

# THE MALONEY ACT EXPERIMENT

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## I. INTRODUCTION

In 1938 Congress passed an Act<sup>1</sup> to amend the Securities Exchange Act of 1934 by adding, *inter alia*, a new section. The object of this amendment, the Maloney Act, was to encourage over-the-counter dealers to organize and regulate their activities under governmental supervision.<sup>2</sup>

The scheme, "a unique experiment in supervised self-regulation,"<sup>3</sup> was hailed as an "especially provocative exercise of governmental power by a private organization."<sup>4</sup> It was to be the instrument which

supplies exactly what voluntary self-regulatory attempts have heretofore lacked, power within the business itself to enforce rules and regulations requiring conduct higher in standard than even that which the government could effectively require by law.<sup>5</sup>

Under the Maloney Act, more than one association of broker dealers could apply for recognition, yet only one did—the National Association of Securities Dealers, Inc. (hereinafter referred to as NASD). Today the NASD embraces almost all the broker dealers in the United States.<sup>6</sup>

This experiment by the NASD was expected to yield useful material for other industries, especially "if the pressure for expanding social controls over private business continued to mount."<sup>7</sup> This expectation did not materialize. No other legislation followed in

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<sup>1</sup> Over-the-Counter Market Act, 52 Stat. 1070 (1938), 15 U.S.C. § 78o (1958).

<sup>2</sup> Frey, Federal Regulation of the Over-the-Counter Securities Market, 106 U. Pa. L. Rev. 1, 45 (1957).

<sup>3</sup> Securities and Exchange Comm'n, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 5, at 188 (1963).

<sup>4</sup> 1 Davis, Administrative Law 141 (1958).

<sup>5</sup> Over-the-counter Trading and the Maloney Act, 48 Yale L.J. 633, 646 (1938). Finally, no writer in this area should fail to cite Douglas, Democracy and Finance 82 (Allen ed. 1940). "Government," said he, will play "the residual role . . . [it] would keep the shot gun so to speak, behind the door, loaded, well oiled, clear, ready for use, but with the hope that it would never be used."

<sup>6</sup> In 1962, of 5,785 registered broker dealers, about 4,750 were NASD members. H.R. Doc. No. 95, supra note 3, pt. 1, at 16. For the organizational scheme of the NASD see generally Grant, The National Association of Securities Dealers, 1942 Wis. L. Rev. 597 (1942); 2 Loss, Securities Regulation 1365-69 (2d ed. 1961).

<sup>7</sup> Westwood & Howard, Self Government in the Securities Business, 17 Law & Contemp. Prob. 518 (1952).

the footsteps of the Maloney Act; no other business followed the lead of the NASD.

In 1959 the NASD celebrated its twentieth anniversary. This prompted evaluations of its past performance by the association and others. The articles written on the subject dealt with one or more aspects of the NASD and concluded that on the whole the experiment had been a success.<sup>8</sup>

This paper will attempt to evaluate the Maloney Act experiment, not by a meticulous investigation into some aspects of the problems of the securities industry, but by an analysis of the system as a whole. In order to facilitate such a discussion, an inquiry will be made into the functions of the broker dealer and into the history and organization of the NASD.

## II. THE BROKER DEALER: A PROFILE OF A TRADE

Although the very name "broker dealer" points to a double capacity, the functions included in that profession are much more diverse. A many-faced man indeed, a broker dealer is a banker, a dealer, a broker, an advisor, a market maker, a fiduciary, and a professional. The last two categories differ from the preceding ones because they describe a status more than an activity. They also point to a trend which, it is believed, may lead to a new classification and set clearer standards for the duties of the broker dealer. Each of the said categories, however, merits a closer examination.

### A. *The Banker*

Whether or not the activities of the broker dealer fall within the legal definition of banking, the two functions are similar. The broker dealer keeps his customers' funds and securities; he grants his customers loans; he uses money deposited with him for his own business as his working capital.<sup>9</sup>

Broker-dealers have contended that the principle of a debtor-creditor relationship should be applicable to the broker and his customer, pointing out that "brokers have always considered that the

<sup>8</sup> See Loss, *supra* note 6, at 1391; Rutter, *The National Association of Securities Dealers: Continuing Government-Industry Cooperative Regulation in the Over-the-Counter Securities Industry*, 7 *Vill. L. Rev.* 611 (1962).

<sup>9</sup> Loss, *supra* note 6, at 1184-92. The latter feature means that the funds so deposited are debts due from the broker dealer to the customer and are not trust funds. Generally, in an ordinary deposit, the relation between the bank and the depositor is that of debtor and creditor. See 1 Scott, *Trusts* 125, § 12.9 (2d ed. 1956). This distinction becomes important if the recipient of the funds becomes insolvent. Scott points out that:

If . . . the trustee becomes insolvent, the beneficiary is entitled to the money if he can identify it . . . or . . . trace it into a product. . . . [I]f a debt was created the creditor is entitled to no priority. . . .

1 Scott, *Trusts* 119, § 12.6 (2d ed. 1956).

relationship between the broker and a customer with a free credit balance is that of a debtor and creditor."<sup>10</sup> Contrary to this view, "there is authority that a broker holds funds in a fiduciary capacity when he receives them for the purchase of a security outright or when they are proceeds from the sale of a security."<sup>11</sup>

A trustee is under two obligations: first, to use the trust money for the benefit of the fiduciary; second, to segregate it from other monies. The rationale of the first requirement is protection of the trust from misuse by the trustee; the reason for the second is its insulation from the claims of the trustee's creditors should he become insolvent. If the money is considered a debt, both of these safeguards are gone.

Far from being academic, this problem involves enormous sums of money. Full information is not available, but according to the New York Stock Exchange (hereinafter referred to as NYSE) report of January 1, 1962, the amount of free credit balances held by members varied from 1,207 to 1,508 million dollars during the year 1961. The firm of Merrill Lynch, Pierce, Fenner & Smith held approximately 233 million dollars in free credit balances on May 26, 1961. Other figures are no less staggering.<sup>12</sup>

The development of the legal relationship between banker and customer indicates the justification for both the broker dealer's demand to consider the deposit money a debt, as well as the arguments against this position. The law governing banking has adapted itself to the new requirements of economic life without relinquishing its role of providing protection to the public.<sup>13</sup> On the one hand, it is now settled that the banker is the debtor and not the trustee of his customer. On the other hand, the law now ensures every depositor repayment of his money on demand. In addition, the banker is no longer free to exercise his discretion in making investments. He must invest a certain sum in liquid assets, refrain from speculative transactions, and obey other regulations of this nature. The method of policing his compliance with the law has also changed. It is no longer left to the beneficiary. The banker is required to keep books and records, and the government's examiners exercise surveillance—as a prophylactic measure—to ensure that business is conducted according to its regulations. This is the price the banker pays for the use of his depositor's money.

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<sup>10</sup> Hearings before the Subcommittee on the Securities and Exchange Commission of the House Committee on Interstate and Foreign Commerce, 82d Cong., 1st Sess., pt. 1, at 829 (1952) (remarks of Mr. John J. Mann, Chairman of the Board of Governors of the New York Curb, now the American Stock Exchange).

<sup>11</sup> Loss, *supra* note 6, at n.9, 1185-86.

<sup>12</sup> See H.R. Doc. No. 95, *supra* note 3, pt. 1, at 394.

<sup>13</sup> 5 Zollmann, *Banks and Banking* 132 (1936).

Although the broker dealer insists on a debtor-creditor relationship with his customer with regard to deposits, the laws governing his activities and the control over them are very different from those regulating the banker's functions.<sup>14</sup> The principal rules governing the broker dealer in his quasi-banking activities are similar to the rules which applied to bankers before legislative intervention. A customer whose funds have been misused by the broker dealer finds his remedies in the law prohibiting misuse of trust money. The NASD rules repeat this same principle of law: a broker dealer is responsible for misuse of customers' funds.<sup>15</sup> Yet the NASD insists that these funds are a debt due to the customer. This position is legally untenable. The relationship of debtor-creditor and trustee-beneficiary cannot exist as to a particular transaction at the same time.<sup>16</sup> "The funds deposited become a part of the property of the bank, which it may, without becoming criminally liable, mingle with its other assets and use in its business until a notice of withdrawal is served . . . ."<sup>17</sup>

Although this writer is aware of no case where the defense of a debtor-creditor relationship was raised in answer to a charge of misuse of customers' funds, it is difficult to see how this double standard can be reconciled. In addition to the general rules on misuse of trust money, the Exchange Act of 1934 limits the hypothecation of customers' securities to the aggregate amount of indebtedness of all the customers of the broker dealer.<sup>18</sup> The NASD further limits the amount for which the customers' securities may be hypothecated to what is "fair and reasonable in view of the indebtedness of the said customer to said member."<sup>19</sup>

There are two ways to safeguard customers' monies against the claims of broker dealers' creditors. The first is to prohibit the commingling of customers' funds; the second is to ensure the financial stability of the broker dealer, *i.e.*, the preventive rule. The prohibition against mingling applies to securities only. Even when the necessary customer's consent is obtained, mingling is allowed only with the securities of other customers.<sup>20</sup> As for free credit balances, there are no rules which require segregation, although the NASD encourages this practice in case of deposits against "when issued" and "when distrib-

<sup>14</sup> For a comparison of the applicable regulatory statutes, see generally Subcommittee on Domestic Finance of the House Committee on Banking and Currency, Comparative Regulations of Financial Institutions, 88th Cong., 1st Sess. (1963).

<sup>15</sup> NASD Rules of Fair Practice (hereinafter R.F.P.), Art. III § 19(a). See also SEAR No. 6986, F. R. Gentry & Co. (1963); SEAR No. 6767, Peter Widdershoven (1963).

<sup>16</sup> Johnson v. Ward, 2 Ill. App. (2d Bradwell) 261, 275-76 (1878).

<sup>17</sup> Zollmann, *supra* note 13, at 145-46.

<sup>18</sup> 48 Stat. 881 (1934), 15 U.S.C. § 78h (1958).

<sup>19</sup> R.F.P., Art. III § 19(c).

<sup>20</sup> 48 Stat. 881 (1934), 15 U.S.C. § 78h (1958).

uted" transactions. The Securities and Exchange Commission (hereinafter the SEC), though empowered to do so,<sup>21</sup> has not promulgated a rule to require segregation. Segregation of securities may present very great practical difficulties in view of the size and magnitude of the deposits. Segregation of free credit balances is incompatible with the debtor-creditor relationship which, as the industry asserts, exists with regard to these funds.

The main preventive rule to protect customers' funds is the Net Capital Rule enacted by the SEC under Section 15(c)(3) of the Exchange Act of 1934.<sup>22</sup> This rule provides that the broker dealer's aggregate indebtedness to all people shall not exceed 2000% of his net capital, as computed by the rule.<sup>23</sup> The Net Capital Rule contains objective standards; its operation does not depend upon judgment and evaluation but upon mathematical calculation. It can be enforced by examination of books and records, which examination also has a preventive effect. The result is a high level of solvency.<sup>24</sup>

The NASD does not have a rule pertaining to capital requirements. It merely polices the Net Capital Rule of the Commission. The NYSE, on the other hand, does impose upon its members more stringent capital requirements and polices them more effectively.<sup>25</sup>

Two additional rules, one enacted jointly (though enforced differently) by the NASD and the NYSE,<sup>26</sup> and the other developed by the SEC,<sup>27</sup> deal with the prohibition to engage in business while insolvent. The NASD rule provides that a customer, *viz.*, a person whose cash and securities are already in the hands of the broker dealer, may require his broker dealer to disclose his financial position. This rule enables the suspicious customer either to allay his fears or to substantiate them. The SEC rule prohibits the broker dealer from engaging in business while insolvent. The NYSE, on the other hand, imposes a duty on a member to notify the exchange of his insolvency. The same duty is imposed on any other member who has heard that another

<sup>21</sup> 48 Stat. 881 (1934), 15 U.S.C. § 78k (1958).

<sup>22</sup> This section empowers the SEC to promulgate rules for the financial responsibility of broker dealers.

<sup>23</sup> Loss, *supra* note 6, at 1350-55; SEAR No. 7142, Babson, Kaye & Robb Co. (1963); SEAR No. 7055, Valley Forge Sec. Co. (1963); H.R. Doc. No. 95, *supra* note 3, pt. 1, at 407-10.

<sup>24</sup> The SEC had held that it was no answer to a violation of the rule that the customer did not suffer any loss. He was exposed to the risk of insolvency of the broker dealer. That was sufficient to establish a violation. SEAR No. 7010, Metropolitan Sec. Inc. (1963).

<sup>25</sup> H.R. Doc. 95, *supra* note 3, pt. 5, at 179. See NYSE Rule 317, CCH N.Y. St. Ex. Guide ¶ 2319, which deals with bonding requirements.

<sup>26</sup> R.F.P., Art. III § 22. While the NASD leaves it to the customer to police the members' insolvency, the NYSE undertakes to do this itself.

<sup>27</sup> 3 Loss, Securities Regulation, 1435-38, 1444 (2d ed. 1961). In the context of this rule, insolvency includes the failure to meet obligations.

member is insolvent. Upon such notice, membership is immediately suspended.<sup>28</sup>

All this "incidental banking," as Professor Loss calls it,<sup>29</sup> has never been supervised, as such, either by state or federal authorities. Demands for more stringent rules have not found a sympathetic ear, mainly because the industry's record was good.<sup>30</sup> It seems that the NYSE is moving toward joint responsibility of its members and will probably cover loss by insurance. The NASD will not be able to do that. Insurance would be much too expensive, if available at all. The development here is toward the elimination of the small firms as independent operators. This is inevitable and desirable, if the public is to be protected. No one can seriously doubt the necessity of minimum capital requirements for operating a bank. There is no reason to consider the same requirement unnecessary in the case of a broker dealer. It seems that these requirements should be even more stringent for a broker dealer than for a bank, if we consider that the securities industry is a billion dollar one and that the broker dealer's other complex and conflicting activities might affect his financial position.

Of all the broker dealer's functions, the banking aspect is easiest to regulate. The rules are based on an objective test. The mens rea is relevant only to a small degree.<sup>31</sup> Evidence is mostly by written documents. The requirements do not interfere with the everyday execution of the business. These rules have been widely accepted and have proved workable. Lastly, the rules are not in themselves conflicting, either as to the standard they set, or to the activities they prescribe. It should be noted that these conflicts do exist in other rules governing the broker dealer.

We shall return to this subject in the latter half of this paper.<sup>32</sup> Nevertheless, the following questions arise: Why are the Exchanges more successful in enforcing the rules than the NASD? Does the present situation, with or without the stricter controls proposed by the Special Study of the SEC,<sup>33</sup> afford sufficient protection to the public? And is self-regulation the best way to regulate the securities industry? If so, should we have a different system of control for the Exchanges than for the NASD?

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<sup>28</sup> CCH N.Y. St. Ex. Guide Art. XIII, 1601-02.

<sup>29</sup> Loss, *supra* note 6, at 1186, 1190.

<sup>30</sup> For a recommendation of more stringent rules, segregation of excess margin and fully paid securities, articulation by the SEC of the NASD rule as to "reasonable relationship" between the debt of the customer and the amount which his securities may be hypothecated, and an amendment of Section 60(e) of the Bankruptcy Act to facilitate the recovery by the customers of money and fully paid securities, see H.R. Doc. No. 95, *supra* note 3, at pt. 1, 415-16.

<sup>31</sup> SEAR No. 6931, Richard H. Holman (1962).

<sup>32</sup> See *infra* §§ III and IV.

<sup>33</sup> See *supra* note 30.

B. *The Broker*

The broker is his customer's agent; hence, his interests must not conflict with those of his customer. Moreover, it must be his interest to achieve the goals set by the customer. In order successfully to carry out his agency, the agent stands in the shoes of his principal. In short, he becomes his principal's fiduciary; as such, he has a duty not to profit at the expense of the beneficiary.<sup>34</sup>

Whenever an agency exists, it is the principal who usually needs protection. The law has provided for this by imposing duties upon the agent regarding both the performance of his obligations and the disclosure of relevant facts, thereby enabling the principal to effectively police the agent's performance. It seems right that the policing should be done by the principal. Apart from the great difficulty of policing by outsiders, the choice of the agent originally lies with the principal. The choice is his and the risk is his; hence, the policing should also be his.

Prima facie, there is no reason why the rules mentioned above should not apply to a broker dealer who acts as a broker, or why additional rules should be necessary. Yet, such additional rules *are* needed. When a person may act either by himself or through an agent, he should bear the risk of malfeasance by his agent. In the case of a broker dealer the public has little choice. The individual investor must, in most cases, resort to the services of the broker dealer. Moreover, the broker is the expert; the customer does not possess the relevant information needed to criticize, judge, or police the broker's performance. The broker dealer usually acts in more than one capacity. Conflicts of interest may arise. Additional protection for the customer may be needed.

One of the most disturbing features of the broker dealers activities as an agent is his laxity of performance. As an agent, he is under a duty to secure for his customer the "best price discoverable in the exercise of reasonable diligence."<sup>35</sup> The Special Study of the SEC has found that compliance with this standard is not always achieved, for the following reasons: the broker's lack of information and his lack of diligence in performance; the order clerk's habitual turning to the same dealer without trying to shop for better terms; the wholesaler's violation of the NASD rules by giving gratuities to the order clerk;

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<sup>34</sup> "A fiduciary relationship involves a duty on the part of the fiduciary to act for the benefit of the other party to the relation as to matters within the scope of the relation." 1 Scott, Trusts 38 § 2.5 (2d ed. 1956). The SEC follows the common law rule: namely, that a broker dealer acting as an agent for a customer in the execution of a transaction assumes the obligations of a fiduciary.

<sup>35</sup> H.R. Doc. No. 95, supra note 3, pt. 2, at 623.

the firm members' personal "understandings" among themselves; and the NASD's faulty policing of the broker.<sup>36</sup>

It would seem that the main reason for the broker dealer's laxity of performance is the lack of knowledge on the part of the customer. He is the only one who has the interest and opportunity to check on the broker, but his inadequate information leads to inefficiency in the agent's performance. The Special Study of the SEC found the NASD policing of the broker's activities to be faulty.

Cloudiness also surrounds the broker's remuneration. The language of the NASD rules is vague. Charges must be "reasonable and not unfairly discriminatory between customers."<sup>37</sup> There must also be an exploration of what is "fair" by

taking into consideration all the relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor.<sup>38</sup>

The following questions still remain unanswered: What is unfair discrimination between customers? What are reasonable charges? Does the inefficient firm receive remuneration according to its own performance, or will it be judged by the performance of another firm, either the most efficient or the mediocre one? How much should a broker earn? And how should the value of other services which he performs be computed so that his charge can be determined?

### C. *The Dealer*

The dealer sells and buys securities for his own account. If the broker dealer were acting only in this capacity, and if securities were simple merchandise, there would be fewer problems. But, as noted above, the dealer usually acts in more than one capacity. Further, securities are not even "intricate merchandise"; they are not merchandise at all in the usual sense of the word.

Buyers and sellers of property are generally conceived of as acting "at arm's length"; if after negotiations they agree upon the terms of a purchase and sale, the transaction is binding upon each, even though one of them may thereby benefit at the expense of the other from his superior knowledge or astuteness.<sup>39</sup>

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<sup>36</sup> See generally H.R. Doc. No. 95, *supra* note 3.

<sup>37</sup> R.F.P., Art. III § 3.

<sup>38</sup> R.F.P., Art. III § 4.

<sup>39</sup> Frey, *supra* note 2, at 2.



There is, however, an important exception to this generalization: *i.e.*, that of fraudulent conduct. In cases of misrepresentation, manipulation, nondisclosure, and malpractice by broker dealers, governmental intervention is required.

Under the old established classification in which a dealer is a seller of merchandise, he is under an obligation not to defraud or to mislead his customer. The securities statutes enlarged the area of protection for the customer.<sup>40</sup> Yet the concept of fraud and misrepresentation is still the basis of the duties of a dealer *qua* dealer.<sup>41</sup> Liability for complete non-disclosure, as distinguished from half-truth (which liability did not exist at common law), is only partially established under the securities statutes. The securities acts impose disclosure requirements on the dealer in specific situations.<sup>42</sup> The requirement of disclosure operates as a deterrent and gives the customer a measure of equality in the bargaining process.<sup>43</sup> The problem becomes acute when the dealer acts in more than one capacity. The development of the laws relating to the dealer's duties is greatly influenced by the broker-dealer-advisor combination. It is therefore useful to relate the tale of the proposal for the segregation of functions of brokers and dealers.

"An aspect of exchange trading which gave Congress considerable concern . . . was the frequent combination in one man of the functions of a broker acting for clients and of a dealer acting for his own profit."<sup>44</sup> The SEC was given the power, under Section 11(b) of the Exchange Act of 1934, to deal with this problem. The SEC conducted a study and published a report in 1936, in which it recommended further study and no immediate action.<sup>45</sup> The report dealt with segregation of the dealer function from the broker function. It did not consider additional segregation in the sense that a dealer could deal with the public through a broker, thereby segregating the dealer from the public.<sup>46</sup> The report concedes that some of the abuses in the securities industry are the direct result of the combination of broker and dealer functions: namely, the inducement of brokerage customers to

<sup>40</sup> See Loss, *supra* note 27, at 1435-38, 1444 for a comparison between the protection afforded by the common law and by the current statutes.

<sup>41</sup> Cary, *The Special Study of Securities Markets of the Securities and Exchange Commission*, 62 Mich. L. Rev. 565 (1964).

<sup>42</sup> The NASD rules cover almost the same territory. See R.F.P., Art. III §§ 7, 12, 13, 14, and 22.

<sup>43</sup> For an assessment of the current rule of disclosure, see Knauss, *A Reappraisal of the Role of Disclosure*, 62 Mich. L. Rev. 635 (1964).

<sup>44</sup> See Loss, *supra* note 6, at 1201.

<sup>45</sup> SEC Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker, p. II, at 22-23 (1936).

<sup>46</sup> This would be according to the English model on the London Stock Exchange; Loss, *supra* note 6, at 1219.

buy the securities which the broker dealer had underwritten or in which he has a trading position; the persuasion of a customer to sell good securities in order to buy securities in which the dealer has an interest; and the difficulty for the unsophisticated customer in distinguishing between the two functions and their implications.

On the other hand, the report specifies abuses which stem from sources other than the combination of the functions, such as high markup, high pressure selling, manipulation, floating inferior securities, and publication of fictitious quotations. Among the practices which are incident to brokerage activities are unsuitable recommendations, excessive trading or "churning," and, in general, the subordination of the interests of the customer to those of the broker. It is clear that the segregation of functions is either meaningless or of very little value if the dealer, though not allowed to act as a broker, is nonetheless permitted to create a fiduciary relationship between himself and the customer. The report points to the danger of an underwriter inducing brokerage customers to buy the securities which he has an interest in selling. But the same danger exists if, instead of brokerage customers, the dealer has buying customers, who have the same trust in him as they would have in an agent. It therefore would seem that the segregation of functions is not very effective if the dealer is permitted to deal directly with the public. Yet, in the United States the system of a dealer selling to customers directly, rather than through a broker, is well entrenched. Talk of segregation, therefore, is completely unrealistic.

The industry has persistently opposed segregation. In 1941 it requested that the SEC's power in the matter of segregation of functions be abolished.<sup>47</sup> The main argument was the loss of profit which would result in higher cost to the customer.<sup>48</sup> Mr. Wallace H. Fulton, in his address on the twentieth anniversary of the NASD, considered the successful combatting of the segregation proposals as one of the chief achievements of the NASD. This is the NASD's position today.

Yet this is not the end of the story. The evil created by the absence of the complete segregation of the dealer from the public continues to exist and had to be remedied. We often see that as a result of an obstruction the same goal is achieved through other means. The attempts to segregate the broker and dealer functions have failed. An alternative method of protecting the customer was to impose upon the dealer the duties of a fiduciary, making the distinction between broker and dealer merely of academic interest. This trend is justified by the facts. In his capacity as a dealer, the broker dealer usually acts as an advisor to the customer. A relationship of trust and confidence is estab-

<sup>47</sup> Loss, *supra* note 6, at 1217.

<sup>48</sup> Hearings before the Subcommittee on Interstate and Foreign Commerce, *supra* note 10, at 828.

lished between them. The difficulty is that the duties which stem from a fiduciary relationship do not always coincide with the interest of the dealer. Duties thus imposed are difficult to enforce if the broker dealer is allowed to continue his conflicting activities. The imposition of fiduciary duties on the dealer is based on the theory that when the dealer hangs out his shingle he represents that he shall deal fairly with his customer:<sup>49</sup> this is known as the "shingle theory." The duty is based not upon the presence of agency but upon his professional status as a broker dealer.<sup>50</sup> This theory applies to excessive markup, failure to deliver stock, unauthorized transactions, pledging securities without authority, accepting funds from customers when insolvent, and high pressure selling, *i.e.*, "boiler rooms."

The weakness of the shingle theory is that it is effective only in the most flagrant cases. It has no preventive power; it does not compel disclosure. It applies only after the customer has already lost his money. Its contribution is that it recognizes the possibility of the dealer's status as a fiduciary.

The distinction between dealer and broker still seems to exist in the price area. The problem of price disclosure is an old one, and the story of the price quotations is that of the limitations of the Maloney Act experiment. In 1943 the SEC proposed a rule requiring full disclosure of the profit by the dealer to the customer. The industry reacted most sharply.

The Commission was informed that if this . . . rule was adopted it would eliminate the need for that part of the work of the Association which represented the greatest service to the industry and the investing public . . . [T]he industry should not have been expected to support an Association whose remaining field of service would be so limited.<sup>51</sup>

The meaning is clear; if this rule were passed, the members would not stand behind the Association. Thus, in effect, at the time of its suggestion, the rule when presented represented a threat to the existence of the NASD. The proposal was abandoned by the SEC in 1947. Since 1943, the NASD has attempted to provide substitutes for full disclosure in its markup policy, its 5% policy, and its unified nationwide quotation system.

The markup policy is stated by the NASD rules as follows:<sup>52</sup>

In the over the counter transactions . . . if a member buys for

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<sup>49</sup> Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).

<sup>50</sup> Knauss, *supra* note 43, at 638.

<sup>51</sup> NASD Publication by Mr. Wallace H. Fulton on the 20th Anniversary of the NASD, 1939.

<sup>52</sup> R.F.P. Art. III § 4. On the history of the markup policy see H.R. Doc. No. 95, *supra* note 3, pt. 2, at 645-52; for criticism of the policy, *id.* pt. 2, at 651.

his own account from his customer, he shall buy or sell at a price which is fair, taking into account all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit.

The 5% policy was an articulation of the markup policy. A survey has shown that most dealers do not exceed the 5% markup. The policy really amounted to an enactment of a custom, and a clarification of what was a "fair price."<sup>53</sup> Disclosure is not a defense against charges under the 5% policy; it is a defense against charges under the markup policy.<sup>54</sup>

As for disclosure to the public, the NASD has developed over the years a better and more unified system of quotations. Yet it does not represent the actual trading price of a security. It is the result of adjustments by various methods.<sup>55</sup> The industry's vigorous position against the public disclosure of the wholesale price is based on many arguments. The small firms even reject quotations on a national basis, maintaining that the latter do not take into account their higher costs. Arguments against disclosure, whether to the customer or to the public, are as follows: only a small percentage of the industry engages in malpractice; the proposed rules will be difficult to enforce and can be easily evaded; those outside the jurisdiction of the NASD are too few to warrant rulemaking by the SEC; expenses of the over-the-counter market are much higher than those of the Exchanges—both for communications and for research; disclosure would affect the liquidity of the market; the customer is free to shop for the best bargain—just as in any market, the problem should be solved not by a rule of the SEC but by cooperation within the industry.<sup>56</sup>

There were many answers and counter-suggestions. It is admitted that no one can predict the results of disclosure, but it is pointed out that in some cases there is a successful over-the-counter market in securities, even though the wholesale price is disclosed and the spread

<sup>53</sup> In order to overcome the anti-trust problem, it was held that the policy is a guide, not a rule. It was also held that expenses added to the price should not be excessive; that contemporary cost of a security might be relevant; that disclosure to the customer was not per se a justification of excessive markup; that the pattern of the member's markup in various transactions and the nature of the member's business were relevant factors. The policy is applicable to selling and buying from the customer as well as to riskless transactions. Naturally, sales accompanied by a prospectus and public offerings where the price is disclosed are exempted from the operation of the rule.

<sup>54</sup> Westwood & Howard, *supra* note 7, at 540.

<sup>55</sup> For a description of the development of the quotation problem, see Securities and Exchange Comm'n, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 2, at 630-43 (1963).

<sup>56</sup> *Id.* pt. 2, at 646.

is greater than on the Exchanges.<sup>57</sup> It is further argued that the public can be educated to pay more for over-the-counter securities, that the existing system encourages aggressive selling to an undesirable degree, and that it results in boiler rooms which sell bad rather than good securities because they can buy bad securities at a low price and mark them up excessively.

The attempts to solve the problem of price by means other than disclosure have not been successful. The end of the story is the recommendations of the Special Study of the SEC which are similar to the SEC proposal in 1943, viz., disclosure and quotations representing actual market price without adjustments.<sup>58</sup>

There is yet another aspect to the price of a security, and the dealer plays yet another role with regard to it. Securities have been described as "intricate merchandise," but they differ from merchandise in the usual sense. "Merchandise" denotes something that is bought and sold but which is destined ultimately for consumption. Many of the general antitrust laws pertaining to competition and other activities affecting prices are designed for this kind of consumer merchandise. Competition is welcome, and price fixing is prohibited because such practices tend to prevent price reduction. Lower prices are the main goal of a state which seeks to raise the standard of living of its citizens. Securities, not being consumer goods, should not necessarily be governed by the same rules. Lower securities prices might not always be in the public interest. The price of a security should be determined by supply and demand of the market operating under normal conditions. That is why stabilization is allowed, even when it results in higher prices; that is why manipulation is forbidden, even when it results in lower prices.

On the Exchanges, manipulation takes a different form than on the over-the-counter markets, mainly because the first is a concentrated, auction market and the latter a dispersed, negotiation market. Regulations forbidding manipulations are contained in the Exchange Act of 1934 and the rules enacted thereunder. The NASD rules cover the same area.<sup>59</sup> Policing such manipulation of the Exchanges was left to the Exchanges themselves. Policing the over-the-counter markets was left to the SEC. Since the over the counter market is a negotiation market, manipulation is tied up with fraud, *i.e.*, the relation

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<sup>57</sup> Loomis & Rotberg, Over-the-counter Market Quotations, 62 Mich. L. Rev. 589 (1964).

<sup>58</sup> H.R. Doc. No. 95, supra note 55, pt. 2, at 674-78, especially recommendations 3, 5, and 7. For full disclosure in riskless transactions, see recommendations 8, 9, 11, and 13.

<sup>59</sup> 48 Stat. 889 (1934), 15 U.S.C. § 78i (1958); 48 Stat. 891 (1934), 15 U.S.C. § 78j (1958); 48 Stat. 895 (1934), 15 U.S.C. § 78o (1958). R.F.P. §§ 5, 6, 11, 17, and 18.

between the broker dealer and his customer, while on the Exchange, it relates to the broker dealer *vis-à-vis* the anonymous public.

We see that with regard to manipulation the Exchanges and the NASD have made a wholehearted attempt at regulation. And even though the attempt may not have been a complete success, there is a consensus that such practices should be eliminated. They hurt every person in the industry, except the manipulator. He profits not only at the expense of the public, but also at the expense of his colleagues. These practices are considered fraudulent and dishonest, and their policing is compatible with the trade's interests. They seem to be best regulated by the industry itself, *i.e.*, by the members in their daily contact with each other.

The main difficulty seems to be that in his relation to the customer the dealer has the advantage of information which the customer, even if he exercises skill and diligence, cannot obtain. He also occupies a position of trust *vis-à-vis* the customer which the usual dealer in merchandise does not. This combination breeds the germ of temptation.

#### D. *The Advisor*

As do the dealer and the money lender, the broker advises. The broker dealer advises the public at large, the owner of a discretionary account, the customer of long standing, the new customer, and the reluctant customer. He also advertises, thereby giving advice in his capacity as dealer.

If he is engaged only in advising the public *qua* advisor, his activities are subject to the provisions of the Investment Advisors Act of 1940.<sup>60</sup> It was recently held that an investment advisor who buys securities immediately prior to recommending them and sells soon afterwards is under a duty to disclose to the public the fact of his dealings in these securities.<sup>61</sup> The advisor was held to be a fiduciary. Disclosure serves here as a preventive measure in case of impropriety, and puts the public in a better position to judge the information and advice rendered.

If the broker dealer advises the customer—even though he is acting as a dealer—he becomes a fiduciary. A dealer who is also in the business of an investment advisor is held to a higher fiduciary standard than a dealer who counsels his customers merely as an incident of his business as a dealer. The dealer investment advisor, although avowedly acting as a principal, has placed himself in a position of trust and confidence in relation to his customer, and is therefore subject to an

<sup>60</sup> 54 Stat. 789 (1940), 15 U.S.C. §§ 80a-1—80a-52 (1958).

<sup>61</sup> SEC v. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963). Note that if the investment advisor is not engaged in selling securities, he is not under any self-regulatory body. 2 Loss, Securities Regulation 1392-1417 (2d ed. 1961). H.R. Doc. No. 95, supra note 55, pt. 1, at 381.

obligation which is stricter than the mere avoidance of taking a price that is not unreasonably related to the market price. He must make full and complete disclosure of every item in the transaction that is relevant to the fact that his interest is adverse to that of his customer.<sup>62</sup>

A broker, as we have seen, is a fiduciary of his customer and is under an obligation to disclose to and to act in the best interests of his customer. If he represents that he is an expert, he should be one.

The cardinal NASD rule of behavior pertaining to advice is as follows:<sup>63</sup>

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

This duty imposes an obligation to obtain the information, even though the customer did not volunteer it. The rule also applies to excessive trading or "churning." The NSYE has the same rule labeled: "Know thy customer." It is interpreted as imposing a duty to "use due diligence in learning the essential facts relative to every customer."<sup>64</sup>

If a member is entrusted with money which he may invest according to his own discretion, he is prohibited from effecting transactions which are excessive in size or frequency in view of the financial resources and character of such an account.<sup>65</sup>

The SEC rule was not limited to discretionary accounts and applied whenever the customer was in the habit of following the dealer's suggestions and whenever the dealer induced his customer to engage in excessive trading.<sup>66</sup>

Before the dealer may offer a loan to the customer he must, under the SEC rule, deliver a statement to the customer setting forth the customer's obligations and risks under such a loan and all the commissions and payments which the customer undertakes to pay. After obtaining information from the customer, the dealer must determine that the entire transaction is suitable to the customer, and must give him a written statement setting forth the basis of such determination.

There are no NASD rules applying specifically to the content of selling literature, *viz.*, the advice of the dealer *qua* dealer, except one

<sup>62</sup> Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). See H.R. Doc. No. 95, *supra* note 55, pt. 5, at 56-60 on research and investment advice.

<sup>63</sup> R.F.P., Art. III § 2.

<sup>64</sup> H.R. Doc. No. 95, *supra* note 55, pt. 1, at 239.

<sup>65</sup> *Id.* pt. 1, at 238-39.

<sup>66</sup> Frey, Federal Regulation of Over-the-Counter Securities Market, 106 U. Pa. L. Rev. 1, 39-40 (1957).

broad general rule—NASD Manual G-19. The NASD enforces the SEC's rules governing selling literature of investment company stock. The NYSE, however, requires truthfulness and good taste, emphasizing that rules can never replace good business judgment.<sup>67</sup>

Finally, the dealer who also advises the issuer is faced with conflicting duties in his dual capacity.<sup>68</sup> The NASD has not dealt with this problem at all, and only recently has the NYSE begun to consider it.

Paralleling the dealer's selling and buying activities are his changing relations with the customers. These range from the relationship of trust in discretionary accounts<sup>69</sup> and public advising<sup>70</sup> to the fiduciary relationship with those customers to whom he gives investment advice, and with whom he establishes confidential relationships.<sup>71</sup> He is also a fiduciary to those customers who relied upon him specially;<sup>72</sup> but his obligation to those strangers to whom he merely supplies literature or with whom he engages in institutional selling is less strict.<sup>73</sup> The requirements and duties imposed upon the broker dealer in this spectrum of relations, trust, fiduciary, semi-fiduciary and advantageous selling position, are not well defined; neither are the relations of the parties clearly delineated. The suitability rule seems to apply to any advice given to any customer, but perhaps would not apply to selling literature. There are two problems with the current rule. First, the rule imposes the same requirements on very different situations. It presupposes a fiduciary relationship between the broker dealer and the customer. One immediately questions the necessity of following this rule if the fiduciary relationship is absent. Second, the rule implies that the broker dealer has his stock or has available various kinds of securities; that he is capable of judging in an unbiased fashion which security is more suitable for his customer; and that, as far as the dealer is concerned, one security sold will be as good as another. It is apparent that all these suppositions are unrealistic. Interwoven in the special rules pertaining to the industry are the general laws regarding fraud, misrepresentation, trustees, and fiduciaries.

When must a broker dealer advise a customer to sell? Suppose he knows or should have known of the impending bankruptcy of a company whose shares he had recommended to the public. Should he stop

<sup>67</sup> NASD Manual J-51; SEAR No. 6846, Mac Robbins & Co. (1962); H.R. Doc. No. 95, supra note 55, pt. 1, at 376.

<sup>68</sup> H.R. Doc. No. 95, supra note 55, pt. 5, at 63-66.

<sup>69</sup> In the Matter of R. H. Johnson & Co., 36 S.E.C. 467 (1955).

<sup>70</sup> SEC v. Capital Gains Research Bureau, Inc., supra note 61.

<sup>71</sup> In the Matter of Hamill & Co., 28 S.E.C. 634 (1948).

<sup>72</sup> In the Matter of Behel, Johnson & Co., 26 S.E.C. 163 (1947).

<sup>73</sup> H.R. Doc. No. 95, supra note 55, pt. 5, at 49.



selling to the public? Or should he recommend sale to the public?<sup>74</sup> Should not advice incidental to selling activities entail duties imposed upon the advisor *qua* advisor? Would it not be more realistic and just to inquire into the selling literature itself? And if it contains advice, to impose upon the sender of the literature the same requirements imposed upon the advisor? These questions have one easily discernable common denominator: they are not matters of degree but of principle. They reflect the different attitudes toward the function and place of the dealer in the regulatory system of the securities business. Is he selling a commodity or is he giving advice? It has been said that he is selling "intricate merchandise." That description has resulted in complex and conflicting standards of behavior. In view of the above questions, the suitability rule therefore raises doubts as to its own suitability.<sup>75</sup>

Before enacting the Securities Act of 1933, Congress was faced with the choice between two conflicting philosophies: disclosure or regulation.<sup>76</sup> The advocates of the disclosure theory prevailed. Investors were to be given all the facts and nothing but the facts, and then, so help them God, they were to form their own judgment as to the worth of the security and the soundness of the business.

The disclosure theory assumes that a public which is given the relevant facts can form its own judgment. This is not always accurate. Just as access to books of law does not enable the public to form an opinion of the legal implications of certain factual situations, so does access to information not assure intelligent comprehension of a prospectus or a financial statement. The achievement of such understanding might require a team of professional men: the lawyer pointing out the legal implications of the structure of the company, the accountant assessing its financial position, the economist evaluating its financing, and the technical expert judging the feasibility of its operations. How many people, except for the institutional investor, do in fact rely upon their own judgment in making an investment decision? The inescapable conclusion is that the broker dealer by his very function and position, whether he wishes to or not, serves as the nation's investment advisor.<sup>77</sup> Evaluating a security is difficult, even after appropriate inquiries. When Congress decided upon the disclosure philosophy it had allotted the broker dealer a place in the regulatory

<sup>74</sup> Knauss, *supra* note 43, at 640. It seems that a broker dealer is under an obligation to inform the client that a security is unsuitable, to furnish financial statements to customers for any security that he recommended, and to reveal the basis for his opinion about a security. H.R. Doc. No. 95, *supra* note 55, pt. 1, at 344.

<sup>75</sup> H.R. Doc. No. 95, *supra* note 55, pt. 1, at 344.

<sup>76</sup> 1 Loss, *Securities Regulation* 21 (2d ed. 1961). See H.R. Doc. No. 95, *supra* note 55, pt. 5, at 59 for recommendations as to more disclosure regarding advice.

<sup>77</sup> Loss, *supra* note 76, at 124.

scheme of the securities business. He is not only under a duty to refrain from abuses, but is also invested with the function of advising the public. The government was to refrain from judging a security as a business proposition. This task thus fell to the securities industry.

#### E. *The Market Maker*

"Each market maker . . . in a sense, functions as a miniature exchange providing a situs for the collection of buy and sell orders."<sup>78</sup> There are, of course, significant differences between the market maker and the Exchange. The market maker determines the selling price of the security and all orders funnel through him; orders do not meet directly as they do on the Exchange. The market maker exercises a greater power and possesses a greater hold over the market which he has created, especially if his is the only market for the particular security.

The market maker aspect of the broker dealer's activity is not only his selling and buying, but also his choice of security in which to make a market. Except for a few securities which are sold directly by the issuer to the public, the above statement applies to all securities, including those which are extremely speculative. The judgment of the security in which he will trade is, in a way, the decision the market maker makes for the investing public.<sup>79</sup> In 1933, Congress placed the responsibility for the distribution of 25 billion worthless securities at the broker dealer's door.<sup>80</sup> There are people in the industry who deny that responsibility. They say that a high percentage of worthless securities is inevitable, and that the broker dealer cannot and should not control this phenomenon. Today, the argument runs, we are familiar only with Ford, General Motors, and other existing automobile manufacturers. But who remembers the public's money which was lost in the hundreds of automobile manufacturing companies which flourished at the beginning of the century but dissolved soon after their incorporation. Who remembers the public investment in canals? And what about today's uranium and electronics? The successes of today are built on the failures of yesterday. A few companies make good while the rest melt away with the public's money. This is the way it has been and this is the way it shall be, for in a capitalistic society the public is the financier of industry's experiments and innovations.

There are, also, allegations that the public's greed is to blame

<sup>78</sup> Loomis & Rotberg, *supra* note 57, at 590.

<sup>79</sup> See H.R. Doc. No. 95, *supra* note 55, pt. 2, at 675 for a recommendation of a system of official identification of the primary market makers in each security.

<sup>80</sup> House Comm. on Interstate & Foreign Commerce, Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. Rep. No. 85, 73rd Cong., 1st Sess. (1933).

for its loss. Yet the public's appetite is whetted by the broker dealer's advertising of quick riches. How far should the public be protected against its own folly? What is the duty of the broker dealer with regard to the choice of securities in which he creates a market? Should the NASD promote higher standards of ethics guiding the market maker in the choice?

### III. THE SCHEME OF THE MALONEY ACT

When the Maloney Act was passed little was known about the over-the-counter markets. Thus, while the Act had an underlying philosophy and a model according to which the over-the-counter broker dealers were to organize and function, the SEC was entrusted with the power to work out the details. The philosophy was self—as opposed to governmental—regulation; the model was the Exchanges.<sup>81</sup>

#### A. *Organization: The Self-Regulation Theory*

The two sides of the coin of self regulation are the relations within the organization—between the members and the organization and between the members themselves—on one hand, and the relations between the organization and its members *vis-à-vis* the public on the other. These two aspects both influence and interact upon each other. When the Maloney Act was passed, the memory of the NIRA fiasco was still fresh in the mind of the country. This memory no doubt contributed to the attitude of the legislators with regard to membership in self-governing bodies and qualifications for entering the trade. It also influenced their decision to minimize government regulation.<sup>82</sup>

The Maloney Act legislators envisaged the following: the creation of a few organizations, democratic in character, in which membership would be voluntary; the provision of incentives for organizing and remaining organized; the regulation of relations between the members and with the public; the promotion of ethical standards; the education of the members; the reduction of governmental expenses; and the guardianship by the government against tyranny of the organization towards its members and against laxity of standards in the public interest. All this was intended to be modelled on the Exchanges, which were considered very much like over the counter markets.

Let us examine this plan in view of twenty-five years of experi-

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<sup>81</sup> As Mr. Justice William O. Douglas said in 1 Conference News, Investment Banking Conference, Inc. No. 11 A: "The pattern is simply that provided by Congress for the Exchange."

<sup>82</sup> A further factor, of which everyone was aware at the time, was that the NYSE was low in the public esteem, for the Whitney scandal had shaken the public's confidence in the NYSE. The over-the-counter market's new organizations were free of any such stigma, and could thus start with a clean slate.

ence. Comparison of the NASD performance will be made with that of the NYSE, and questions arising out of this comparison will be posed.

### B. *Number of Organizations*

One of the unexpected results of the Maloney Act was the emergence of only one organization of broker dealers instead of many. Although this development is welcome because of the ease of coordination, it has great disadvantages. Standards and activities of members are highly diverse. The result is a compromise with regard to principles; and, as we shall see, the deterioration of the organization's control over its members, generalization of the rules without the possibility of articulation, and lack of member enthusiasm when the organization does not serve their vital interests.

### C. *Voluntary Organization*

The assumption that an industry will always choose to regulate itself instead of being regulated by the government has not always been substantiated by later experience. Yet, broadly speaking, it is reasonable to accept the proposition that the securities industry in general and the NASD in particular preferred self to governmental regulation.

The Maloney Act did not make membership in the future organizations of the broker dealers compulsory. It merely made membership attractive; profit and prestige were the positive incentives to become and stay a member.<sup>83</sup> The Act granted the organization partial exemption from the anti-trust laws by allowing a provision that only members may be granted discounts and price concessions by other members.<sup>84</sup>

As previously noted, the inception of the NASD was surrounded by greater public support and prestige than the NYSE then had. Twenty-five years later the picture is completely different. There is no doubt that the NYSE is the leader of the industry. Every member of the NYSE advertises the fact that he is a member. Yet the NASD rules limit advertisement of membership in it.<sup>85</sup> Two reasons were given for this limitation. First, as long as many members are not up to the minimum standard—because there are no requirements as to minimum capital, knowledge and experience—such advertising would operate as a fraud on the public. It might create the impression that there is a special guaranteed standard attached to membership. Second,

<sup>83</sup> "Businessmen do not strive for profit alone; . . . security, power and prestige play an important role, in conjunction with, or even in opposition to, the profit motive." Katona, *Psychological Analysis of Economic Behaviour* 194 (1963).

<sup>84</sup> 52 Stat. 1070 (1938), 15 U.S.C. § 78o (1958).

<sup>85</sup> NASD By-Laws, Art. VIII § 2; NASD Manual H-10.

the larger members are not at all eager to advertise their membership in the NASD.

The main reason for the NASD not maintaining a high degree of prestige seems to be the quality of its members and the diversity of their activities—from the giant Merrill Lynch to the one-man office. The Exchange, on the other hand, is more homogeneous. Until recently, the principle of unqualified entry into the trade prevailed. This resulted in loss of prestige for the organization. One insolvent member or one boiler room can spoil the reputation of hundreds of firms if the public attributes its failings to the entire organization.

The profit incentive for joining the NASD has its limits. It is of little value to a member who does not take part in underwriting which may be policed with regard to concessions while other transactions may not. And, in fact, there is little difference here between a member and a non-member if the first does not participate in underwriting. Further, one may sell securities without being a member of the NASD. As a result, the profit incentive is effective only to the extent that it pays to be a member. If the rules of the NASD cut too deeply into profit, the incentive is gone. The different position of the Exchange may be noted. Loss of membership there means loss of the right to trade on the Exchange. The control of the NASD upon its members is, therefore, less than that of the Exchange and the incentive to join and remain in it is weaker.

#### D. *Furthering of Common and Public Interests*

People unite in order to further their common interests. Workers join trade unions; businessmen join chambers of commerce. Quite naturally, the NASD's choice of a solution to any problem is influenced by self-interest. It is in the interest of over-the-counter markets that companies shall not be registered on the Exchanges, that the profit of the broker dealer shall not be disclosed to the customer—although both may also be in the public interest. It is also in the interest of the over-the-counter markets that variable annuities be considered securities—which happens to coincide with the view of the SEC that this is also in the public interest. There is nothing disreputable in this attitude. On the contrary, it welds the members together and gives the association its *raison d'être*. But it must be accepted as a limitation of self-regulation in the public interest.

The SEC criticized the NYSE for advertising in order to stimulate business for the Exchange.<sup>86</sup> “In its role as self-regulator the Exchange stands in the shoes of the government itself, and must have the appropriate degree of aloofness.”<sup>87</sup> Self-govern-

<sup>86</sup> H.R. Doc. No. 95, supra note 55, pt. 5, at 182.

<sup>87</sup> Ibid.

ment can be viewed not only as power bestowed on the individual, but also as conduct consistent with the public interest which does not require governmental intervention. A father who disciplines his son exercises governmental powers, usually with discretion and freedom from intervention. Yet when he oversteps the boundaries of what is considered the public interest, *e.g.*, causing the child physical harm, government will step in, impose restrictions, and sanction them by penalties. The father performs his governmental duties without aloofness; he gratifies his own desires and interests. Too great a degree of aloofness is, however, incompatible with human nature, especially when the activities dealt with are not professional. Why is the absence of aloofness injurious to self-government? Is being an outsider the only way to govern? Could not self-government be carried out even more effectively when motivated by self-interest? Mr. Justice Douglas recognized this element: "[R]estrictions must be consistent with profit motive, which in the final analysis is and must remain the driving force in our economy."<sup>88</sup> It would seem better to realize the limitations of self-government, and utilize it to the extent that it is compatible with self-interest, rather than trying to shape it against the nature of things, thereby rendering it impotent.

Lastly, the involuntary aspect of the voluntary organization must not be overlooked. The securities industry was not given a choice between self-government or no government. It was given a choice between self-government or Governmental government. The industry chose the former.<sup>89</sup> Its philosophy of self-regulation is based on the theory that if the industry does not do it, the government will; therefore, the industry had better do it. The necessity of taking the public interest into account comes in through the back door. It is the means of keeping the government out rather than the realization that serving the public is one of the goals of the industry.

The attitude towards public interest is one of the important elements for consideration in evaluating the limitations and advantages of self-regulation. We may conclude that the NASD and the Exchanges, do not, as do the professions,<sup>90</sup> consider the public interest

<sup>88</sup> Douglas, *Democracy and Finance* 645 (Allen ed. 1940).

<sup>89</sup> Commencement Announcement Exercises, Trinity College, Hartford, Conn., June 10, 1962. See Commencement Address by Mr. Keith Funston, Chairman, NYSE.

<sup>90</sup> Let us consider the attitude of the professions toward the public interest. The goal of public service is embedded in the definition of a profession. Pound, *The Lawyer from Antiquity to Modern Times* 5 (1953). A profession performs a unique service; it requires a long period of academic training. Service to the community rather than economic gain is the dominant motive. We may measure the broker dealer's activities against these criteria. He does perform a unique and essential service to the public but he has no academic training. He has been granted, like a profession, a large measure of self-government and autonomy; he is also subject to a code of ethical conduct. Although at least part of his trade is to give service, profit is his goal. The public interest is stated

as one of their goals; rather, the NASD and the Exchanges consider it as a means to an end.

#### E. *Democratic, Open Organization*

The principle established by the Maloney Act was that any honest man may be a broker dealer. A converse development has taken place in some professions and vocations, that of achieving a high standard of performance by voluntary action.

In 1942, the NASD proposed to set a minimum capital requirement for membership, which was rejected by the Commission.<sup>91</sup> The membership qualifications required by the states and the SEC do not include a period of preparation or special knowledge for broker dealers in general or for underwriters, market makers, and investment advisors. Since 1956, the NASD has provided for an examination program, but with only limited success.<sup>92</sup>

It is difficult to predict the result of imposing high standard examinations. It would seem that the greater the degree of specialization the higher the standards will become. This in turn might lead to professionalization of some of the functions of the broker dealer, *i.e.*, in his capacity as an advisor. It might lead to the division of the NASD into groups representing the more specific interests of the different functions. This may well be only a theoretical possibility, but it certainly would be beneficial both to the broker dealers and to the public.

#### F. *Ethics*

One of the purposes of the Maloney Act was to create an organization of broker dealers which would promulgate and enforce rules for higher standards of conduct than those of the government. The industry has asserted that it imposes rules of ethical conduct on its members, and the SEC expects this of the industry.<sup>93</sup>

Both the industry and the Commission distinguish between a legal and an ethical requirement, the first to be enacted by the government and the second by the self-governing bodies. Is there in fact a difference between ethical and legal rules in the securities industry? It may

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in negative terms: he should refrain from wrongdoing because it does not pay. This attitude is the crux of the matter, the heart of the difference between a profession and the broker dealer's activity. Loomis & Rotberg, *supra* note 57, at 497.

<sup>91</sup> A group organizes voluntarily and distinguishes itself by acquiring a higher standard of knowledge and skill. Then the higher standard receives state recognition and protection. Finally, the law imposes the requirements which were initiated by the private group on any person who wishes to practice the profession. See Freund, *Legislative Regulation passim* (1932).

<sup>92</sup> H.R. Doc. No. 95, *supra* note 55, pt. 1, at 73.

<sup>93</sup> "If the latter are to fulfill the role for which they are thought to be uniquely suited, they must also, of course, exert leadership in defining and elevating ethical standards for their members, above and beyond the legal requirements." H.R. Doc. No. 95, *supra* note 55, pt. 1, at 161.

lie in the sanctions behind them. Ethical rules may be those enforced by social, rather than by legal means. This, however, is not the case. Both the SEC and NASD rules are laws in the sense that they are backed by almost identical sanctions and both derive their power from the legal scheme of the securities statutes.

Another distinction may be in the kind of rule. Laws tend to be prohibitive rather than requiring affirmative actions because "prohibitions are more easily enforceable than requirements, and the violation of a prohibition . . . is less easily excused than the violation of a requirement."<sup>94</sup> Rules of ethics tend to be of the requiring type by setting a manner of conduct. But, again, this is not the case. Most of the NASD rules correspond to the rules of the SEC. With few exceptions, most of them are prohibitive in nature.<sup>95</sup>

There are also cases where the ethical standard prescribed by a group is higher than the legal standard set by the legislature because it represents not the course of conduct of the majority, but that of a minority.<sup>96</sup> The argument that the rules of the NASD are "above and beyond the call of duty" of the industry to the public, is untenable. Most of the rules are an incorporation of the anti-fraud provisions of the securities statutes and the rules enacted thereunder. Furthermore, it seems that if the self-regulatory body had not enacted the rules, the SEC would have done so. Yet, in its role of self-regulator of the interrelationships of its members, the NASD has promoted ethical standards of conduct. As a result, the securities business carries out its contractual obligations much more promptly than required by law and performs contracts even in cases where the law does not impose an obligation to perform.

### G. Enforcement

A group which participates in the promulgation of a rule applicable to it will obey that rule better than if it did not share in its enactment. It has also been shown that the more active the members of the group are in the enactment of the rule, the more effective is its enforcement.<sup>97</sup>

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<sup>94</sup> Freund, *supra* note 91, at 87.

<sup>95</sup> Unfortunately, these rules are couched in vague language and have been applied in varying situations; thus a clear principle has not been enunciated.

<sup>96</sup> "[I]n the regulation of professions, higher standards are possible under a system of optional than under a system of compulsory certification." Freund, *supra* note 91, at 105.

<sup>97</sup> Voluntary Compliance: An Adjunct to the Mandatory Process, 38 *Ind. L. Rev.* 377, 386-87, 398 (1962). This is an account of the results achieved by the FTC through conferences with representatives of business, consumers, and public services. The guides and rules are promulgated by the FTC alone. Intensive and informal compliance follows the conferences. The conference method seems to provide the consumer and the businessman with the rallying point essential to extensive efforts in self regulation. See Jaffe,



The promulgation of the NASD rules does not follow this pattern. The NASD does not initiate its rule making; it is prodded into legislation by the SEC. The staff of the SEC meets with the staff of the NASD and they negotiate the demands which the former puts before the latter. Upon agreement a proposal is separately laid before the SEC and the Board of Governors of the NASD. If all agree—well and good. If not, remarks and objections are passed to the staffs which negotiate again, until all finally agree. This has been the pattern of action during the last twenty-five years. Thus, one of the great advantages of self-regulation, *viz.*, the participation of every member or most members in the rule-making which results in effective adherence to the rules, has been lost to the NASD.<sup>98</sup> The NASD had the tools and the power to use them, yet failed to do so. The reasons for this failure would seem to be the diversity of membership and the conflicts of interest—both of the members and of their individual functions—so as to make a unanimous or majority decision difficult, if not impossible.

The tendency of the NASD and the NYSE has been to base the adjudications on violations of the Net Capital Rule rather than on unethical conduct, such as improper selling practices or violation of the suitability rule. Both the Exchange and the NASD are reluctant to proceed against members on improper selling practices. Violation of the Net Capital Rule is easier to prove. Proceedings on improper selling practices involve persons outside the trade and hurt the reputation of the industry because they imply moral turpitude. Bankruptcy of a member hurts the interests of the industry more than improper selling; and, finally, there seems to be no consensus as to what constitutes proper selling practices. The result is curious. In contrast to the Exchange, there is little justification for bestowing upon the NASD the power to self-regulate the financial responsibility of its members. There is justification for investing it with power to regulate selling practices. Yet the association neglects the policing of the latter while it attends to violations of the former.

The main tool for policing is the staff. It is the key to control both by the NASD and the Exchanges. In the securities industry, policing has greatly improved whenever a staff was given power to

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Law Making by Private Groups, 51 Harv. L. Rev. 201, 212 (1937): "Participation in management satisfies the craving for self-expression, for power. . . . [I]t may stimulate initiative and quicken the sense of responsibility. . . ."

<sup>98</sup> Most of the NASD rules, except the original ones, do not take the form of amendments to the Rules of Fair Practice, but are interpretations and resolutions. The reason for this form of legislation is the fear of dissent on the part of some of the members, or, worse still, of the majority. The method of interpretative rules was challenged and upheld on the theory that these were not rules at all.

oversee the performance of those regulated.<sup>99</sup> The staff is loyal to the organization and identifies its interests with the organization's goals. It is permanent, gathers experience, and has practical as well as technical knowledge of the problems. What has developed in the NASD is a private police power. There is no doubt that one of the main reasons for the loose organization of the NASD not falling apart at the seams is the existence of its staff.

A systematic analysis of the rules governing various abuses in the securities industry may lead to a classification of rules which lend themselves to self-regulation and others which do not. Where self-regulation is effective, the method of adjudication which is less formal and time-consuming, the business attitude, and all the other advantages of adjudication by members of the trade come into play.

#### H. *Expenses to the Government*

One of the reasons for self-regulation is that it is less expensive to the government. But note that while the policing of national and state financial institutions is done by the government, the expenses in most of the cases are borne by the institutions.<sup>100</sup> It may well prove cheaper for the industry to be policed by the SEC.

Policing of malpractice which cannot be recorded is invested in non-governmental bodies not because of expenses but because of difficulties inherent in policing such activities.

#### IV. THE GOVERNMENT'S ROLE: GUARDING AGAINST LAXITY OF STANDARDS IN THE PUBLIC INTEREST AND AGAINST THE TYRANNY OF THE ORGANIZATION TOWARD ITS MEMBERS

Until recently, the staffs of the SEC and of the NASD worked more in an atmosphere of service than in one of surveillance. They negotiated, and they agreed, but no one obeyed. The suggestion that it is the right and duty of the SEC to supervise the performance of the Exchange has been sharply criticized by the members of the Exchange, who prefer the maintenance of the *status quo*.

The intention of the SEC is to change the existing relations with the self-governing bodies, to place more emphasis on supervision, to make frequent visits to the offices of the NASD in the districts, to

<sup>99</sup> H.R. Doc. No. 95, supra note 55, pt. 5, at 190.

<sup>100</sup> In 8 states costs are financed by a combination of fees and appropriations; in 21 states banking departments are financed by legislative appropriations; in 20 states costs are borne by the banks. All national banks pay for examinations by the Federal authorities. The Federal Deposit Insurance Corporation pays the costs of examination of insured banks who are not members of the Federal Reserve System from its insurance assessments. Subcommittee on Domestic Finance of the House Committee on Banking and Currency, Comparative Regulations of Financial Institutions, 88th Cong., 1st Sess., 60 (1963).

supervise complaints, adjudications and recording, and to prompt the district offices of the NASD into more active self-regulation.

It is doubtful whether indiscriminate prodding by the SEC's staff will produce the desired results in the long run. Government can effectively curb power. It is less effective in activating power through reluctant rulers. Incessant prodding need not produce habits when other forces act against these habits. The experience in the promulgation of NASD rules casts doubts on the power of activating techniques. It might have the reverse effect of what is expected, for a self-governing body gets used to the fact that it need not legislate until it is required to do so.

Yet, there comes a point at which no change is a stalemate, as in the case of the quotations problem. Some change must be made. Some risk must be taken when years of experiments have brought no satisfactory results.

Proponents of change argue that self-regulation should not be used as a method to control the securities industry. Self-interest of the broker dealer is in direct conflict with public interest. It is too great to be overcome. Prodding is no solution. Self-regulation is just as expensive as direct regulation. Policing of financial responsibility should be borne by the industry. Selling practices and other activities which are difficult to police by the government are not policed by the industry either. The problem should be solved by changing the rules. Black and white rules, containing objective tests, will enable the customer, if disclosure is imposed, to police the practices. The advocates of this position conclude that the best method is direct government regulation.

The relations between the government and the self-regulating bodies need not be the same in all areas of the broker dealer's activities. Different problems require different solutions. The Commission, in fact, has been more active than it might seem. It has initiated almost all the new legislation, and has developed a new concept of liability, the shingle theory. While it formerly left the field of policing to the NASD, the SEC now intends to enter that area as well.<sup>101</sup> The NASD is left with one field of activity: the regulation of the relations between its members. In this field it has been a success.<sup>102</sup>

The sanctity of contract has been maintained by the securities industry at a higher level than is required by law because the industry could not exist otherwise. Breach of contract is very severely punished.

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<sup>101</sup> It is interesting to contrast the reaction of the NASD and the NYSE to the SEC's increased activity. While the NYSE is trying to maintain the status quo, the NASD seems to accept the recent staff program of visits and inspections.

<sup>102</sup> H.R. Doc. 95, supra note 55, pt. 5, at 196.

In fact, on a few occasions, the SEC has put a check on the zeal of the NASD in this area.<sup>103</sup>

As a trade association regulating the business practices between members, the NASD has fulfilled a useful function without which trade could not be carried on. The SEC has played the conventional role of judicially reviewing the NASD decisions and providing safeguards against possible tyranny of the organization.<sup>104</sup>

#### V. THE EXCHANGE AS A MODEL

The model for the Maloney Act experiment was the Exchange. Barring minor differences it was considered similar to the over-the-counter markets. The similarity lay in the economic function of the two bodies, the economic relationship to the nation, and the basic fiduciary responsibility to the investors. But the Exchanges are different from the over-the-counter markets in many important aspects.

The Exchange is an old institution. Its rules developed with the needs of the members and were adapted to new circumstances. The rules were an example of private law-making influenced by the government because of the importance of its functions to the public. The prime objective of the Exchange was to regulate the activities of its members. In 1792, twenty-four brokers had organized in New York in order "to promote . . . just and equitable principles of trade and business." This maxim is now considered to express the standard of conduct of the NYSE toward the public. At the date of incorporation these words probably established the principle governing the members' behavior toward each other. Only later did the principle acquire a new and wider meaning. The same process may be observed in the evolution of the principle: "Know thy customer." It was first used as a warning to the members against defaulting customers, and subsequently developed into a rule imposing a duty upon the members to give the customers suitable advice.

The public utility aspect of the Exchange was superimposed onto the traditional organism. The NASD lacked that tradition, for it was a legislative creation based on the Exchange and influenced by the NIRA era. Other elements of the Exchange which are absent in the over-the-counter markets made it difficult for the NASD to develop a tradition of its own and impossible for it to adopt fully the traditions of the Exchange.

The Exchange is the market place where all business must be conducted. As a result, it is valuable to the members and has an importance apart from any member. It is not replaceable and its good-

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<sup>103</sup> See 2 Loss, *Securities Regulation* 1379 (2d ed. 1961). In the Matter of Nat'l Ass'n of Sec. Dealers, Inc., 19 S.E.C. 424 (1945).

<sup>104</sup> Loss, *supra* note 103, at 1374.

will be priceless. The members have a real interest in promoting the reputation of the Exchange as well as that of the members. Since the over-the-counter market is widely dispersed, its members do not have a similar interest in promoting its reputation.

The Exchange is an auction market: the over-the-counter market is a negotiation market. They deal in different kinds of securities. The over-the-counter market creates markets for local issues, small issues which are not distributed widely enough for auction trading, or blocks of securities too large to be readily digested by the Exchanges. The quality of the securities traded on the over-the-counter market tends to involve either the least or the most amount of risk.<sup>105</sup> Most brokers on the Exchange act as brokers; most brokers on the over-the-counter market act as dealers.<sup>106</sup> Thus, it is clear that the model of the Exchange cannot solve the problems which are peculiar to the over-the-counter markets such as price disclosure and public quotations, or adequate and prompt execution of orders, simply because these problems do not exist on the Exchange.

Apart from the value of the Exchange as a market place, that the members of the Exchange execute their business in only one place affects their behavior. It is easier to control. Customs as to dress, movement on the floor, sign language and the like, add to the power of the organization over its members. The need for a code of conduct is much greater on the Exchange than in the over-the-counter market. The NASD members do not all deal with one another. They trade in smaller groups. The Exchange needs one code; otherwise chaos will ensue.

Notwithstanding the Exchange Act of 1934, which was designed to convert the Exchanges from private clubs to public institutions, the Exchanges retained a great measure of autonomy.<sup>107</sup> They impose membership requirements and codes of behavior among the members, between the members and outsiders.<sup>108</sup> The NASD has remained an open organization.

These differences may explain why the NASD has less control over its members and imposes less stringent rules of conduct than the Exchange. They may explain why the model of the Exchange did not always help to solve the problems of the over-the-counter markets.

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<sup>105</sup> *Id.* at 1277-78, 1283-87.

<sup>106</sup> Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 *Geo. Wash. L. Rev.* 86, 91-92 (1959).

<sup>107</sup> Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 *Geo. Wash. L. Rev.* 214, 221-22 (1959).

<sup>108</sup> *Silver v. NYSE*, 373 U.S. 341 (1963).

## VI. THE SUBSTANTIVE RULES

The various functions of the broker dealer do not conflict per se. A conflict does exist between the rules of conduct regulating these functions, or between some of these rules and the self-interest of the broker dealer, *e.g.*, the dealer-advisor functions. There is no agreement on the standards governing the broker dealer's activities. There is no agreement regarding the governing function among his various activities. The SEC tends to emphasize the advisory function, which leads to a higher standard for a fiduciary, even when the broker dealer is simultaneously acting in another capacity. The industry emphasizes its merchandising aspect, and argues that the broker dealer is subject to the duties of a merchandiser even when he is also acting in his advisory capacity. Under these circumstances, general provisions are of little help. Most of the disagreements about legislation between the SEC and the industry stem from the differences of opinion as to the principles underlying the duties of the broker dealer, *e.g.*, the segregation and the quotation and disclosure problems. Some persisting difficulties of enforcement also have their roots in this discord, *e.g.*, selling practices and the execution of orders.

Although the SEC imposes the standards of a fiduciary on the broker dealer, it does not apply that standard invariably. Fiduciary duties are not imposed in all securities transactions, but only in special circumstances. Neither does the SEC apply all the remedies that result from a breach of fiduciary duties. Rather, it limits them to disclosure.

The problems with which the NASD had to deal had plagued the industry even before the birth of the NASD, *e.g.*, quotations, price disclosure, manipulation, representation, churning, misuse of customers' funds, et cetera. It seems that except for free-riding (which is similar, but not identical to the old practice of "corners"), none of the undesirable practices is new. Yet the NASD has not succeeded in eliminating these practices or even in defining standards of conduct. Even the customs of the industry lack clear underlying principles.<sup>100</sup> The SEC has therefore taken steps to establish new standards. The process still continues; the new law is in the making.

## VII. CONCLUSION

The demands made upon the NASD seem to be as conflicting as the functions of the trade itself. It was expected to act as an Exchange, although it lacks the essential elements of an Exchange. It was required to perform like a professional organization, although it does

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<sup>100</sup> Jackson, *Stock Broker's Liability under Customs, Usages, and Rules*, 12 Clev. Mar. L. Rev. 111 (1963).

not have the attributes of a professional organization. It was designed to be an open association—and yet to maintain a high standard of performance by its members.

The NASD is essentially a trade organization; and, like every trade organization, should possess self-regulating powers. It is doubtful whether at this stage the NASD should be expected to do more than regulate the relations between its members under the supervision of the SEC. In a decade, it had proved incapable of establishing accepted standards of behavior for the activities of the trade. Neither was it capable of solving problems in a selfless manner. It has acted like a trade organization and should be recognized as such.

Unlike the Exchange, the NASD has not developed a large measure of control over its members. It was formed on the model of an Exchange—which is not wholly appropriate—and remained a loose, diffuse organization. It seems that before a body can be entrusted with the duty of imposing rules which might be adverse to its members' interests, that organization must have the strong backing of its members. While the Exchanges do fulfill this requirement, the NASD does not. As a condition precedent to its being a self-regulating body in the sense of the Maloney Act, it should be a strong trade organization. During the years, the roles of the SEC and the NASD have been reversed. The NASD acted, but its actions were initiated by the SEC. The NASD showed initiative mainly when regulating the relations between members. Past experience has proved that it is unrealistic to expect the NASD to regulate in the public interest; it seems wasteful for the SEC to regulate through the NASD. The SEC has initiated most of the legislation and enforcement programs of the NASD *de facto*. Why not grant this situation recognition *de jure*?

In time, the relations between the SEC and the NASD might be reversed again. The industry could always assume self-regulation by imposing a higher standard of behavior upon itself. The NASD may split into smaller groups. Members whose main activity is service (*e.g.*, advising) may professionalize in the sense described in this paper.<sup>110</sup> Members whose size and function are similar may form tighter trading units and assume more Exchange features, more unified standards of conduct, and less conflicting functions (*e.g.*, wholesale dealers). These groups may recapture their self-regulatory powers simply by exercising them, thereby rendering government intervention unnecessary. It may well be that greater awareness of public needs is better developed through voluntarily organizing than by decree. Such awareness may be sharpened by the desire to restrict government activities; it may also be motivated by the goals of higher profits and

<sup>110</sup> See *supra* note 90.

prestige. Finally, such an awareness of the public needs may be motivated by self-interest, when, as in the case of the NYSE, the trade realizes its function as a public utility.

If the NASD is treated as a trade organization, if it develops according to its peculiar needs and functions, if it becomes strong, if it splits into unified groups, it may then be capable of assuming the full burdens of self-regulation imposed upon it by the Maloney Act.