th Cir. 1968), cert. denied, 394 U.S. 930 (1969).

134/ See, e.g., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1969); N. Sims Organ & Co. v. Securities and Exchange Commission, 293 F.2d 78, 80 n.3 (2d Cir. 1961), cert. denied, 368 U.S. 968 (1962); R. Baruch & Co., 43 S.E.C. 13, 19 (1966); Hughes v. Securities and Exchange Commission, 174 F.2d 969, 973-74 (D.C. Cir. 1949).

2. Insider trading and Rule 10b-5

Rule 10b-5 does not expressly refer to "insider trading," nor does it specifically impose an affirmative duty to disclose upon one who maintains complete silence in connection with the purchase or sale of a security. Clause (2) of Rule 10b-5 prohibits omissions to state material facts only when "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Nonetheless, courts have uniformly held that Rule 10b-5 prohibits trading by corporate insiders on the basis of undisclosed material corporate information. As one court has explained:

> The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uniformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. 135/

The duty of an insider to abstain from trading on non-public material information is based, in part, upon a fiduciary obligation owed to the corporation, and to the individual shareholders with whom he trades. 136/ In addition to

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135/ Speed v. Transamerica, 99 F. Supp. 808, 829 (D. Del. 1951). See also Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963):

> The statute and the rule [Rule 10b-5] basically call for fair play and abstention on the part of the corporate insider from taking unfair advantage of the uninformed outsider or minority stockholder.

136/ See e.g., Securities and Exchange Commission v. Texas Gulf Sulfur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968) (en banc), cert. denied, sub nom., Coates v. Securities and Exchange Commission, 394 U.S. 976 (1969):

> where a corporate purpose is . . . served by withholding the news of a material fact, those persons who are thus quite properly true to their corporate trust must not during the period of nondisclosure deal personally . . . or give to outsiders confidential information not generally available to all the corporations' stockholders and to the public at large.

fundamental notions of fairness, the prohibition on insider trading under Rule 10b-5 is also grounded on Congress' concern that investors in the public securities markets "have relatively equal access to material information." 137/ The prohibition of insider trading under Rule 10b-5 not only benefits particular shareholders, but just as importantly lends assurance to the public and the financial community of the integrity of the Nation's securities markets. As Congressman Wolverton explained in regard to the passage of the Exchange Act:

> If there were a justifiable belief that security markets actually were "free and open," that all buyers and sellers met on substantially equal terms . . . the response would be a greater investment interest in securities and a consequent improvement in all phases of the securities markets. 138/

The landmark Commission decision establishing liability for trading on material, non-public information by corporate insiders and their tippees is Cady, Roberts & Co. 139/ In Cady, Roberts, a registered representative serving as a corporate director leaked to a partner in his broker-dealer firm information about an impending decrease in dividends by the corporation. The partner, in turn, executed trades for discretionary accounts on the basis of this non-public information. The Commission, in suspending the partner from exchange membership, held that an insider has a duty either to disclose inside information or to abstain from trading:

> [T]he obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be

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137/ Securities and Exchange Commission v. Texas Gulf Sulfur Co., supra, 401 F.2d at 848.

138/ 78 Cong. Rec. 7865-66 (1934).

139/ 40 S.E.C. 907 (1961).

> available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing. 140/

The "abstain or disclose" stricture was adopted by the Second Circuit in the landmark decision, Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra; and has been uniformly followed by other courts. 141/ In Texas Gulf, the Second Circuit also held that Section 10(b) and Rule 10b-5 prohibits trading on inside information not only by corporate insiders, but by their "tippees" as well. The tipper, moreover, may be liable to persons trading with his direct or indirect tippees, 142/ since:

> [W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or acquaintance of the insider, or understandings could arise under which reciprocal tips between insiders in different corporations could be given. 143/

3. Trading on material "market information"

Section 10(b) was intended by Congress to be a "catch-all" extending to "any" fraudulent scheme or "new manipulative and cunning devices." 144/

140/ 40 S.E.C. at 912.

141/ See e.g. Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232, 255 (1979). Stier v. Smith, 473 F.2d 1205, 1208 (5th Cir. 1973); Pennaluna & Co. v. Securities and Exchange Commission, 410 F.2d 861, 869-70 (9th Cir. 1969), cert. denied, 396 U.S. 1007 (1970).

142/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, at 852; See e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974).

143/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra 1308.

144/ See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 9-13 (1971).

Accordingly, frauds involving "market information" 145/ like other fraudulent practices occuring in connection with a purchase or sale of securities, are within the compass of Section 10(b) and Rule 10b-5. The Supreme Court 146/ and lower federal courts 147/ have applied Section 10(b) and Rule 10b-5, in certain circumstances to those who trade on undisclosed, but material, market information. In Affiliated Ute Citizens v. United States, 148/ for example, the defendant bank and its employees purchased shares directly from plaintiffs and arranged for the sale of shares to third parties. The defendants, who acted, in effect, as market makers in the stock, failed to disclose to the sellers at the time of the purchase that the current market value of the stock on the resale market was far higher than the sellers believed. The Court found this omission, in the face of an affirmative duty to disclose, to be violative of Rule 10b-5. 149/

The reach of Rule 10b-5 in "market information" cases is presented in United States v. Chiarella, 150/ a case now pending before the Supreme

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145/ "Market information" as used herein refers to information concerning actual or potential supply and demand in the market for a particular security, as opposed to information which originates from an issuer, concerning, e.g., its assets or earning power.

146/ Affiliated Ute Citizens v. United States, 406 U.S. 128, 144-54 (1972).

147/ See, e.g., Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1303-07 (2d Cir. 1974).

148/ 406 U.S. 128, 144-54 (1972).

149/ Id. at 128. See also Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1303-07 (2d Cir. 1974) (trading by corporate merger consultants on knowledge of impending merger).

150/ 588 F.2d 1358 (2d Cir. 1978), cert. granted, 99 S.Ct. 2158 (May 14, 1979), 78-1202.

Court. The Second Circuit in Chiarella upheld the criminal conviction of a financial printer under Rule 10b-5 for trading upon confidential information regarding tender offers entrusted to him in his capacity as a printer. The court held that the printer's secret conversion of information operated as a fraud on the acquiring company. And, the court noted that the use of the converted information also operated as a fraud on the persons who sold him securities of the target companies. 151/

4. Fraud by securities professionals

Rule 10b-5 and other anti-fraud provisions have a special application to securities professionals. By virtue of their pivotal position in the securities markets and their status as professionals, broker-dealers are deemed, simply by hanging out their "shingles," to make an implied representation of fair dealing to their customers. The "shingle theory," was first articulated by the Commission in Duker & Duker: 152/

> Inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly and in accordance with the standards of the profession. It is neither fair dealing nor in accordance with such standards, to exploit trust and ignorance for profit far higher than might be realized from an informed customer. 153/

151/ Id. at 1364, 1368 at n.14. See also Zwieg v. Hearst Corp., [Current] Fed. Sec L. Rep. (CCH) ¶ 96,851, at 95,460-62 (9th Cir. 1979); Courtland v. Walston & Co., 340 F. Supp. 1076, 1082-84 (S.D.N.Y. 1972); Blyth & Co. [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,647 (1969); Herbert L. Honohan, 13 S.E.C. 754 (1943).

152/ 6 S.E.C. 386 (1939).

153/ Id. at 388-89. A brokerage firm was alleged to have sold securities to customers above market price and purchased other securities from customers substantially below market price without customers' knowledge.

In Charles Hughes & Co. v. Securities and Exchange Commission, 154/ the Second Circuit adopted the "shingle theory" articulated by the Commission in Duker. The Second Circuit affirmed Commission revocation of a broker-dealer's license where the broker-dealer sold securities at substantially inflated prices without disclosure of the excessive mark-up. The court stated that the broker-dealer was "under a special duty, in view of its expert knowledge and proffered advice, not to take advantage of its customers' ignorance of market conditions." 155/

Apart from, but related to, imposition of liability under the "shingle theory," a securities professional found to occupy a position of trust and confidence to his customer may be liable under Rule 10b-5 to his customers for failure to disclose an abuse of that fiduciary position. The District Columbia Circuit, in Arleen W. Hughes v. Securities and Exchange Commission, 156/ held that the defendant (a registered broker-dealer and investment adviser) had a fiduciary duty to act in her customers' best interests and to disclose any conflict of interest. Trading as principal with her clients, without disclosing, among other things, the best price at which her clients could purchase the securities in the open market, the D.C. Circuit found, violated Rule 10b-5. 157/

Both the "shingle theory" and the "fiduciary" theory have been applied in a number of particular contexts to impose Rule 10b-5 liability on securities

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154/ 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

155/ 139 F.2d at 437.

156/ 174 F.2d 969 (D.C. Cir. 1949), aff'g, Arleen W. Hughes, 27 S.E.C. 629 (1948).

157/ See also Chasins v. Smith, Barney & Co., 305 F. Supp. 489 (S.D.N.Y. 1969), motion to amend denied, 306 F. Supp. 177 (S.D.N.Y. 1969), aff'd, 438 F. 2d 1167 (2d Cir. 1970) (failure to disclose market-making capacity violates Rule 10b-5).

professionals. For example, liability under the "shingle theory" may arise where a broker engages in excessive trades, i.e., "churns", the customer's account for the purpose of generating commission income. 158/ A churning violation entails proof that the broker controlled purchases and sales in the customer's account, 159/ a requirement which is satisfied where trading is shown to have taken place in a discretionary account. 160/ To sustain a churning violation, one must also establish that trading was excessive in light of the customer's circumstances, 161/ and that the broker disregarded his customer's interest for his own profit. 162/

158/ See generally, J. Logan & Co., 41 S.E.C. 88 (1962), aff'd per curium, sub nom., Hersch v. Securities and Exchange Commission, 325 F.2d 147 (9th Cir. 1963), cert. denied, 377 U.S. 937 (1964); Looper & Co., 38 S.E.C. 294 (1958). Moscarelli v. Stamm, 288 F. Supp. 453, 457 (E.D.N.Y. 1968); Further, churning of a discretionary account is specifically forbidden by Rule 15c1-7(a), promulgated under Section 15(c) of the Exchange Act. This rule provides that trading in discretionary accounts may not be excessive in size or frequency in view of the financial resources and character of the account. 17 C.F.R. §240.15c1-7(a).

159/ See, e.g., Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836, 838-39 (E.D. Va. 1968); J. Logan & Co., 41 S.E.C. 88 (1962), aff'd per curium, sub nom., Hersch v. Securities and Exchange Commission, 325 F.2d 147 (9th Cir. 1963), cert. denied, 377 U.S. 937 (1964); Looper & Co., 38 S.E.C. 294 (1958). See also Newberger, Loeb & Co. v. Gross, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,649 (S.D.N.Y. 1976), aff'd, 563 F.2d 1057, 1069-70 (2d Cir. 1977), cert. denied, 434 U.S. 1037 (1978); Shorrock v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,251 (D. Ore. 1977) (an experienced and sophisticated customer who regularly makes his own investment decisions will have difficulty prevailing in a churning action).

160/ See note 158, supra.

161/ See, e.g., Stevens v. Abbot, Proctor & Paine, 288 F. Supp. 836, 841-42, 45 Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 432, 435 (N.D. Cal. 1968), modif'd on other grounds, 430 F.2d 1202 (9th Cir. 1970). Looper & Co., 38 S.E.C. 294, 296 (1958).

162/ See, e.g., Stevens v. Abbot, Proctor & Paine, 288 F. Supp. 836, 841-42, 45 (E.D. Va. 1968); Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 434-35 (N.D. Cal. 1968), modif'd on other grounds, 430 F.2d 1202 (9th Cir. 1970).

Related to churning, a broker-dealer also violates Rule 10b-5 by executing trades in excess of his authority, since a broker impliedly represents that he will adhere to the scope of his agency. 163/ A broker-dealer also impliedly represents that he will seek to obtain the "best execution" of a trade for his customer -- that is, to buy or sell securities at a total cost which under all circumstances is most favorable to a customer. 164/ The Commission has explained that a broker's duty to seek best execution does not require him in every case actually to secure the best price for his customer regardless of expense or other relevant considerations; a broker is obligated, however, to "exercise his professional judgment to seek out the best market for his clients." 165/ The cases decided thus far involving failure to seek best execution have also entailed, in one respect or another, instances of self-dealing by a broker-dealer, or have involved other conflicts of interest. 166/

163/ See, e.g., Kavil v. A.L. Stamm & Co., [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,915 (S.D.N.Y. 1967).

164/ See,e.g., Opper v. Hancock Securities Corp., 250 F. Supp. 668 (S.D.N.Y.), aff'd per curiam, 367 F.2d 157 (2d. Cir. 1966); Barnett v. United States, 319 F.2d 340 (8th Cir. 1963); Hughes v. Securities and Exchange Commission, 174 F.2d 969 (D.C. Cir 1949); Silverman v. Bear, Stearns & Co., 331 F. Supp. 1334 (E.D. Pa. 1971); Delaware Management Co., Securities Exchange Act Release No. 8128 [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,458 (1967).

165/ Securities Exchange Act Release No. 11628 (Sept. 2, 1975), 7 SEC Docket 762, 770 (Sept. 16, 1975); see also Securities Exchange Act Release No. 14415 (Jan. 26, 1978), 14 SEC Docket 14, 23-24 (Feb. 7 1978) (Commission declined, at interim stage of national market system, to adopt a rule requiring achievement of best execution); Status Report, Development of a National Market System, Securities Exchange Act Release No. 15671 (March 22, 1979), 17 SEC Docket 24, 35-36 (Apr. 3, 1979) (duty of brokers using automatic order routing systems to assess periodically the quality of competing markets).

166/ See note 164, supra.

Under the "shingle theory" a broker-dealer also impliedly represents that he will not prefer his own proprietary trading over the timely execution of his customer's orders. 167/ A broker-dealer also impliedly represents that he is solvent; engaging in business while insolvent, absent disclosure, is fraudulent. 168/ Similarly, a broker-dealer who transacts business in violation of the net capital 169/ or recordkeeping 170/ requirements, absent disclosure, violates Rule 10b-5. The Commission and the courts have held that failure by a broker to execute a customer's order promptly is inconsistent with an implied representation of due diligence, and thus violative of Rule 10b-5. 171/

167/ See, e.g., Opper v. Hancock Securities Corp., 250 F. Supp. 668, 673-74 (S.D.N.Y.), aff'd per curiam, 367 F.2d 157 (2d Cir. 1966). Besides the applicability of Rule 10b-5, self-regulatory organizations have adopted rules at the insistence of the Commission to govern execution of customers' orders. See Securities and Exchange Commission, Report on the Feasibility and Advisability of the Segregation Dealer and Broker, Appendix 0-1 at 166 (June 20, 1936). (The fifth rule recommended for adoption by exchanges prohibits trading for a broker's own account where the broker has an unexecuted customer order for the same security.) Id. at 168. See, e.g., NYSE Rule 92, 2 NYSE Guide (CCH) ¶ 2092; Amex Rule 150, Amex Guide (CCH) ¶ 9290.

168/ See, e.g., Securities and Exchange Commission v. Resch Cassin & Co., 362 F. Supp. 964, 978 (S.D.N.Y. 1973).

169/ See, e.g., Joseph V. Shields Jr., Securities Exchange Act Release No. 8484 (Jan. 3, 1969).

170/ See, Pickard & Co., Securities Exchange Act Release No. 8447 (Nov. 14, 1960); Acmerge Securities Co., Securities Exchange Act Release No. 7962, at 1 (Sept. 26, 1966).

171/ See, e.g., Silverman v. Bear, Stearns & Co., 331 F. Supp. 1334, 1337 (E.D. Pa. 1971); Opper v. Hancock Securities Corp., 250 F. Supp. 668, 673-75 (S.D.N.Y.), aff'd per curiam, 367 F.2d 157 (2d Cir. 1966); Leo G. MacLaughlin Securities Co., Securities Exchange Act Release No. 7783 (Jan. 5, 1966).

Certain trading practices of market professionals, based on misuse of market information may violate Rule 10b-5, as well as self-regulatory organization ("SRO") rules. One example is the practice of "front-running,"

(footnote continued)

In a recent release the Commission has also cautioned that broker-dealers have an obligation promptly to distribute dividends and interest payments on securities held in custody for their customers, and that failure to do so without proper notification is inconsistent with an obligation to deal fairly with customers. 172/

With respect to recommendations by a broker, courts have held that a broker impliedly represents that he has an adequate and reasonable basis for making a recommendation. 173/ And, in order to form a reasonable basis, brokers are under a duty to make a reasonable investigation with regard to recommendations. 174/

171/ (footnote continued)

defined by the Commission as "the practice of trading a security while in possession of unreported information concerning a block transaction in the same or related security." The Commission has taken the position that the practice at least violates the prohibition in exchange rules which proscribe conduct inconsistent with just and equitable principles of trade. See Securities Exchange Act Release No. 14156 (Nov. 19, 1977) (letter from George A. Fitzsimmons, Secretary, SEC, to Joseph V. Sullivan, President, Chicago Board of Options Exchange ("CBOE"); Report of the Special Study of the Options Markets, Chapter III, The Use of Options By Professional Traders, 59-64 (Feb. 15, 1979).

172/ Securities Exchange Act Release No. 15194 (Sept. 27, 1978), 15 SEC Docket 1174, 1175 (Oct. 11, 1978).

173/ See, e.g., Hiller v. Securities and Exchange Commission, 429 F.2d 856, 857-58 (2d Cir. 1970); Hanley v. Securities and Exchange Commission, 415 F.2d 589, 597 (2d Cir. 1969), aff'g, Richard J. Buck & Co., Securities Exchange Act Release No. 8482, at 6, 8 (Dec. 31, 1968).

174/ See, e.g., Hanley v. Securities and Exchange Commission, 415 F.2d 589, 595-97 (2d Cir. 1969).

C. Suitability

Closely related to the concept of fraud in regulating professional behavior is the concept of suitability. Historically, the latter concept is based largely on the ethically-oriented directives to SROs contained in the 1934 Act (e.g., "just and equitable principles of trade"). Its development, scope, and applicability to options are perhaps best reflected in the following excerpt from the Options Study. 175/

> 2. The Suitability Doctrine
>
> The doctrine that a securities recommendation must not be unsuitable for a customer in light of his financial resources and investment objectives is a key element in the broker-dealer's obligation to deal fairly with its customers. The doctrine requires that a broker-dealer and its registered representatives recommend for the firm's customers only those securities transactions which they reasonably believe are suitable in light of the customer's financial situation and needs. 176/ The suitability requirement does not attempt to make a registered representative, or the brokerage firm for which he works an insurer of favorable investment performance. It does, however, obligate the brokerage firm and registered representative to make sure that any recommendations made are done so with the customer's interests and characteristics uppermost in mind. As such, the doctrine, and the self-regulatory organization rules which codify it, are meant to serve as a fundamental protection for customers who rely on the judgment and expertise of their brokerage firms and their registered representatives.
>
> Many customers have difficulty comprehending the risks involved in options trading, and, out of necessity, develop a total dependence upon the advice of their registered representatives. In these circumstances,

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175/ Pp. 338-346, footnotes in original (renumbered).

176/ See generally R. MUNDHEIM, Professional Responsibility of Broker-Dealers: The Suitability Doctrine, 1965 DUKE L.J. 445 (1965) [hereinafter cited as MUNDHEIM]; N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS (1977), ¶ 2.08 [hereinafter cited as WOLFSON].

where options customers frequently cannot make informed decisions concerning their own accounts, the responsibility of registered represnetatives to assure that recommendations made to customers are suitable is all the more meaningful.

a. Traditional concepts of suitability

The suitabilty doctrine originally developed as an ethical standard of business conduct and was first set down in the 1930s as a guideline to the NASD Rules of Fair Practice. As now incorporated into the NASD rules, it states:

> [I]n recommending to a customer the purchase, sale or exchange of any security, a [broker-dealer] member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. 176/ (Emphasis added.)

The NASD suitability rule, therefore, requires that member firms have a reasonable basis for believing that a recommendation is suitable, but does not require specifically that firms inquire into the customer's financial circumstances and investment objectives. 177/

The NYSE and AMEX have not adopted rules which directly address suitability of recommendations to buy or sell listed stocks or bonds. However, both exchanges do impose on member firms a duty to use "due diligence to learn the essential facts relative to every customer." 178/ Although this requirement, to "know your customer", might have been designed originally to protect member firms against poor credit risks, it has been interpreted over the years to serve also as protection for customers against unsuitable recommendations. 179/

176/ NASD Rules of Fair Practice, Art. III, § 2, NASD MANUAL (CCH) ¶ 2152.

177/ Ibid., "Policy of the Board of Governors", (discusses NASD policies relating to this rule).

178/ Rule 405, 2 NYSE GUIDE (CCH) ¶ 2405; Rule 411 2 ASE GUIDE (CCH) ¶ 9431.

179/ WOLFSON, at ¶ 2.01[1]; MUNDHEIM, at 451 n. 14 and 463 n.54.

In 1967, the Commission adopted its own suitability rule, applicable to brokerage firms which are not members of the NASD or of any national exchange. Known as the "SECO" suitability rule, it provides that:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person. (Emphasis added.) 180/

Unlike the NASD rule, the Commission's rule imposes on brokerage firms a specific affirmative duty to inquire into a customer's circumstances.

b. Suitability developed for listed options

When the CBOE was established in 1973, it adopted a suitability rule which included the traditional standards of suitability and paralleled the Commission's own rule. Therefore, like the Commission's rule, the CBOE rule imposes on brokerage firms a specific affirmative duty to conduct reasonable inquiry into a customer's circumstances and to have reasonable grounds for believing that a recommendation is not unsuitable for the customer.

In addition, the CBOE rule included additional and more stringent suitability standards to recognize the potentially greater risks inherent in uncovered call writing transactions. When the rule was amended in 1977 to include puts, these standards were also made applicable to recommendations for put writing transactions. These additional requirements provide that:

> [A] recommendation to a customer of [writing a put or an uncovered] call option contract, shall be deemed unsuitable for the customer unless, upon the information furnished by the customer, the person making the recommendation has a reasonable basis for believing ... that the customer has such knowledge and experience in financial

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180/ Securities Exchange Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1977).

> matters that he may reasonably be expected to be capable of evaluating the risks of such transaction, and such financial capability as to be able to carry such position in the option contract. 181/ (Emphasis added.)

The most significant difference between this standard and the traditional standard applicable to supposedly less risky options transactions is that this new standard requires that the firm have a reasonable basis for believing that the customer is sophisticated enough in financial matters to understand the risks of uncovered call writing and put writing strategies. The rule relating to other options strategies requires no such finding.

Other self-regulatory organizations have adopted suitability rules similar to the CBOE's, both with respect to general options trading and to the more risky uncovered call writing and put writing strategies. 182/

The Options Study believes that the current suitability standards applicable to options transactions should be strengthened in the following ways:

(1) A Finding that the Customer is Capable of Evaluating the Risks of Options Transactions

The current options prospectus states on the cover page in bold face type:

> Both the purchase and writing of Options involve a high degree of risk and are not suitable for many investors. Such transactions should be entered into only by investors who have read and understand this prospectus and, in particular, who understand the nature and extent of their rights and obligations and are aware of the risks involved. (Emphasis added.)

181/ Rule 9.9, CBOE GUIDE (CCH) ¶ 2309.

182/ Rule 923, 2 ASE GUIDE (CCH) ¶ 9723; Art. XLVM, Rule 5, MSE GUIDE (CCH) ¶2115; Rule 1026, PHLX GUIDE ¶ 3026. Unlike the CBOE rule, the suitability standards of the other options exchanges apply to all transactions in put or uncovered call writing, whether or not recommended. This means that the firm must refuse to effect any unsolicited transaction in either put or uncovered call writing unless the firm has a reasonable basis for a suitability determination.

As discussed above, the options exchanges do not require that a broker-dealer recommending options transactions to a customer have a reasonable basis for believing that the customer understands the risks of the recommended transactions, except when the particular recommendation or transaction is to write uncovered calls or to write put options.

The Options Study believes that a customer should be made aware, on an on-going basis, of the risks of any and all options transactions undertaken by the customer and that a brokerage firm should not be permitted to recommend any options transaction to a customer unless the firm reasonably believes that the customer is capable of both evaluating the risks and bearing the financial burden of those risks.

Accordingly, the Options Study recommends:

- THE SELF-REGULATORY ORGANIZATIONS SHOULD REVISE THEIR OPTIONS CUSTOMER SUITABILITY RULES TO PROHIBIT A BROKER-DEALER FROM RECOMMENDING ANY OPENING OPTIONS TRANSACTIONS TO A CUSTOMER UNLESS THE BROKER-DEALER HAS A REASONABLE BASIS FOR BELIEVING THE CUSTOMER IS ABLE TO EVALUATE THE RISKS OF THE PARTICULAR RECOMMENDED TRANSACTION AND IS FINANCIALLY ABLE TO BEAR THE RISKS OF THE RECOMMENDED POSITIONS.

(2) An Affirmative Requirement to Obtain Suitability Information Before Recommendations are Made

A broker-dealer's duty of "reasonable inquiry" under the suitability rules requires that the firms at least ask the customer for suitability information. If a customer refuses to furnish this information, the firm must, nevertheless, have "reasonable grounds" on which to base a suitability determination.

The CBOE guidelines make clear that "[m]aking a recommendation without knowing the customer's essential facts or other information will result in the recommendation being unsuitable." 183/ However, these guidelines do permit options

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183/ CBOE Educational Circular #6, at 10.

transactions to be recommended to a customer who refuses to furnish suitability information, provided the firm has other information indicating that the recommended transaction is not unsuitable for the customer.

Estimating suitabilty information for a customer who refuses to furnish this information can result in the same problems that occur when a registered representative fails to inquire into a customer's background. Unless sufficiently comprehensive customer information is actually obtained, suitability determinations cannot be made.

Accordingly, to clarify and strengthen firms' obligations to obtain suitability information for customers, the Options Study recommends:

> THE RULES OF THE SELF-REGULATORY ORGANIZATIONS SHOULD BE AMENDED TO PROHIBIT FIRMS FROM RECOMMENDING OPENING OPTIONS TRANSACTIONS TO ANY CUSTOMER WHO REFUSES TO PROVIDE INFORMATION, AND FOR WHOM THE FIRMS DO NOT OTHERWISE HAVE INDEPENDENTLY VERIFIED INFORMATION SUFFICIENT FOR THE SUITABILTY DETERMINATION.

(c) Account opening rules

The existing suitability rules require that a brokerage firm ask its customers for certain information and use the information obtained, along with any other information known about the customer, in determining whether recommended options transactions are suitable for that customer. In an attempt to assure that such information is obtained and used, all the options exchanges have adopted rules which require that before a customer is permitted to trade options, his brokerage firm must make an initial determination that listed options trading is not unsuitable for him.

The CBOE's "know your customer" rule is a typical options exchange account opening rule. It requires that suitability information be obtained, recorded, and used by a brokerage firm in determining whether to approve the account for options trading:

> In approving a customer's account for options transactions, a member organization shall exercise due diligence to learn the essential facts as to the customer, his investment objectives, financial situation and needs. A record of this information shall be maintained by the

> member organization and, based upon such information, a Registered Options Principal who is an officer or partner of the member organization shall approve in writing the customer's account for options transactions.... 184/

Other self-regulatory organizations have adopted similar account opening rules. 185/

d. Summary

In conjunction with account opening requirements, current suitability standards applicable to a firm's initial determination of the general suitability of option trading for a customer, and of specific transactions after the customer is approved for options trading, can be summarized as follows:

(1) The brokerage firm generally must acquire, use and maintain a current record of information regarding the customer's background, financial resources and investment objectives.

(2) Using the information thus acquired, the brokerage firm must make three determinations:

> (a) does the customer have sufficient financial resources to bear the risks of a recommended transaction;
>
> (b) are the risks of a recommended transaction appropriate in light of the customer's investment objectives; and
>
> (c) with respect to recommendations of put or uncovered call writing transactions, is the customer sufficiently sophisticated to enable him to comprehend the risks involved in such transactions. 186/

The Options Study went on to make some additional recommendations to improve the industry's procedures for achieving compliance with the substan-

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184/ Rule 9.7(b), CBOE GUIDE (CCH) ¶ 2307.

185/ Rule 921, 2 ASE GUIDE (CCH) ¶ 9721; Art. XLVIII, Rule 3, MSE GUIDE (CCH) ¶ 2113; Rule X, Sec. 18(b), PSE GUIDE (CCH) ¶ 4993; Rule 1024(b), PHLX GUIDE (CCH) ¶3204.

186/ As noted above, the Options Study believes this requirement should be made applicable to all recommended transactions.

tive conduct standards in this area. 187/ The SROs are currently considering those proposals.

In certain situations, violations of the suitability standards may also subject a broker to liability under Rule 10b-5 or other fraud provisions. 188/ In any event, a violation by a securities professional of those standards will at least be considered as one of the indicia of a fraudulent course of conduct. 189/

D. The Duty to Supervise

For the most part, implementation of the duty of broker-dealers and their supervisory employees to supervise their sales personnel and other associated persons to prevent violations of law and SRO standards of conduct has also rested primarily with the SROs. The duty has been spelled out in a variety of SRO rules which, in effect, carry the idea of self-regulation (or self-discipline) down to the firm and intra-firm levels. 190/

First, the NASD's rule on this subject (which is the most explicit and applies to virtually all firms doing a conventional securities business, including options retailing) provides for general supervision obligations which, at least in theory, can be violated without a showing of an actual violation of other rules or harm to the public. 191/ It also calls for each member to have written supervisory procedures which can be reviewed by SRO examiners

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187/ At pp. 347-368.

188/ See Wolfson, supra n. 176, (1977, Supp. 1979) ¶2.08[2].

189/ Ibid.

190/ See, in general, Options Study, at 314-338.

191/ Rules of Fair Practice, Art. II. Sec. 27, NASD Manual (CCH) ¶2177.

for their adequacy. Each "office of supervisory jurisdiction" 192/ in the firm, including the headquarters office, must designate particular firm officials to do the job. Member firms must: keep necessary records; review the activities of each of their offices, "including a periodic examination of customer accounts, to detect and prevent irregularities and abuses;" conduct, from the headquarters office, an inspection, at least annually, of each office which has supervisory jurisdiction; and review and initial all relevant transactions and correspondence of the firm's registered representatives who solicit or execute securities transactions.

Further, the SROs have developed special qualification requirements for firm principals, including senior supervisors. The NASD administers a special examination for newly-appointed principals of member firms. Moreover, as the Options Study has pointed out: 193/

> When the CBOE introduced trading in listed options, it recognized that firms offering this new and complex product to the public ought to have one person within the firm's management structure who possessed some expertise about listed options. Accordingly, the CBOE required each member firm to designate one officer or general partner to be the firm's "Registered Options Principal" ("ROP") who would be responsible for "the supervision... of all [the firm's retail] customer accounts" insofar as those accounts trade options. 194/ The ROP would be required to pass a qualifying examination in options.

192/ Id., at subsec. (f).

193/ pp. 316-317, footnotes in original. (renumbered).

194/ Rule 9.8, CBOE GUIDE (CCH) ¶2309. Later, when the number of Registered Options Principals in each firm multiplied causing some confusion as to precisely where responsibility for compliance with exchange rules lay, CBOE revised its rules to reestablish the concept of a single senior managerial officer with supervisory responsibilities for the firm's overall options business. This new "chief" options supervisor was dubbed "Senior Registered Options Principal" ("SROP").

> The CBOE, however, did not fashion its rule to fit the decentralized management structure of broker-dealer firms. Instead of requiring that the options business of each sales office of a firm be supervised by an ROP, it provided only for the designation of one home office ROP. As other exchanges began to offer options, they, too, adopted the ROP concept and required that their members designate an officer or partner to be the firm's ROP. 195/ Like the CBOE, the other exchanges required that members designate only one options-qualified person to supervise the firm's entire listed options business.
>
> The ROP concept is the primary supervisory innovation developed by options exchanges to deal with increased problems of supervision of options accounts. The ROP concept may eventually prove to be a sound principle on which firms may build acceptable options supervisory systems. The Options Study has found, however, that as presently designed and implemented, the ROP system is inadequate to assure proper supervision of a broker-dealer firm's business in listed options.

The Options Study therefore made a number of recommendations, which the SROs are now studying, to make this system as well as the substantive supervision requirements more effective. The Study's report concluded that: "The intricacies associated with trading options are such that strict supervision of each registered representative's activities by his brokerage firm is essential to the protection of public customers." 196/ As already noted, these same intricacies and their resulting risks for the unwary investor have led to other special regulatory approaches to options trading, such as in the areas of suitability and 1933 Act disclosure.

E. Hiring and Termination Procedures and Standards

Again quoting from the Options Study: 197/

> To assure that persons applying for positions as securities salespersons have the requisite character and

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195/ See, e.g., Rule 920, 2 ASE GUIDE (CCH) ¶ 9720.

196/ P. 314. On November 16, 1979, the NASD announced (Notice to Members 79-36) that beginning December 15, 1979 it will implement for the options exchanges the administration of a new 2-1/2 hour ROP exam to be given through its automated, controlled testing system ("Plato").

197/ P. 307, footnotes in original (renumbered).

> capabilities to service customer needs adequately, the NYSE requires that member firms "make a thorough inquiry into the previous record and reputation of persons whom they contemplate employing." The NYSE recommends that "[t]he background and reputation check should, whenever possible, include at least personal conversations with all employers during the previous 3 years ..." 198/ The options exchanges likewise require that their members make a reasonable investigation of the credentials of all prospective employees. 199/

Among other things, the investigation is intended to uncover "statutory disqualifications," if any, of applicants for association, which would then be revealed in the formal applications filed with the SROs concerned. 200/ The screening would also disclose the necessity for a person entering the firm to pass a qualifying written examination. The requirements in that regard for options sales personnel are summarized by the Options Study: 201/

> The options exchanges all require that employees of member firms be registered with the exchange before they are permitted to sell that exchange's listed options to customers. As a prerequisite to registration, the salesperson must pass an options qualifying examination.
>
> Two examinations are presently in use. The NASD "Series 7" qualifying examination is given to all applicants who are new to the securities industry and who are seeking to become registered to sell securities for the first time (i.e., to become "registered representatives"). The "Puts and Calls" examination is given to persons who are already registered representatives, but who passed the Series 7 examination (or became registered on the basis of earlier standards) before listed options were included in the registration requirements. 202/

198/ Rule 345, 2 NYSE Guide (CCH) ¶ 2345.18.

199/ See, e.g., Rule 34.02, 2 ASE Guide (CCH) ¶ 9390.

200/ See Sec. 3(a)(39), 6(c)(2), 15A(g)(2) of the 1934 Act.

201/ At pp. 298-300, footnote in original (renumbered).

202/ For a short period of time the Series 7 examination included questions on calls but not puts, and persons who took the test during that period subsequently had to pass a separate "Puts" examination if they wished to offer puts to customers.

The Series 7 examination consists of 250 multiple choice questions and covers virtually all types of securities products available to investors. Questions relating to listed call options have been included in the examination since May 1977. At present, approximately twenty questions — eight percent of the examination — directly concern options, and, on occasion, as many as ten more questions may be devoted to the margin treatment of options transactions. An applicant must achieve a seventy percent correct score to pass the examination (175 correct answers); none of the subjects is scored separately. The examination is "closed book" and is administered once a month at various NASD testing centers around the country.

As presently structured, the Series 7 examination has little relationship to the actual qualifications of a person to sell listed options. Since only twenty questions directly concern options and since an applicant may miss a full seventy-five questions without failing the examination, an applicant may miss every options question and still become "qualified" to sell options.

On the other hand, the "Puts and Calls" examination, which consists of forty to fifty multiple choice questions, is devoted entirely to options. To pass this test, a person would appear to need some understanding of the product. As with the Series 7 examination, however, the industry has permitted those who take the "Puts and Calls" test to pass it without necessarily possessing any knowledge of options. First, the examination is given "in house" which means that brokerage firms may devise their own procedures for administering the test. The opportunity for abuse is apparent, and it is not surprising that rumors abound as to widespread misconduct in the administering of the test. Second, no official passing grade has ever been established for the examination (although a "rule-of-thumb" seventy-five percent passing score has been suggested by the CBOE). The established brokerage firm procedure following the examination is for the options supervisor who administered the test to "review" with each candidate his incorrect answers and then to retest him until he "passes." For this reason, the "Puts and Calls" test, like the Series 7 examination, does not serve to assure that options "qualified" registered representatives are knowledgeable about options.

As with the ROP testing program previously discussed, it is expected that the problems noted by the Study concerning examinations for sales employees will be concretely addressed by the SROs in the near future.

The NYSE, NASD and the options exchanges all require member firms to file notices with them when a salesperson leaves the firm for any reason. 203/ The notification forms require the firm to specify the reasons for termination and disclose whether the salesperson had been the subject of any major complaints. The notices must be filed with the SRO promptly following the termination. These notices are an important monitoring tool for the SROs, whose follow-up procedures will be considered in a separate memorandum.

F. Basic Broker-Dealer Recordkeeping and Reporting Requirements Under the 1934 Act

1. Recordkeeping

All broker-dealers are required to make and keep current certain prescribed books and records. Rule 17a-3 under the 1934 Act specifies which records must be maintained for registered broker-dealers. 204/ Implicit in the rule is the

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203/ See, e.g., Rule 345.13, 2NYSE Guide (CCH) ¶2345; Rule 9.3, CBOE Guide (CCH) ¶2303; Rule 341.09, 2 Amex Guide (CCH) ¶9391.

204/ Specifically, the rule requires that firms maintain such records as:

> Blotters containing an itemized daily record of all purchases and sales of securities; ledgers reflecting all assets and liabilities, income and expense and capital accounts; ledger accounts itemizing separately each cash and margin account of customers and of the broker; ledgers reflecting securities in transfer, dividends and interest received, securities borrowed, securities loaned, moneys borrowed; moneys loaned; securities failed to receive and failed to deliver; securities records reflecting separately for each security "long" and "short" positions and their locations a memorandum of each brokerage order and other instruction for the purchase and sale of securities whether executed or unexecuted, and specifying the terms of the order; a memorandum of each purchase and sale for the account of the broker-dealer showing the price and time of execution; copies of confirmations of all purchases and sales of securities; a record of each cash and margin account; records of all puts, calls, spreads and straddles and other options; trial balances; employment questionnaires for the individuals associated with the broker; Rule 17f-2, (fingerprinting) records; and copies of Form X-17F-1A, (lost and stolen securities reports under Rule 17f-1), if applicable.

requirement that all books and records be true and accurate. 205/

The rules of the Commission also encompass a program for the preservation of specified records for stated periods of time. For the most part, all records must be preserved in an easily accessible place for two years. Some must be preserved for six years 206/ and others for three years. 207/ Fundamental documents, such a charters, by-laws, partnership articles, and the like, must be kept for the life of the enterprise. Rule 17a-4 calls for the preservation of records which Rule 17a-3 does not require to be made. For example, Rule 17a-4(b)(4) calls for three-year preservation of "originals of all communications received and copies of all communications sent by such member, broker, or dealer (including inter-office memoranda and communications) relating to his business as such." The number, variety, and kinds of such communications and memoranda are not prescribed. But once any such written materials are made or received, they must be preserved. This would include the records made pursuant to requirements such as those contained in the various suitability and supervision rules of the SROs. 208/ Under Section 17(a) of the Act, the books and records of the broker-dealer must be made available for Commission inspection without notice at any reasonable time.

205/ For publicly-owned broker-dealers subject to Section 13(b)(2) of the Act, the requirement is explicit.

206/ Rule 17a-4(a) and (c).

207/ Rule 17a-4(b).

208/ Those broker-dealers who are also registered with the CFTC as futures commission merchants file an amended X-17A-5 form which is accepted by both the SEC and the CFTC. See Securities Exchange Act Release No. 15899 (June 5, 1979).

2. Reporting

Form X-17A-5, promulgated by the Commission under Rule 17a-5, serves as the basis for a uniform system of financial reporting by broker-dealers. The form is officially described as the financial and operational combined uniform single report, and is known by its acronym, the FOCUS Report. This reporting system was adopted in 1975. It superseded a variety of forms previously utilized for financial reporting, surveillance and collection of economic data by the Commission, exchanges and self-regulatory organizations.

Registered broker-dealers must file, on either a monthly or quarterly basis, applicable portions of the FOCUS Report with the Commission, self-regulatory organization, or the exchange designated as their examining authority. Although the reports, except for a year-end audited report which must be filed with the Commission, need not be audited, the introductory page of the FOCUS Report contains a representation by the broker-dealer or his officers that the information filed is true, correct, and complete.

If the broker-dealer does a general securities business, Part I of the FOCUS Report must be filed within ten business days after the end of each month, and Part II within 17 business days after the end of the calendar quarter. If the broker-dealer does not do a general securities business, Part IIA must be filed within 17 business days after the end of each calendar quarter, unless the broker-dealer is a new member of an SRO, in which case the SRO may impose additional filing requirements. 209/

Part I of the FOCUS Report requires, among other things, a reporting of the total number of buy and sell tickets executed, markets made,

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209/ Part IIA is shorter and less detailed than Part II.

inventory positions held, securities borrowed and other specific financial data concerning the broker-dealer's operations.

Part II of the FOCUS Report is defined in instructions to the report as the basic financial and operations report required of broker-dealers subject to the minimum net capital requirement. 210/ It requires a detailed statement of financial position, a statement of income, a statement of changes in ownership equity, a statement of changes in subordinated liabilities, a net capital computation, computation of the special reserve requirements imposed pursuant to Rule 15c3-3, a statement of equities and subordinated liabilities which have either matured or are proposed to be withdrawn from the business of the broker-dealer within the next six months but not deducted from the net capital computation, and a statement of the broker-dealer's securities failed to deliver or failed to receive.

Rule 17a-5, in addition to providing for the FOCUS form, also requires that within 60 days of a fixed or determinable day at the end of each calendar or fiscal year, the broker-dealer must file with the Commission an audited statement of financial condition, including a statement of income or loss, a statement of changes in financial position, a statement of changes in shareholders' equity and a statement of changes in subordinated liabilities. The statements must be prepared on a basis consistent with Part II or IIA of the FOCUS Report and include, in supporting schedules, net capital and Rule 15c3-3 computations from the FOCUS Report. The broker-dealer must include or attach the unaudited figures on Part II or Part IIA of the FOCUS

210/ See Rule 15c3-1(a)(1).

Report for the periods in question and submit a statement of explanation in the event the audited figures differ materially from unaudited figures.

The accountant conducting the audit must be certified and in good standing under the laws of his place of residence, and "independent." 211/ The accountant must clearly identify those matters in the statements as to which he takes exception. Along with the audit report, the accountant is also required to file a supplemental report setting forth any material inadequacies found to exist or found to have existed since the date of the previous audit.

Under Rule 17a-5(f)(4), not more than 15 business days after replacement of an accountant for any reason, the broker-dealer must file a special notice with the Commission setting forth the details of any problems which prompted the change. The broker-dealer is also required to send the accountant a copy of the proposed notice, solicit his agreement or disagreement concerning the reasons for the change, and forward the accountant's letter to the Commission, along with the notice.

Rule 17a-5 also performs an additional, "early warning" function. Paragraph (b)(1) requires that if any broker-dealer holding a membership interest in a national securities exchange ceases to be a member in good standing, within two days thereafter he must file with the Commission Part II of Form X-17A-5. Thus the Commission receives indirect notification that an exchange has found a problem with one of its members.

211/ See Securities Exchange Act Release No. 9662 (July 5, 1972).

Similarly, subparagraph (h)(2) of Rule 17a-5 requires that if during the course of an audit an independent accountant determines that material inadequacies exist with the broker-dealer's accounting system, the broker-dealer must notify the Commission telegraphically within 24 hours. A copy of the notice must be submitted to the accountant who discovered the inadequacies. If the accountant disagrees with the statements contained in the notice, he must inform the Commission or the designated examining authority within 24 hours.

Another early warning reporting provision is found in Rule 17a-11. This rule was adopted by the Commission to give the Commission and other self-regulatory bodies some advance warning of financial problems when they are encountered by brokerage firms. The rule requires of every broker-dealer subject to the net capital rule, that if its capital falls below the minimum required by the rule, it shall give immediate telegraphic notice to the Commission that its capital has been impaired. Within 24 hours the broker-dealer must also file Part II of the Form X-17A-5 which sets forth basic financial information from which the staff of the Commission can attempt to determine the seriousness of the problem.

If at any time during the month the broker-dealer's net capital, even though not in violation of the rule, declines to the point where the excess of such capital over the minimum required is only 120%, additional reports must be filed. Monthly reports are then required of the broker-dealer until three successive months have elapsed where the broker-dealer's net capital is more than 120% of the minimum.

Paragraph (c) of the rule requires a broker-dealer to give telegraphic notice to the Commission when he discovers his books and records are not being kept current and within 48 hours to file a report setting forth the corrective steps being taken.

Paragraph (d) of the rule requires telegraphic notice to the Commission when the broker-dealer is advised by his accountant of any material inadequacies in his financial records. This notice must be filed within 24 hours of the accountant's notification. Within 48 hours it must be followed up by a report setting forth the steps being taken to correct the deficiences.

G. Protection of Customer Funds and Securities

The Securities Exchange Act contains several provisions intended to protect customer funds and securities held by brokers and dealers. First, Section 15(a)(3) makes it unlawful for a broker or dealer to effect any transaction in contravention of such rules and regulations as the Commission shall prescribe to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including the custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. This section provides that the rules must (A) require the maintenance of reserves with respect to customers' deposits or credit balances and (B) establish minimum financial responsibility for all brokers and dealers.

1. Rule 15c3-3

Aside from the net capital rule, 212/ the most important rule adopted under Section 15(c)(3) is Rule 15c3-3 which has separate, but related, provisions with respect to customer funds and customer securities.

a. Customer securities

Rule 15c3-3 requires a daily determination by the broker-dealer of the fully-paid and excess margin securities of customers required to be in his physical possession or control. It prescribes the time periods within which a broker-dealer must act to bring securities under his possession or control if his daily determination shows a deficit with respect to his customers' fully-paid and excess margin

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212/ See n. 2, supra.

securities. If the determination as at the close of a given business day reveals that the broker-dealer has physical possession or control of all securities of a particular issue, during the following business day, the firm may effect delivery of shares of such issue received that day to fulfill any of that day's delivery obligations.

A broker-dealer has "control" of securities not in his physical possession under the Rule when they are held in certain defined locations -- e.g., by a bank custodian; by a branch office or in transit between offices of the broker-dealer; or by a clearing corporation.

For those securities not in physical possession or control (e.g., a deficiency in any security), the Rule provides for two business days and five business days, respectively, for the release of securities from a lien and for the return of loaned securities in order to reduce them to possession or control for compliance with the Rule. In addition, the time after which a fail to receive must be reduced to possession through a buy-in or other procedure is 30 days.

The objective of these provisions are to assure that a broker-dealer will not make inappropriate use of customer's fully-paid for or excess margin securities.

b. Customer funds

The second part of the rule requires brokers or dealers to establish and deposit funds in a "reserve bank account" pursuant to a formula which endeavors to limit the use of customers' funds and securities by the broker-dealer as working capital, except in certain defined, but important, areas. Those permissible areas are the financing of customers' margin accounts and the borrowing of

securities to effectuate customers' short sales and delivery on customers' fails-to-deliver, -- i.e., those credit extension activities of securities firms that have been an integral part of their retail operations.

The formula, in form and concept, places on the credit side customer funds for which the broker-dealer is accountable and on the debit side funds located in permissible areas where they may be deployed, or if not so deployed, deposited in a required special reserve bank account.

The credit items 213/ represent, among other things, customers' credit balances held by the broker or dealer, customers' monies deposited with the broker or dealer, and in general, any and all monies held by the broker or dealer which are due customers, held to pay for customers' purchases or derived by lending or hypothecating customers' securities. In addition, several penalty, or potential customer exposure items, are also included as credit items in the formula. The rule, in effect, permits the broker or dealer to utilize customers' monies, as defined by the credit items in the formula, only for the purpose of financing customer transactions represented by the debit items 214/ in the formula.

213/ See Rule 15c3-3(a), Exhibit A - formula for determination of reserve requirements of brokers and dealers, items 1 through 9.

214/ For example, customers' purchases on margin, debits in customers' cash accounts, monies deposited with other brokers or dealers to borrow securities to deliver on customers' short sales and receivables from other brokers or dealers for customers' securities sold but not yet delivered by the customer are transactions which may be financed by a broker or dealer with customers' monies under the formula.

In sum, the Rule's objective is to assure that all money obligations to customers, as defined by the credit side of the formula, will be covered, in the event of liquidation, by either money deposited in the reserve bank account or by secured, collectable receivables reflected in the debit side of the formula. That coverage, plus the cushion of liquidity provided by the net capital rule form the basis for the overall customer protection provided by the Commission's financial responsibility requirements.

Further, the Commission has pointed out that the formula approach has the following desirable effects:

> It is designed to achieve an effective prohibition against a broker-dealer's use of customer funds and securities to finance activities for its own account. It motivates a firm to resolve aged stock dividend receivables, security differences and suspense account items and to avoid the accumulation of fails-to-receive. It seeks to control the quality of margin indebtedness extended by firms to customers. It also provides an incentive to a firm to reduce to possession or control customer fully-paid securities "as soon as possible." 215/

2. Hypothecation Rules

In addition to Rule 15c3-3, the hypothecation rules (Rules 15c2-1 and 8c-1) are designed to protect customer securities which are the subjects of loans. In general, the hypothecation rules provide:

> 1. A firm may not hypothecate or pledge securities carried for the account of its customer in such a way as to permit the securities of the customer to be commingled with the securities of other customers unless it first obtains the written consent of such customer. A limited exception from the written consent requirement is afforded for securities which are carried for customers in special cash accounts, provided that at or before the completion of the transaction, the broker-dealer gives written notice to each customer disclosing that the securities are or may be hypothecated under circumstances permitting the commingling of the securities with those of other customers. This written notice may be on the confirmation.

215/ Securities Exchange Act Release No. 9856 (November 10, 1972).

2. A firm may not hypothecate securities carried for the account of its customers under a lien for a loan made to the firm in such a way as will permit such securities to be commingled with the securities of any person other than a bona fide customer, e.g., the firm's officers and directors.

3. A firm may not hypothecate securities carried for the account of customers to secure a loan which exceeds the aggregate indebtedness of all customer accounts. "Aggregate indebtedness" is the aggregate of all the debits in the accounts of customers carried by the firm in respect of the securities carried for their accounts.

3. Rule 17a-13

The Commission has also adopted Rule 17a-13 requiring regular "box counts" and other verification of all securities for which a broker-dealer is responsible. The rule applies, with certain limited exceptions, to all broker-dealers who hold customers' funds or securities. In brief, broker-dealers subject to the Rule must, once every calendar quarter:

(1) physically examine and count all securities held;

(2) account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, and failed to deliver or other-wise subject to his control or direction but not in his physical possession, by examination and comparison of the supporting detail records with the appropriate ledger control accounts; and if such securities are not in his physical possession and have been in that status for longer than thirty days, the firm must verify their status.

(3) compare the results of the examination and verification with the firm's records; and

(4) post the unresolved differences to the firm's books and records within seven days.

The equivalent procedures conducted by the firm's auditors in connection with the firm's annual report of financial condition (Form X-17A-5) may be substituted for the firm's examination, count, verification, and comparison for the quarter in which the audit date falls. These quarterly procedures are to be made no less than two nor more than four months apart. The rule specifically allows cyclical

counts, whereby all locations would be counted for a specific security, and all security positions would be counted within the prescribed period. These procedures are to be conducted or supervised by persons not normally responsible for handling securities or making the subject records.

4. Securities Investor Protection Act ("SIPA") of 1970

Finally, of substantial importance in the 1934 Act system for protecting investor assets are the provisions of SIPA which applies "as if [it] constituted an amendment to, and was included as a section of" the 1934 Act. SIPA created a fund -- and a non-profit corporation, the Securities Investor Protection Corporation ("SIPC") to administer the fund subject to certain Commission supervision -- for the reimbursement of customers of insolvent broker-dealers holding customer funds and securities. In brief, SIPC is required to pay to the trustee in the failing firm's liquidation up to $100,000 per account to satisfy customer claims for such assets, except that the payment for cash claims cannot exceed $40,000. At the present time there are only a few limited classes of registered broker-dealers not covered by the SIPC fund -- e.g., those who restrict their business to mutual funds and variable annuities sales.

H. Civil Liabilities under the Federal Securities Laws

1. Express remedies

The federal securities laws contain a number of provisions which impose civil liability on persons who violate certain statutory requirements, and expressly provide private remedies for such violations. The discussion which follows summarizes the civil liability provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. 216/

a. Securities Act of 1933

The Securities Act of 1933 sets forth three specific civil liability provisions. First, Section 12(1) 217/ imposes liability for rescission or

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216/ See subsection 2, infra, for a discussion of Investment Advisers Act liabilities.

217/ Section 12(1) of the Securities Act, 15 U.S.C. 77e (1) provides that

> Any person who offers or sells a security in violation of Section 5 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.

damages upon any person who offers or sells a security in violation of the registration or prospectus provisions of Section 5 of the Act. Liability under Section 12(1) extends to any person with whom a plaintiff is in privity of contract. Thus, depending upon the facts of a particular case, a plaintiff under Section 12(1) may recover from an issuer, underwriter, or dealer. The standard under Section 12(1) is practically one of strict liability. A plaintiff need only establish (1) privity with the defendant, or alternatively, that the defendant, is a "controlling" person 218/ of one with whom plaintiff is in privity, (2) use of the mails or any means of interstate commerce in the sale to plaintiff, (3) failure by the defendant to comply with either the registration or prospectus requirement, (4) timeliness of the institution of suit within the statute of limitations under Section 13 of the Act, 219/ and (5) making of adequate tender where the plaintiff seeks rescission. Once these elements are established, a defendant has available only the affirmative defense that the security sold, or transaction involved, was exempt from the requirements Section 5. The seller's state of mind is irrelevant in establishing liability under Section 12(1), 220/ and a plaintiff need

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218/ Section 15 of the Securities Act, 15 U.S.C. 77o, provides that

> Every person who . . . controls any person liable under section 11 or 12, shall also be liable... to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

219/ Section 13 of the Securities Act, 15 U.S.C. 77m, requires that actions be brought within one year after the alleged violation of Section 5, and within three years after the security was "bona fide offered to the public."

220/ See e.g., Wonnemann v. Stratford Securities Co., [1961 Transfer Binder] Fed. Sec. L. Rep. [CCH] ¶ 91,034 (S.D.N.Y. 1961).

not prove reliance upon any misstatement, nor causation between the violation of Section 5 and damages claimed. 221/

In respect to actions brought under Section 12(1), it should be borne in mind that Section 5 not only proscribes the sale of unregistered securities, but also prohibits (1) the sale of registered securities without an earlier or contemporaneous delivery of a prospectus, (2) the use of a prospectus not meeting the requirements of Section 10 of the Securities Act, and (3) the offer or sale of a security prior to the filing of a registration statement or while a refusal order or stop order is in effect or a notice of a stop order proceeding has issued.

A second express right of action under the Securities Act is provided by Section 11. That provision, in brief, imposes liability for damages upon the issuer of registered securities, and several other classes of persons, for material statements in a registration statement which are false or misleading, and for omissions of material facts required to be stated in order to make the statements in the registration statement not misleading. Those subject to liability under Section 11 are:

(1) every person who signed the registration statement (a category which includes the issuer itself);

(2) all directors of the issuer (including all persons who are named in the registration statement as "about to become" directors)

(3) all underwriters of the offering; and

(4) any "expert" (for example, an accountant, engineer or appraiser) who prepared or certified any part of the registration statement.

221/ See e.g., Newberg v. American Dryer Corp., 195 F. Supp. 345, 352 (E.D. Pa. 1961).

In contrast to an action under Section 12(1) (and Section 12(2)), a plaintiff bringing suit under Section 11 need not establish privity of contract with the issuer or any other defendant. Thus, purchasers in the open market of securities traceable to the public offering may maintain an action under Section 11 at any time before the statute of limitations runs its course. 222/ An issuer is subject to strict liability in an action brought under Section 11, unless it can establish that the plaintiff knew of the untruth or omission in the registration statement at the time of his purchase of the security. As to an issuer and all other defendants, moreover, a plaintiff under Section 11 normally need not establish reliance 223/ on the misleading statement or omission.

All defendants other than the issuer in a suit under Section 11 have a defense that they had "after reasonable investigation, reasonable ground to believe and did believe" that the statements were true and complete. Through this "due diligence" defense, Congress thus provided that negligence, rather than scienter, governs liability under Section 11. As the House Report accompanying the bill which was to become the Securities Act explained,

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222/ Section 13 of the Securities Act requires institution of a suit under Section 11(1) within one year after the discovery of the untrue statement or omission, or after such discovery should have been made by the exercise of reasonable diligence, and (2) within three years after the security was first offered to the public.

223/ By virtue of subparagraph (a) of Section 11, however, if the issuer sends to its shareholders an earnings statement covering a period of twelve months after the effective date of the registration statement, a person who thereafter purchases a security must establish reliance in order to recover under Section 11. Such reliance, however, may be demonstrated "without proof of the reading of the registration statement."

Section 11 imposes a burden of "competence as well as innocence" upon persons involved in the issuance of securities. 224/

Finally, Section 12(2) of the Securities Act 225/ imposes liability for rescission or damages upon anyone who, using facilities of interstate commerce, offers or sells any security by means of a material misstatement. In contrast to an action under Section 11, a plaintiff under Section 12(2) must establish privity of contract with the defendant or, alternatively, establish that the defendant, by operation of Section 15 of the Securities Act, is a "controlling person" of one from whom the plaintiff purchased the security. Proof of reliance, however, is not required in a suit under Section 12(2). And while a plaintiff need not prove scienter, a defendant has an affirmative defense that "he did not know, and in the exercise of reasonable care could not have known, of [the] untruth or omission."

224/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

225/ Section 12(2) of the Securities Act, 15 U.S.C. 771(2), provides that:

> Any person who offers or 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.

Under Section 13 of the Act, a suit under Section 12(2) must be brought within one year after the discovery of the untrue statement or omission, or after the discovery should have been made; but in no event may a suit be brought more than three years after the sale. While some overlap exists between Sections 11 and 12(2), suits under the latter provision (1) encompass all securities, whether or not registered or exempt from registration, (2) include oral as well as written misrepresentations, and (3) subject ordinary dealers, a class not covered by Section 11, to liability.

Under Section 22(a) of the Securities Act, a plaintiff has a broad choice of venue for any civil action. A suit may be brought either in the district where the defendant "is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein * * *." Further, service of process may be "in any other district of which the defendant is an inhabitant or wherever the defendant may be found."

b. Securities Exchange Act of 1934

The Exchange Act also contains several statutory provisions expressly providing for maintenance of private actions.

To prevent unfair use of inside information, Congress provided under Section 16(b) of the Exchange Act that an issuer may recover any profit realized by a corporate insider in any purchase and sale, or sale and purchase, of any equity security of the issuer within a six-month period or less. Those insiders subject to liability under Section 16(b) are beneficial owners of at least 10% of any class of equity securities, directors, and officers. Section 16(b) is a broad prophylactic rule — liability attaches automatically regardless of intent, and, indeed, regardless of whether the defendant

actually traded on any inside information. A suit under Section 16(b) may be instituted by the issuer, or derivatively by a shareholder if the issuer (1) fails to bring the suit within 60 days after a request or (2) fails diligently to prosecute a suit filed within that period. Section 16(b) requires that a suit be brought within two years after the date profits were realized by the insider.

Section 18 of the Exchange Act provides a further express right of action. That provision imposes liability on any person who makes, or causes to be made, in any application or report or document filed with the Commission under the Exchange Act, any statement which "was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact . . .." A person may recover damages as a result of such statement if he relied upon it and purchased or sold a security at a price which was affected by the statement. In addition to damages, Section 18 enables a plaintiff to recover attorneys' fees and costs. A defendant has an affirmative defense that he acted in good faith and had no knowledge that the statement was false or misleading. The Section requires that suit be brought within one year after the discovery of the facts constituting the cause of action, and within three years after the cause of action accrued. 226/

226/ A third express right of action is provided under Section 9(e) of the Exchange Act, 15 U.S.C. 78i(e). Section 9 prohibits manipulation of securities registered on exchanges, through such conduct as (1) creating a false appearance of active trading in a registered security through "wash sales" or "matched orders", (2) raising or depressing the price of a security in order to induce its purchase or sale by others; and (3) effecting transactions in securities in order to stabilize the price in contravention of Commission rules. Section 9(e) of the Exchange Act renders a person who willfully engages in such manipulative conduct liable to any person who purchased or sold a security "at a price which

(footnote continued)

Similar to Section 15 of the Securities Act, Section 20 of the Exchange Act subjects "controlling persons" to liability for violations of the Act by a controlled person. A controlling person may avoid liability, if he proves that he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Finally, the venue and service of process provisions under Section 27 of the Exchange Act are similar to the venue and process provisions in the Securities Act.

c. Investment Company Act of 1940

As under the other acts discussed above, the Investment Company Act also contains certain provisions which provide for express civil liability. Section 30(f) of the Investment Company Act contains a similar express right of action for insider profits as Section 16(b) of the Exchange Act. However, in addition to the beneficial owner, director, and officer of a registered closed-end investment company, the section's liability for short-sale profits in shares of the investment company also applies to a member of any advisory board, an investment adviser to the company, and an affiliated person of an investment adviser.

Secondly, Section 36 of the Investment Company Act empowers a shareholder of an investment company to bring an action against an investment adviser for breach of fiduciary duty with respect to the receipt of compensation for services paid by the investment company. In such an action, a plaintiff

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226/ (footnote continued)

was effected by such act or transaction" for "the damages sustained as a result of such act or transaction." Thus, a plaintiff under Section 9(e) need not establish privity, but must show causation. The statute of limitations under Section 9(e) requires that suit be instituted within one year after the discovery of the facts constituting the violation, and, in any event, within three years after the violation.

need not establish that the breach of fiduciary duty constituted personal misconduct.

Section 47(b) of the Investment Company Act contains a "voiding" provision with regard to contracts similar to that under Section 29(b) of the Exchange Act. In addition, Section 44 of the Investment Company Act contains venue and process provisions similar to the 1933 and 1934 Acts, with the exception that the venue provision does not refer to the district where the defendant is "found." 227/

2. Implied rights of action

In this section, we trace the development of implied private rights of action under certain provisions of the federal securities laws. As we discuss below, the Supreme Court, as well as the lower federal courts, were originally, and for several decades thereafter, very receptive to the implication of private rights of action under various provisions of the federal securities laws. In recent years, however, Supreme Court decisions have evidenced an increasingly cautious approach by the Court

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227/ Since the express liability provisions of the remainder of the federal securities laws are similar to the provisions already discussed, a brief summary of them should suffice. Public Utility Holding Company Act of 1935: Section 16(a) (incorporates by reference Section 18 of the Exchange Act), Section 17(b) (comparable to Section 16(b) of the Exchange Act), Section 25 (contains venue and process provision similar to Investment Company Act), Section 26(b) (comparable to Section 29(b) of the Exchange Act), Section 27 (liability of controlling persons); Trust Indenture Act of 1939: Section 323(a) (similar to Section 18 of the Exchange Act with the exception that the plaintiff need not under this provision buy or sell at a price affected by the misstatement)," Section 322(b) (contains incorporation by reference of venue and process provision of the Securities Act); Investment Advisers Act of 1940: Section 215(b) (contract voiding provision similar to Section 29(b) of the Exchange Act), Section 214 (contains venue and process provision similar to Investment Company Act).

to the implication of new causes of actions and to the extension of those previously recognized.

a. Leading decisions on implied rights of action under the federal securities laws.

In Kardon v. National Gypsum Co., 228/ a court first recognized a private right of action for conduct violative of Rule 10b-5. In Kardon, plaintiffs, through fraudulent representations and omissions, were induced to sell shares of stock at substantially less than their true value. The Kardon court relied upon the "tort" theory in holding that a private cause of action was available under Section 10(b) and Rule 10b-5 to redress this fraud. Citing the Restatement of Torts, 229/ the court explained that persons injured by conduct violative of a statutory mandate may obtain private relief against a defendant, where the intent of the statute is to protect the plaintiff and others similarly situated. 230/ Under the "tort" theory, a general presumption in favor of the implication of a private cause of action is established. The inquiry, according to the Kardon court is:

228/ 69 F. Supp. 512 (E.D. Pa. 1946). The Supreme Court has described Kardon as the "seminal" case in the area. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975). Prior to Kardon, courts had recognized private rights of action under a number of other provisions of the federal securities laws. See Deckert v. Independence Shares Corp., 311 U.S. 282 (1940) (implied equitable remedies under Section 12(2) of the Securities Act to supplement express civil liability provisions of that Section); Goldstein v. Groesbeck, 142 F.2d 422 (2d Cir. 1944) (private right of action under Section 4(a)(2) of the Public Utility Holding Company Act, which prohibits entry into service or construction contracts by unregistered holding companies); Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876 (S.D.N.Y. 1941) (implied cause of action for damages under Section 15(c)(1) of Exchange Act, which prohibits fraud by brokers in the over-the-counter market).

229/ Restatement of Torts (Second) Section 286. See also Texas & Pacific R. Co. v. Rigsby, 421 U.S. 33 (1916).

230/ 69 F. Supp. at 513-14.

> whether an intention can be implied to deny a remedy and to wipe out a liability which normally by virtue of basic principles of tort law accompanies the doing of the prohibited act. 231/

Because the purpose of Section 10(b) is to prohibit all manipulative or deceptive devices in the purchase or sale of securities, the court concluded that the mere omission of an express provision for civil liability under Section 10(b), even in the face of express causes of action for violations of other provisions of the Exchange Act, is not sufficient to negate a private right of action. 232/ As a second basis for implying a cause of action, the Kardon court relied on Section 29(b) of the Exchange Act. 233/ The court explained that "a statutory enactment that a contract of a certain kind shall be void almost necessarily implies a remedy in respect of it." 234/

231/ Ibid.

232/ Ibid.

233/ Section 29(b) of the Exchange Act, 15 U.S.C. 77cc(b), provides, in part, that:

> Every contract made in violation of any provision of this [Act] or of any rule or regulation thereunder, and every contract . . . heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this [Act] or any rule or regulation thereunder, shall be void . . . as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract.

234/ 69 F. Supp. at 514.

After Kardon, courts uniformly found that a private right of action may be maintained for violations of Rule 10b-5. 235/ And, by the time the issue reached it 25 years later in Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), the Supreme Court stated that "it is now well established that a private right of action is implied under Section 10(b)," 236/ notwithstanding the availability of a remedy under state law. 237/ The Court in Bankers Life stressed that "Section 10(b) must be read flexibly, not technically and restrictively," 404 U.S. at 12, and that a private right of action may be maintained whether the fraud occurs upon exchanges, in the over-the-counter market, or, as in the instant case, in face-to-face dealings. Ibid.

In addition to Rule 10b-5, it is now well-established that an implied cause of action may be maintained against those who solicit proxies in violation of Section 14(a) of the Exchange Act and rules thereunder. 238/

235/ See, e.g., Jannigan v. Taylor, 344 F.2d 781 (1st Cir.), cert. denied, 382 U.S. 879 (1965); Hooper v. Mountain States Securities Corp., 282 F.2d 195, 201 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

236/ Superintendent of Insurance of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971).

237/ "Since there was a 'sale' of a security and since fraud was used 'in connection with it,' there is redress under Section 10(b), whatever might be available as a remedy under state law." Superintendent of Insurance, supra, 404 U.S. at 12.

238/ See, e.g., Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961); Mack v. Mishkin, 172 F. Supp. 885, 888 (S.D.N.Y. 1959); Central Founding Corp. v. Gondleman, 166 F. Supp. 429 (S.D.N.Y. 1958); Phillips v. United Corp., [1947 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,395 (S.D.N.Y. 1947).

(footnote continued)

The Supreme Court confirmed availability of a private right of action under Section 14(a) in J.I. Case Co. v. Borak. 239/ In Borak, shareholders, alleging that a merger was effected through the circulation of a false and misleading proxy statement in violation of Section 14(a) and the proxy rules, brought a derivative action seeking equitable relief and damages. The Supreme Court in Borak noted that Section 14(a) expressly refers to "the protection of investors" as the legislative purpose furthered by regulation of proxy solicitations. 240/ While the Exchange Act makes no specific reference to a private right of action, the Court explained that the legislative purpose of protecting investors "certainly implies the availability of judicial relief where necessary to achieve that

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___/ (footnote continued from page 3)

Section 14(a) of the Exchange Act, 15 U.S.C. 78n(a), provides 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 a national securities exchange or otherwise, 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, 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 pursuant to section 12 of this title.

The proxy rules, adopted by the Commission, inter alia, specify the information required to be presented in proxy materials, the mechanics of proxy solicitation, and prohibit false and misleading statements in such materials. See 17 C.F.R. §§ 240.14a-1 to 14a-12.

239/ 377 U.S. 426 (1964).

240/ Borak, supra, 377 U.S. at 432.

result." 241/ Although the solicitation of proxies arguably does not involve a "contract" for purposes of Section 29(b) of the Exchange Act, the Borak Court identified Section 27 of the Exchange Act as a separate statutory basis for an implied cause of action for violations of Section 14(a). 242/ That Section vests exclusive jurisdiction in federal district courts over "suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or rules and regulations thereunder." In view of this provision, the Court concluded that federal courts are not restricted to the grant of prospective relief, but "have the power to grant all necessary remedial relief," including rescission or damages. 243/ Finally, in upholding the availability of a private right of action under Section 14(a), the Court emphasized that the Commission's resources in detecting violations of the proxy rules were limited, and that "private enforcement of the proxy rules provides a necessary supplement to Commission actions * * *. [I]t is the duty of the courts * * * to provide such remedies as are necessary to make effective the [C]ongressional purpose." 244/

Section 6 of the Exchange Act, which requires a national securities exchange, inter alia, to enforce compliance by its members with the provisions of that act and its own rules, is a third provision under which

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241/ Ibid. Moreover, the Court held that a private right of action is available both to shareholders in a derivative action, and to the corporation itself in a direct action. Ibid.

242/ Id. at 430-31.

243/ Id. at 435. (emphasis supplied). The Supreme Court reaffirmed the implication of a private right of action under Section 14(a) in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), where the Court also held that attorney fees could be awarded to successful plaintiffs in such actions.

244/ Id. at 432-33; see also Dann v. Studebaker-Packard Corp., 288 F.2d 201, 209 (6th Cir. 1961).

courts, in certain circumstances, have recognized a private right of action by investors. The leading case for implication of a private right of action against an exchange under Section 6 is the Second Circuit's decision in Baird v. Franklin. 245/ In Baird, a customer of a member firm whose partner had converted the customer's securities sought to recover damages against the New York Stock Exchange ("NYSE") for failure promptly to detect the conversion and take disciplinary action against the partner. The majority, without elaboration, recognized a private right of action, but affirmed dismissal of the complaint for failure to prove causation. Judge Clark, though dissenting on the element of burden of proof, advanced the "tort" theory as a basis for a private right of action against the NYSE, 246/ and explained that a private right under Section 6(b) must be implied in order to effectuate Congress' purpose to provide reasonably complete and effective protections for investors through the mechanism of exchange self-regulation. 247/

245/ 141 F.2d 238 (2d Cir.), cert denied, 323 U.S. 737 (1944).

246/ Id., at 245.

247/ Id., at 246.

Another court has delineated the availability of an implied right of action against an exchange under Section 6 to encompass:

> acts, events, schemes, or circumstances surrounding exchange members of which the exchange knows or has reasonable cause to know, or those events and circumstances which would reasonably put the exchange on notice, of a violation or suspected violation of a securities law, regulation or rule, or exchange rule.

Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 368 (7th Cir.), cert. denied, 419 U.S. 875 (1974). (finding that exchange exercised due care in examining member's financial condition). See also Butterman v. Walston, 387 F.2d 822, 825 (7th Cir. 1967), (1968), cert denied, 391 U.S. 913, rehearing denied, 392 U.S. 947 (1968).

In subsequent cases, courts have recognized private rights of action against exchanges under Section 6 of the Exchange Act not only by investors, but also by limited partners and subordinated lenders of member organizations of an exchange. 248/

Federal courts have also recognized an implied right of action under Section 7 of the Exchange Act in favor of investors against broker-dealers who extend credit in violation of the margin requirements of the Federal Reserve Board. 249/ In the seminal decision, Remar v. Clayton Securities Corp., 250/ Judge Wyzanski, writing for the U.S. District Court for the District of Massachusetts, stated that the "main purpose" of the margin provisions was to establish:

> an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market. 251/

However, since the "protection of the small speculator" was also an intent of the provisions, the Remar court concluded that an action should be implied on behalf of the investor for margin violations. 252/ In Pearlstein

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248/ See, e.g., Hughes v. Dempsey-Tegeler & Co., Inc., 534 F.2d. 156,165 n.4 (9th Cir.), cert. denied, 429 U.S. 896 (1976); New York Stock Exchange v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975); Weinberger v. New York Stock Exchange, 335 F. Supp. 139 (S.D.N.Y. 1971); but see Lank v. New York Stock Exchange, 548 F.2d 61 (2d Cir. 1977) (no private right of action under Section 6 on behalf of a member organization's receiver).

249/ See 12 C.F.R. Parts 220-224.

250/ 81 F. Supp. 1014 (D. Mass. 1949).

251/ Id. at 1017.

252/ Id. For other decisions recognizing a right of action under Section 7 of the Exchange Act, see Appel v. Levine, 85 F. Supp. 240 (S.D.N.Y. 1948); Goldenberg v. Bache & Co., 270 F.2d 675, 680 (5th Cir. 1959);

(footnote continued)

v. Scudder & German, 253/ the Second Circuit similarly recognized that margin requirements were enacted primarily for macro-economic purposes, but reasoned that a private right of action should be implied under Section 7 because "[P]rivate actions * * * are a highly effective means of protecting the economy as a whole from margin violations by brokers and dealers." 254/

Apart from direct violation of the Securities Exchange Act and rules thereunder, federal courts have also recognized, in certain circumstances, implied private rights of action against broker-dealers for violations of rules of exchanges, and other self-regulatory organizations, promulgated pursuant to authority under the Securities Exchange Act. In the landmark decision, Colonial Realty Corp. v. Bache & Co., 255/ Judge Friendly, writing

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252/ (footnote continued)

Grove v. First National Bank of Hermine, 352 F. Supp. 1250, 1252 (W.D. Pa. 1972), aff'd, 489 F.2d 512 (3d Cir. 1973), as amended (1974); Moscarelli v. Stamm, 288 F. Supp. 453, 459 (E.D.N.Y. 1968); Reader v. Hirsh, 197 F. Supp. 111, 114 (S.D.N.Y. 1961); Spoon v. Walston & Co., Inc., 478 F.2d 246 (6th Cir. 1973); Landry v. Hemphill, Noyes & Co., 473 F.2d 365 (1st Cir.), cert. denied, 414 U.S. 1002, rehearing denied, 415 U.S. 960 (1973).

253/ 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013 (1971).

254/ Id. at 1140. A new issue is raised whether an implied right of action for margin violations survives following an amendment in 1970 to Section 7 of the Exchange Act, which prohibits, under new paragraph (f) and Regulation X adopted thereunder, the receipt of any extension of credit in contravention of Federal Reserve Board rules. Several courts have upheld a private right of action by a customer for margin violations after the amendment of Section 7, see, e.g., Palmer v. Thomson & McKinnon Auchincloss, Inc., 427 F. Supp. 915 (D. Conn. 1977), while others have held otherwise. See Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,931 (4th Cir., July 16, 1979); Utah State University v. Bear, Stearns & Co., 549 F.2d 164, 170 (10th Cir.), cert. denied, 434 U.S. 890 (1977).

255/ 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966).

for the Second Circuit, stated that a determination of whether a private right of action is available in this area "start[s] from the proposition that the judicial recognition and enforcement of a private remedy not expressly afforded by the Securities Exchange Act is predicated on the duty of the courts 'to make effective the Congressional purpose,'" 358 F.2d at 181, citing J.I. Case Co. v. Borak, supra, 377 U.S. at 433. However, discerning whether a legislative purpose is served by a particular rule of an exchange, according to Judge Friendly, is complicated somewhat by the exchanges' "wide range of discretion in establishing standards and principles that should govern trading of securities on the auction market." 256/ Moreover, Judge Friendly observed that the statutory grant of disciplinary authority to exchanges over their members is an indication that Congress "did not intend violations of all rules adopted under Section 6(b) to give rise to civil claims under federal law." 257/ Nonetheless, the court stated that

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256/ Ten years after the decision in Colonial Realty, Congress enacted the Securities Acts Amendments of 1975, Pub. L. No. 94-29, which, inter alia, amended Section 6(b) to prescribe specific standards and purposes to which the rules of an exchange must conform. Whereas prior to 1975 an exchange was permitted under former Section 6(c) to adopt any rules not inconsistent with the Exchange Act, rules thereunder or state law, exchange rules must now affirmatively serve certain purposes identified under Section 6(b): for example, the protection of public investors and the public interest; the promotion of cooperation and coordination with persons engaged in executing securities transactions; the prevention of fraudulent and manipulative acts and practices; the removal of impediments to a free and open market and the development of a national market systems. Moreover, under Section 19(b), as amended in 1975, an exchange cannot unilaterally adopt new rules or amend existing rules, but instead must generally obtain affirmative Commission approval, approval based upon a finding by the Commission that an exchange's rule change is consistent with the requirements of the Exchange Act.

257/ 358 F.2d at 181.

"the concept of supervised self-regulation is broad enough to encompass a rule which provides what amounts to a substitute for regulation by the SEC." 258/ Accordingly, in determining whether a private right of action may be implied for violation of an exchange rule, Judge Friendly explained that --

> the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. 259/

A somewhat different standard for assessing availability of private actions for exchange rule violations was articulated by the Seventh Circuit in Buttrey v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 260/ in which the court held that breach of the NYSE's "know your customer" rule supported a private right of action. 261/ The two-part test applied

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258/ Id. at 182.

259/ Ibid. Applying this standard, the Colonial Realty court found that no private right of action could be maintained for breach of a rule of the NYSE calling upon members to adhere to "just and equitable principles of trade." The court explained that such rules encompass "a wide variety of misconduct, including merely unethical behavior which Congress could well not have intended to give rise to a legal claim." Ibid.

260/ 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969).

261/ See also Greyer v. Paine, Webber Jackson & Curtis, Inc., 389 F. Supp. 678 (D. Wyo. 1975) (implied right of action under NYSE "know your customer" rule and NASD "suitability" rule); Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974) (implied action for violation of (1) NYSE rule prohibiting broker from agreeing to share in profits and losses of customer accounts and (2) NYSE "know your customer" rule). Other courts, however, have declined to find a private right of action for violation of the "know your customer" rule, on the theory that the rule was intended for the protection of member firms themselves,

(footnote continued)

by the Buttrey court turns on (1) whether the particular rule is designed "for the direct protection of investors," and if so, (2) whether the conduct involves more than mere errors of judgment or negligence, and instead is "tantamount to fraud." 262/

Courts have found implied rights of action for violation of a number of other rules of self-regulatory organizations, including the NASD's Rules of Fair Practice, 263/ and exchange margin maintenance rules. 264/

2. Recent decisions

In recent years, the Supreme Court has examined under closer scrutiny claims to establish implied causes of action for violation of federal laws, including the federal securities laws. 265/ In adopting a more cautious

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261/ (footnote continued)

as much as for their customers. See, e.g., Landy v. Federal Deposit Insurance Corporation, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); Birotte v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 468 F. Supp. 1172 (D.N.J. 1979); Piper, Jaffray & Hopwood v. Ladin, 399 F. Supp. 292 (S.D. Iowa 1975). Zagari v. Dean Witter & Company, Inc., [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,777 (N.D. Cal. 1976).

262/ 410 F.2d at 142-43.

263/ See Avern Trust v. Clarke, 415 F.2d 1238, 1242 (7th Cir. 1969), cert. denied, 397 U.S. 963 (1970); See also Securities and Exchange Commission v. First Securities Company of Chicago, 463 F.2d 981 (7th Cir. 1972) (claimants in receivership had right of action for broker-dealer's violation of rule of the NASD imposing supervisory duties on member firms).

264/ Evans v. Kerbs & Co., 411 F. Supp 616 (S.D.N.Y. 1976); Neill v. David A. Noyes & Co., 416 F. Supp. 78 (1976).

265/ The first case indicating a more restrictive view of implied causes of action was National Railroad Passenger Corp. v. Association of Railroad Passengers, 414 U.S. 453 (1974), where the Court held that the provisions in the Rail Passenger Service Act of 1970 expressly authorizing certain suits by the Attorney General or affected employees

(footnote continued)

approach toward new implied rights of action, however, the Court has not reversed any of its prior decisions recognizing implied causes of action under various provisions of the federal securities laws — most notably Rule 10b-5.

In 1975, the Supreme Court refined the analytical framework for implied remedies in Cort v. Ash, 266/ (a non-securities law case) by articulating a four-pronged test: 267/

1. First, is the plaintiff "one of the class for whose especial benefit the statute was enacted," . . . that is, does the statute create a federal right in favor of the plaintiff?

2. Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one?

3. Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff?

4. And, finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?

265/ (footnote continued)

precluded maintenance of a private right of action by railroad passengers.

In Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975), the Supreme Court held that a receiver of a defunct brokerage firm could not maintain an implied cause of action under the Securities Investor Protection Act to compel the Securities Investor Protection Corporation ("SIPC") to exercise its statutory authority to liquidate a failing broker. The Court explained that permitting an implied right would have been at cross-purposes with "the overall structure and purpose of the SIPC scheme," Id. at 421, and hence distinguished Borak, where private enforcement was found to further, rather than frustrate, achievement of statutory goals. Id. at 424.

266/ 422 U.S. 66 (1975). The Court held that there was no private right of action based on a criminal statute prohibiting corporate contributions in federal elections.

267/ Id. at 78.

Following Cort, the Supreme Court, in Piper v. Chris-Craft Industries, Inc., held that an unsuccessful tender offeror had no standing to sue the management of a "target" corporation and a successful tender offeror for money damages based upon violations of Section 14(e) of the Exchange Act. Central to its holding was the Court's finding that frustrated tender offerors do not constitute a class for whose "especial benefit" the tender offer provisions of the securities laws were enacted. The holding in Piper, however, did not exclude the possibility that a private action under Section 14(e) could be invoked by a "shareholder-offeree" or the "target" corporation of a tender offer. 430 U.S. at 42n.28. Further, the Court in Piper left open the question of whether a private party's standing to sue for violation of Section 14(e) is greater where injunctive relief, rather than damages, is sought. 430 U.S. at 47 n.33. 268/

In Transamerica Mortgage Advisers, Inc. v. Lewis, No. 77-1645 (U.S., Nov. 13, 1979), the Supreme Court addressed whether a private right of action may be maintained under the Investment Advisers Act of 1940 for alleged conduct by an adviser which violates the antifraud provision of that Act, Section 206. 269/

268/ See e.g., Humana, Inc. v. American Medicorp, Inc., 445 F. Supp. 613, 616 (S.D.N.Y. 1977); Weeks Dredging and Contracting, Inc. v. American Dredging Co., 451 F. Supp. 468 (E.D. Pa. 1978) (tender offeror has implied right of action for injunctive relief under Section 14(e)); Crane Co. v. American Standard, Inc., [Current] Fed Sec. L. Rep. (CCH) ¶ 96,823 (2d. Cir. 1979) (reaffirmed previous holding in Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970), that a tender offeror may sue for injunctive relief under Section 14(e)).

269/ 15 U.S.C. 80b-6. See n. 116, supra.

The Ninth Circuit in Lewis, 270/ following decisions of the Fifth and Second Circuits, 271/ held that a private action for both equitable relief and damages existed for violations of Section 206.

The Supreme Court in Lewis found that a private of action for rescission exists under the Advisers Act for violations of Section 206, but that a right of action for damages is unavailable. Notwithstanding that the legislative history is "entirely silent" on whether Congress intended that private actions be available under the Advisers Act (Slip op. at 6), the Court held that a private right for rescission is implied under Section 215(b) of the Advisers Act. That Section provides that contracts whose formation or performance would violate the Advisers Act "shall be void * * * as regards the rights of" the violator and successors in interest. Citing Kardon, supra, with approval, which implied a Rule 10b-5 cause of action under the "voiding" provision of the Exchange Act, the Court stated (Slip op. at 7):

> By declaring certain contracts void, §215 by its terms necessarily contemplates that the issue of voidness under its criteria may be litigated somewhere. At the very least Congress must have assumed that §215 could be raised defensively in private litigation to preclude the enforcement of an investment advisers contract. But the legal consequences of voidness are typically not so limited. A person with the power to avoid a contract ordinarily may resort to a court to have the contract rescinded and to obtain restitution of consideration paid.

270/ Lewis v. Transamerica Corp., 595 F.2d 237 (9th Cir. 1978).

271/ Wilson v. First Houston Investment Corp., 566 F.2d 1235 (5th Cir. 1978); Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977).

The Court further held that injunctive relief and restitution, in addition to rescission, are available remedies in an action brought under Section 215 of the Advisers Act. (Slip op at 7.) The Court, however, found that no private right of action to recover damages is available under the Advisers Act. Of critical importance, the Court noted that the Advisers Act, unlike the Exchange Act, does not establish any express private damage actions. According to the Court, the absence of such provisions "strongly suggests that Congress was simply unwilling to impose any potential liability to a private suitor." Slip op. at 9. In finding no private damage action, the Court also placed emphasis on Section 214, the jurisdictional provision of the Advisers Act, which confers upon federal courts jurisdiction over "all suits in equity," but grants no jurisdiction over "actions at law." 272/

In sum, although the Supreme Court has recently been cautious with regard to the implication of new rights of action, the protections afforded by both the express and implied rights of action brought under the federal securities laws provide broad civil remedies for injured investors, 273/

272/ In contrast, the provisions of the other federal securities laws discussed herein give federal courts jurisdiction over both equitable and legal actions. See Section 22(a) of the Securities Act, 15 U.S.C. 77v(a); Section 27 of the Securities Exchange Act, 15 U.S.C. 78aa; Section 44 of the Investment Company Act, 15 U.S.C. 80a-43.

273/ The implied private actions discussed in this section are, of course, not exhaustive. See also Liang v. Dean Witter & Co., 540 F.2d 1107 (D.C. Cir. 1976) (implied cause of action under Rule 10b-16 for failure by broker to disclose standards used in determining maintenance margin); Warren v. Bokum Resources Corp., 433 F. Supp. 1360 (D.N.M. 1977) (implied action for purchasing shares in contravention of Rule 10b-13 during tender and exchange offers); Cant v. A.G. Becker & Co., Inc., [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,747 (N.D. Ill. 1974) (implied action against broker-dealer for failure to disclose whether acting in agency or principal capacity as required under Rule 15cl-4 (now Rule 10b-10) under the Exchange Act).

Further, as the Lewis decision demonstrates, it is reasonable to assume that the Supreme Court, and lower courts, will continue to recognize the implication of additional actions under the federal securities laws where found to be consistent with Congressional intent.

I. Other Methods for Obtaining Redress of Investor Injury

1. Commission and SRO Activities

In Part II, we mentioned the various formal statutory powers which the Commission, the SROs, and the courts possess under the federal securities laws to enforce compliance with those laws and rules adopted under them. From the investor's viewpoint, the enforcement activities of these institutions may sometimes be seen as protective only of his/her future interests. The perception may be fortified by the fact that the federal securities laws do not authorize the Commission, in administrative proceedings, to award restitution or damages to investors, and that the SROs generally have not regarded it as appropriate to direct offending members to make restitution or pay damages as "fitting sanctions" in their disciplinary proceedings.

In practice, however, the public investor's immediate pecuniary interests do receive a high degree of Commission and SRO attention. In the first place, disciplinary sanctions of both the Commission and the SROs and the court actions instituted by the Commission are publicly reported; and since those reports may supply the victim of violative conduct, at little or no cost to him, with a factual (and/or legal) basis for the institution of a private suit to seek redress for injuries, enforcement policy as to the selection of cases to be pursued normally takes that factor into account. Also, in determining the severity of administrative sanctions to be imposed, both

the Commission and the SROs consider, as mitigative, action taken by respondents to "repair" the damages they have caused. Moreover, the SROs provide arbitration facilities which investors may use to obtain monetary recovery. 274/ In general, the SRO rules require members and their associated persons to submit to an arbitration proceeding initiated by a public customer when the grievance involves their securities business.

2. Ancillary relief in injunctive actions

Additionally, the courts may participate in the recovery process in a way which, in view of its particular significance here, merits some further discussion.

The Court of Appeals for the Second Circuit has stated:

> It is now well established that Section 22(a) of the 1933 Act . . . and Section 27 of the 1934 Act . . . confer general equity powers upon the [federal] district courts. Once the equity jurisdiction of the district court has been properly invoked [such as in an injunctive action under Section 17 of the 1933 Act or Section 21 of the 1934 Act], the court possesses the necessary power to fashion an appropriate remedy. Thus, while neither [Act] . . . specifically authorizes the ancillary relief granted in this case, '[i]t is for the federal courts to adjust their remedies so as to grant the necessary relief where federally secured rights are invaded . . . Accordingly, . . . the SEC may seek other than injunctive relief to effectuate the purposes of the federal securities laws. 275/ (Emphasis added.)

274/ See, e.g., 2 NYSE Guide (CCH) ¶2480 ff.; CBOE Guide (CCH) ¶2511 ff.

275/ SEC v. Manor Nursing Centers, Inc. 458 F.2d 1082, 1103-4 (citations omitted).

Among the pertinent forms of ancillary relief given in Commission-initiated injunctive actions are:

1. Disgorgement by defendants of gains realized by Rule 10b-5 violations. If the victims of the fraud can be identified, courts have ordered the disgorged funds paid to them or, in some cases, the court will order the funds held in the court's registry until the damaged investors can be located and file their claims.

2. Rescission. In some instances defendants have been directed to offer rescission to defrauded individuals.

3. Appointment of trustee or receiver. Courts may specially appoint a person to take such actions as assuming control and/or custody of the defendant's assets or records to facilitate disgorgement or rescission and accounting therefor to the court. While this is usually considered an extraordinary remedy, it has been used effectively in a substantial number of cases. 276/

276/ See, Jacobs, Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5, 53 St. John's Law Review 397, Spring, 1979, at 410-421, 437-449 and cases cited therein.