SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 4048/February 18, 1948

In the Matter of: ARLEEN W. HUGHES doing business as E.W.HUGHES & COMPANY
515 Exchange National Bank Building, Colorado Springs,Colorado

BROKER-DEALER REGISTRATION

Grounds for Revocation or Suspension

Failure to Make Full Disclosure

Where registered broker-dealer, who is also a registered investment adviser, sells her own securities to clients to whom she purportedly renders impartial investment advice and fails to disclose fully to such clients the nature and extent of her adverse interest, including her cost of the securities and the best price at which the security might be purchased in the open market, held, willful violation of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Effect of Registration as Broker-Dealer and Investment Adviser

A broker-dealer registered as such under the Securities Exchange Act of 1934 and also registered as an investment adviser under the Investment Advisers Act of 1940 is amenable to regulation under both statutes and may have his broker-dealer registration revoked for willful violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 where such violations are based upon broker-dealer's failure to make disclosure required of him in his capacity as a fiduciary.

Louis Loss, A. Marvin Lungren, Olga M. Steig, Arden L. Andresen and Elmer A. Carlson, for the Trading and Exchange Division of the Commission.

Donald C. McCreery and Paul W. Lee, for the registrant.

FINDINGS AND OPINION OF THE COMMISSION

This is a proceeding under Section 15 (b) of the Securities Exchange Act of 1934[1] to determine whether the registration of Arleen W. Hughes as a broker and dealer should be revoked.

[1] Section 15 (b) of the Securities Exchange Act provides in pertinent part:
"The Commission shall, after appropriate notice and opportunity for hearing, by order . . . revoke the registration of any broker or dealer if it finds that such . . . revocation is in the public interest and that . . . such broker or dealer whether prior or subsequent to becoming such . . . has willfully violated any provision of the Securities Act of 1933, as amended, or of this title, or of any rule or regulation thereunder. . ."

Registrant has been engaged in the securities business in Colorado Springs, Colorado, as a broker and dealer since 1928. From 1928 to 1939 she and her husband, the late E. W. Hughes, conducted business as a partnership under the firm name of E.W. Hughes & Company. Upon the death of her husband in 1939, registrant continued the business under the same firm name, operating as a sole proprietorship. In 1940 she registered as a broker and dealer under the Securities Exchange Act, and in 1942 she registered as an investment adviser under the Investment Advisers Act of 1940.

The order instituting this proceeding raises the question whether registrant willfully violated the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 (including rules issued thereunder) set out in the margin.[2] It alleges that from approximately September 1, 1944, to April 17, 1946, registrant sold securities to clients to whom she purported to render impartial investment advice for compensation under an investment advisory contract and

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[2] Section 17 (a) of the Securities Act of 1933 provides:

"It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly --

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

"(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in 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."

Section 10 (b) of the Securities Exchange Act of 1934 provides in part:

"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 securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule X-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,

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

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

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

Section 15 (c) (1) of the Securities Exchange Act provides:

"No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this subsection, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent."

Rule X-15C1-2 provides:

"(a) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

"(b) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading."

with whom she was in a fiduciary relationship, without fully disclosing to the clients the nature and extent of her adverse interest, including, among other things, (1) the best price at which the securities could be purchased for the clients in the open market in the exercise of reasonable diligence, and (2) the cost to the registrant of the securities sold by registrant to such clients.[3]

After appropriate notice a private hearing was held before a trial examiner. The trial examiner filed an advisory report finding that the registrant had violated the statutes and rules in the respects charged. Both the registrant and the Trading and Exchange Division submitted exceptions to the examiner's report and supporting briefs. We heard oral argument. Our findings and conclusions herein are based on an independent review of the record.

We shall consider, in turn, (1) the nature of the registrant's business and her methods of operation, (2) the disclosure required of the registrant, (3) whether the disclosure she makes is adequate, (4) whether this proceeding, as contended by the registrant, has been improperly brought under the Securities Exchange Act, and (5) the questions of "willfulness" and "public interest."[4]

1. Registrant's Business

The bulk of registrant's business is with about 175 investment advisory clients. Since January 1943 registrant has executed with each of her clients a "Memorandum of Agreement," which states that E.W. Hughes & Company and the client desire to enter into the agreement for the purpose of carrying out the terms and intent of the Securities Exchange Act and the Investment Advisers Act and the rules and regulations thereunder and to declare the respective rights and obligations of the two parties as between themselves. The agreement provides, inter alia, that the registrant in all dealings and transactions is to act "as a broker or dealer and investment adviser," and that the

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[3] The order for hearing also contained allegations that registrant willfully violated Section 17(a) of the Securities Exchange Act and Rule X-17A-5 adopted thereunder by filing reports of financial conditions for the years 1943 and 1944 which did not meet the minimum audit requirements prescribed by the rule and were not certified by a certified public accountant or a public accountant who was in fact independent. Registrant testified that she relied upon her accountants to prepare the reports and believed that they were being prepared in accordance with the requirements of the rule. When notified of the deficiencies in the reports she promptly retained other accountants to prepare future reports. A broker-dealer is not relieved of the responsibility of complying with Rule X-17A-5 merely by relying on accountants for the preparation of the reports required by the rule. The trial examiner did not find this violation to be willful. However, although we disagree with the examiner in this respect and find that the record establishes a willful violation, we do not believe that the "public interest," under the circumstances of this case, requires the imposition of any remedial sanctions directed against registrant by reason of this violation. In a proceeding under Rule II (e) of our Rules of Practice, the accountants who had prepared registrant's financial statements were suspended from practice before this Commission for a period of one year. We found that they had violated our auditing requirements in the preparation of these statements and had made false and misleading certifications. Williams & Kingsolver, S.E.C. (1947), Accounting Release No. 59.

[4] Registrant has stated that the procedure followed in this case does not comply with Sections 5 (a), 7 (b), 7 (c) and 10 (e) of the Administrative Procedure Act. This statement is unaccompanied by any explanation and no attempt has been made to indicate any specific respects in which the registrant believes the procedure to be deficient. The short answer to this point is that the Administrative Procedure Act which was approved June 11, 1946, by its terms has no application to any proceeding initiated prior to its effective date. The instant proceeding was instituted on April 17, 1946. Moreover, the record shows that the procedure followed in this case has afforded the registrant detailed notice, a full opportunity for hearing and all other rights which are essential to a fair hearing. And even if we assumed that the Act applied to this proceeding, we have not found any respect in which the procedure followed does not fully comply with all of its provisions.

“Company, when acting as investment adviser, shall act as Principal in every such transaction, except as otherwise agreed.”

Paragraph 5 of the agreement contains the following schedule of rates and charges to be paid by the client to the registrant:

“(a) BONDS (including other evidences of indebtedness), purchased by Customer.

$40 per $1,000 face value on transactions up to $10,000.

$30 per $1,000 face value on transactions over $10,000.

$20 per $1,000 face value on transactions over $20,000.

$10 per $1,000 face value on transactions over $30,000.

Expense: postage, insurance, taxes and transfer charges to be added.

“(b) BONDS (including other evidences of indebtedness), sold by Customer.

$10 per $1,000 face value.

Expense: charges by other dealers or brokers, postage, insurance and taxes to be added.

“(c) STOCKS (of all classes), purchased by Client.

Base price under $1.00 per share -- 1/8th point per share.

Base price $1.00 to $9.99 per share -- 1 point per share.

Base price $10.00 to $19.99 per share -- 2 points per share.

Base price over $20.00 per share -- 3 points per share.

Expense: postage, insurance, taxes and transfer charges to be added.

“(d) STOCKS (of all classes), sold by Client.

One half point per share.

Expense: charges by other dealers or brokers, postage, insurance and taxes to be added.

“(e) BASE PRICE - means the mean between the bid and asked price on the day of sale or purchase; or if no bid and asked price on that day, then the actual purchase or sale price.

"(f) COST TO CLIENT: The applicable rate charge shall be added to base price, and total shown as Client's cost, to which are to be added expense items chargeable.

"(g) APPLICABILITY: The foregoing schedule of rates shall apply to all transactions, whether relating to over-the-counter, listed or unlisted securities, except syndicated issues or underwritings, and whether Company is acting as Principal or Agent."

Generally, the registrant handles a client's entire account, advises the client with respect to an investment program, and, from time to time, recommends the purchase or sale of particular securities on the basis of information which she collects and analyzes. When recommending a particular security as a suitable investment, registrant furnishes her clients detailed information covering the business and financial data of the issuer and informs them as to the approximate price the securities will cost them. The client usually gives the registrant leeway up to a point or so from the approximate price. Where the actual price would exceed this margin of a point or so, registrant re-consults the client. Registrant's clients invariably follow her advice.

In filling a client's order for the purchase of a security, registrant either supplies the security from inventory or purchases the security "for her own account" and then as "principal" confirms the sale to the client. Although, as we have pointed out, the Memorandum of Agreement provides that the price to the client will be the charge for investment advice plus the "base price," which is defined to be the mean between the bid and asked quotations on the day of the sale or if there are no such quotations, registrant's actual purchase price, registrant does not, in practice, always adhere to this formula. Where she supplies securities from inventory, registrant uses as the "base price": (1) the price at which an actual sale was effected elsewhere on the day of the transaction as reported to the registrant by Lewisohn & Co., a New York securities firm with whom she does business regularly; or (2) in the absence of an actual sale, the price she would have to pay if she purchased the security that day as determined by her on the basis of the daily quotations furnished to her by Lewisohn & Co.; or (3) if neither of these is available the mean between the bid and asked quotations supplied to her daily by Lewisohn & Co. Where registrant does not have an inventory in a security and purchases the security to cover an order placed by a client, she uses her actual cost as the "base price." In all cases, registrant adds to the "base price" an amount not exceeding the investment advisory charges provided for in the agreement, and the total is shown as a net price on the confirmation. The net price and the postage tax and insurance expense to the client are the only cost data shown in the confirmation. Registrant does not advise her clients as to which method she uses in a particular transaction to determine the "base price."

Unless the client specifically requests the information, the registrant does not at any time disclose the current bid and asked quotations or her own cost of the securities she recommends and sells to the client. Nor does she advise the client whether the securities are supplied from inventory or from a purchase made by her to cover the client's order. Registrant uses the mails and instrumentalities of interstate commerce in the sale of these securities.

2. Disclosure Required of Registrant

The Trading and Exchange Division contends that registrant occupies a fiduciary relationship with her clients and as such may not deal with them as principal unless she first obtains their informed

consent, based on a full disclosure of the nature and extent of her adverse interest, including, at least, the cost to her of the securities she sells to her clients and the best price (discoverable by her in the exercise of reasonable diligence) at which those securities could be currently purchased elsewhere, if such price is lower than the price charged the client. The Division asserts that the registrant does not make these minimum disclosures. Registrant, on the other hand, apparently concedes that she is in a fiduciary relationship with her clients but maintains that, notwithstanding that relationship, she need only disclose to a client that she is selling her own securities and, if the client consents to her acting in such capacity, she is under no duty to make any further disclosure, provided she commits no fraud and deals fairly in such transactions. Registrant asserts, and the Division denies, that each of registrant's clients understands and has consented to her dealing for her own account.

The record discloses that registrant's clients have implicit trust and confidence in her. They rely on her for investment advice and consistently follow her recommendations as to the purchase and sale of securities. Registrant herself testified that her clients follow her advice "in almost every instance." This reliance and repose of trust and confidence, of course, stem from the relationship created by registrant's position as an investment adviser. The very function of furnishing investment counsel on a fee basis -- learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities -- cultivates a confidential and intimate relationship and imposes a duty upon the registrant to act in the best interests of her clients and to make only such recommendations as will best serve such interests. In brief, it is her duty to act in behalf of her clients. Under these circumstances, as registrant concedes, she is a fiduciary; she has asked for and received the highest degree of trust and confidence on the representation that she will act in the best interests of her clients.

Since loyalty to his trust is the first duty which a fiduciary owes to his principal, it is the general rule that a fiduciary must not put himself into a position where his own interests may come in conflict with those of his principal. To prevent any conflict and the possible subordination of this duty to act solely for the benefit of his principal, a fiduciary at common law is forbidden to deal as an adverse party with his principal. An exception is made, however, where the principal gives his informed consent to such dealings. The question of law presented here is the extent of disclosure which must be made by a person, in the type of fiduciary relationship assumed by registrant, in obtaining consent to his selling his own securities to his principal. More specifically, the issue is whether such a fiduciary must make any disclosure in addition to the fact that he proposes to deal on his own account. We believe that it is perfectly clear that additional disclosure, and a consent based on such additional disclosure, are necessary before the fiduciary can assume such a conflicting position.

It is well settled that a fiduciary, as, for example, an agent,[5] who sells his own property to his principal must disclose his cost to the principal so that the principal will know what profits the fiduciary will realize by effecting the transaction.[6] In *Allender Company, Inc., 9 S.E.C. 1043 (1941)* in defining the duties of a firm which purportedly acted as principal in selling securities to its customers, but which we found was in fact an agent, we stated (at p. 1054):

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[5] "An agent is a fiduciary with respect to matters within the scope of his agency." 1 Restatement of Agency, Section 13.
[6] *Old Dominion Copper Mining and Smelting Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905); Norris v. Beyer, 124 N.J. Eq. 284, 1 A. 2d 460 (1938).*

"It was under a duty to disclose fully and completely all material facts, including the price it paid for the securities. Its failure to do so was fraudulent. Its profits were secret profits and its failure to disclose them was also fraudulent. The customers' knowledge that the respondent was making some profit did not constitute adequate disclosure . . ."[7]

A corollary of the fiduciary's duty of loyalty to his principal is his duty to obtain or dispose of property for his principal at the best price discoverable in the exercise of reasonable diligence. To give effect to this duty, the courts have required a fiduciary who proposes to deal on his own account with his principal to disclose the best price at which the transaction could be effected elsewhere.[8] The Restatement of Agency in commenting on the disclosures which an agent must make where he is acting as an adverse party declares:

". . . the disclosure must include not only the fact that the agent is acting for his own account . . . but also all other facts which he should realize have or are likely to have a bearing upon the desirability of the transaction from the viewpoint of the principal. This includes, in the case of sales to him by the principal, not only the price which can be obtained but also all facts affecting the desirability of sale, . . . and all other matters which a disinterested and skillful agent advising the principal would think reasonably relevant."[9]

In other words, the duty of loyalty to his principal requires a fiduciary to disclose all material circumstances fully and completely. In the securities field one of the essential facts an investor should generally have before him in determining the desirability of either purchasing or selling a security is the current market price of the security. The disclosure of current market price will usually be of even greater significance than the disclosure of cost because market price is the test by which the value of securities is generally measured.[10] For example, where a fiduciary sells securities which he has held in inventory for some time and the market price of the securities has fallen below the fiduciary's cost, disclosure of cost alone without disclosure of current market price would generally be affirmatively misleading. Of course, disclosure of the best available market price is of less significance to the investor where such market price is less favorable than the price at which the fiduciary proposes to buy from or sell to his client.

To summarize, registrant has asked for and received the highest degree of trust and confidence on the representation that she desires to act as investment counsel for her clients and recommend

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[7] See also *William J. Stelmack Corporation, 11 S.E.C. 601, 618-619 (1942),* where we stated: "Included in the facts which must be thus disclosed is the price paid by the agent for the property which he sells to the principal as an adverse party, and the price he receives for property he buys from the principal." In *Norris v. Beyer, 124 N.J. Eq. 284, 1 A. 2d 460, 461 (1938)* in holding that a gain realized by a securities firm which acted as investment counsel was a secret profit, the court relied on the fact that the firm never told the client the amount of its profit or the rate although the client did know the firm was making some commission.

[8] In *Doyen v. Bauer, 211 Minn. 136, 300 N.W. 451, 455 (1941),* the court stated: "Whether the sale be made to a third person or to the agent himself, the agent is guilty of fraud where he fails to communicate to his principal the fact that a more advantageous price can be procured than that at which the sale is actually made, for the reason that the duty of loyalty imposes upon the agent the obligation to inform his principal of all facts affecting his rights or interests." See also *Berkeley Sulphur Springs v. Liberty, 162 A. 191 (N.J. 1932); Van Dusen v. Bigelow, 13 N.D. 277, 100 N.W. 723 (1904); Rodman v. Manning, 53 Ore. 336, 99 Pac. 657 (1909).*

[9] 2 Restatement of Agency, Section 390, comment a.

[10] Cf. *Rice v. Eisner, 16 F. 2d 358, 361* (C.C.A. 2, 1926), cert. den., *273 U.S. 764 (1927).*

purchases and sales of securities solely on the basis of their best interests. As a general rule and aside from the limited exception which we have discussed, it would be highly improper for registrant to take a conflicting position in which, on the one hand, she is motivated to sell securities which may be most profitable to her and in her own best interests and, on the other, to recommend the purchase of securities solely on the basis of the best interests of her clients. And, of course, registrant has a free choice to avoid this conflict by confining her activities only to those of investment counsel so that she would be motivated to act only for the best interests of her clients. But, if registrant chooses to assume a role in which she is motivated by conflicting interests, under the exception we have discussed she may do so if, but only if, she obtains her client's consent after disclosure not only that she proposes to deal with them for her own account but also of all other facts which may be material to the formulation of an independent opinion by the client as to the advisability of entering into the transaction. These facts should include, as we have already stated, registrant's own cost of the securities she proposes to sell as well as the market value of the securities where the market price is better than the price asked of the client. This requirement, as we have shown, has its basis in well settled propositions of law and imposes no novel obligation upon the registrant. Nor, as the registrant contends, is proof of overreaching a condition precedent to the requirement that such disclosures be made.[11] These disclosures constitute a safeguard which the law imposes to prevent the possibility of abuse which is inherent in a situation presenting conflicts between a fiduciary's self-interest and his loyalty to his principal. These disclosures are required whether the fiduciary is moved by good or bad intentions for the law "acts not on the possibility, that, in some cases, the sense of . . . duty may prevail over the motives of self-interest, but it provides against the probability in many cases, and the danger in all cases, that the dictates of self-interest will exercise a predominant influence, and supersede that of duty."[12] In *William J. Stelmack Corporation, 11 S.E.C. 601, 621 (1942)* in finding that a securities firm violated the anti-fraud provisions of the Securities Act and Securities Exchange Act by trading with customers as principal without fully disclosing its adverse interest notwithstanding the fact that the firm's past course of conduct had established a fiduciary relationship with its customers, we stated:

"Counsel for registrant denied that registrant's customers had suffered any damage as a result of registrant's conduct. We doubt this strongly, but in any event, the absence of damage . . . does not, in our opinion, remove this case from the type of fraudulent conduct proscribed by the Securities Act and the Securities Exchange Act."[13]

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[11] The registrant has confused two distinct propositions declared in our previous decisions. One proposition is that where a securities firm is dealing with its customers at arm's length there is no obligation to make any disclosure with respect to market price provided the price charged the customer is reasonably related to the prevailing market price. *Charles Hughes & Co., Inc., 13 S.E.C. 676 (1943),* aff'd. sub nom. *Charles Hughes & Co., Inc. v. S.E.C., 139 F. 2d 434* (C.C.A. 2, 1943), cert. den. *321 U.S. 786 (1944).* The second proposition is that where a firm is a fiduciary it must disclose all material facts, and in the absence of such disclosure, any profit it takes is a secret profit even though the price charged the customer is reasonably related to prevailing market prices. See Harry Marks, S.E.C. (1947), Securities Exchange Act Release No. 3906. It is this second proposition which is in issue in the instant case. In some cases, e.g. Allender Company, Inc. and *William J. Stelmack Corporation, supra,* both propositions have been in issue and we have relied on both in arriving at our decision.

[12] *Michoud v. Girod, 4 How. 503, 554-555 (1846).*

[13] Proof of all of the elements of common law fraud is not necessary to establish fraud within the meaning of the anti-fraud provisions of the Securities Act and Securities Exchange Act. In *Charles Hughes & Co., Inc. v. S.E.C., 139 F. 2d 434, 437* (C.C.A. 2, 1943) the court pointed out with respect to these provisions: "We need not stop to decide, however, how far common law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor." Cf. *People v. Federated Radio Corporation, 244 N.Y.*

Our determination that registrant is a fiduciary with respect to her customers and is obligated to make the indicated disclosures does not stem merely from the fact that she renders investment advice, a common practice of over-the-counter firms generally. Our conclusion rests on the fact that registrant has created a relationship of trust and confidence with her clients by holding herself out as performing confidential advisory services for a fee, and has represented that she would act solely in the best interests of her clients and that she would make only such recommendations as would serve their interests. And, in fact, the record clearly demonstrates that registrant's clients reposed complete trust and confidence in her, as would be expected, since they retained her for the express purpose of advising and counseling them. We emphasize that it is not intended that the disclosure requirements, which we have found applicable to registrant, be imposed upon broker-dealers who render investment advice merely as an incident to their broker-dealer activities unless they have by a course of conduct placed themselves in a position of trust and confidence as to their customers.

Accordingly, since the disclosure requirements we have discussed would be applicable only in situations where a broker-dealer has cultivated a position of trust and confidence, it is clear that there is no merit to the assertion made by the registrant that imposition of such requirement upon her would in effect constitute adoption of a rule which would require the disclosure of market quotations by all registered broker-dealers in every transaction effected by them over the counter. Such a rule was at one time proposed by the Trading and Exchange Division and was circulated to the public for comment. However, after consideration of the comments received, we specifically rejected the proposal. Securities Exchange Act Release No. 3940, April 2, 1947. The proposed rule would have required disclosure in all arm's-length principal transactions; it was in no way restricted to instances, such as that presented in this proceeding, where a broker-dealer renders investment advice for a fee and occupies a position of trust and confidence with respect to his customers. And, as we have shown, our decision herein is not based on any new rule or even on any new interpretation of the statute since, in the situation such as that under consideration in this proceeding, the duty of full disclosure was imposed as a matter of general common law long before the passage of the Securities Exchange Act.

3. Adequacy of Registrant's Disclosure

Registrant takes the position that the disclosure which it makes by way of its Memorandum of Agreement satisfies all of its duties and obligations in this respect. Consequently, it is necessary to determine whether that Agreement is adequate to afford investors the disclosure which we have found to be required. We think the disclosure contained in the Agreement is entirely inadequate in several respects.

Registrant has an affirmative obligation to disclose all material facts to her clients in a manner which is clear enough so that a client is fully apprised of the facts and is in a position to give his

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33, 154 N.E. 655 (1926). Moreover, Section 17 (a) of the Securities Act refers not only to "fraud" but also makes it an independent offense "to obtain money or property by means of any untrue statement of a material fact or any comission 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, . . ." Rules X-10B-5 and X-15C1-2 promulgated under the Securities Exchange Act contain similar provisions.

informed consent. And this disclosure, if it is to be meaningful and effective, must be timely. It must be provided before the completion of the transaction so that the client will know all the facts at the time that he is asked to give his consent. Registrant cannot satisfy this duty by executing an agreement with her clients which the record shows some clients do not understand and which, in any event, does not contain the essential facts which she must communicate.

The record discloses that registrant, in discussing the Memorandum of Agreement with her clients, makes no attempt to do more than briefly summarize its terms.[14] It appears that some clients had no understanding at all of the nature and significance of the Agreement, the keystone of registrant's alleged disclosure. One client testified that the Agreement "was agreeable to me at the time. I couldn't go into it. It was so long." In some cases registrant created the impression that execution of the Agreement was a formality required as a result of her registration with this Commission. Clients testified that they thought the Agreement was "obligatory on her part"; "some legality that it was necessary for the office to go through with"; "a protection"; "just according to comply with the law"; or "simply a business arrangement." These statements are not expressions of persons who have given their informed consent to their adviser's taking an adverse position in dealing with them.[15]

Some clients did not clearly understand that the registrant was selling her own securities.[16] For example, one client, a housewife, testified:

"Q. Under the terms of this memorandum agreement, Exhibit No. 4, did you understand that the firm of E.W. Hughes and Company would sell securities to you which it, that is, the firm, owned?

"A. I didn't go into that, no. No, I don't know that I understood it or even thought about it. I had no reason to question the agreement between Hughes and Company and myself. I mean, I wanted advice as to what to do and that is why I went to her.

"Q. Do you know whether or not the firm owns the securities which it has recommended that you purchase?

"A. No -- well, occasionally she will say I perhaps can get you some of this or some of that, but as far as I know she may or may not. I couldn't answer that yes or no."

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[14] In response to the question "do you make any explanation of the Memorandum of Agreement at the time of presentation to a client?", the registrant testified: "Well, I always call it to their attention that I want them to read all of it. Sometimes they read it in the office and other times they take it home and study it. And, then, if they have any questions to ask that I will be very glad to answer them to the best of my ability. And I usually tell them that it sets forth our method of doing business together and that it sets forth the maximum profits that we will take on any transaction; that it gives me the privilege of acting as principal or agent. And, unless they bring up other questions, there isn't much else discussed about it. Sometimes they do and sometimes they don't."

[15] Nor do these statements suggest that the clients, as registrant intimates, have consciously waived their right to disclosure of information which they know they would otherwise be entitled to.

[16] Registrant apparently contends that the question whether she disclosed the capacity in which she was acting is not raised by the order instituting this proceeding. The order alleges that registrant sold securities to her clients "without fully disclosing to such clients the nature and extent of her adverse interest . . ." The question of disclosure of capacity is clearly encompassed by this language.

Other clients did not know the meaning of the term "principal," the only term used by the registrant in both the Agreement and in confirmations given to clients which would convey the idea that she was selling her own securities. One client, for example, also a housewife, testified:

"Q. Referring to the agreement, Exhibit 4, and particularly to paragraph (i), was any explanation made of the term 'principal' at or before the time that you signed it?

"A. Well, I suppose 'principal' is understood that she is the owner of the securities or that she may purchase the securities for me. I suppose that is the meaning of that."

It is clear from this testimony that certain of registrant's clients did not understand that registrant consistently proposed to, and in fact did, sell her own securities to them. Accordingly, registrant did not fulfill her affirmative obligation to disclose the capacity in which she acted, a duty which even she concedes she must perform. In this connection, we may point out that no hard and fast rule can be set down as to an appropriate method for registrant to disclose the fact that she proposes to deal on her own account. The method and extent of disclosure depends upon the particular client involved. The investor who is not familiar with the practices of the securities business requires a more extensive explanation than the informed investor. The explanation must be such, however, that the particular client is clearly advised and understands before the completion of each transaction that registrant proposes to sell her own securities.[17]

As we have previously pointed out, the Memorandum of Agreement provides that the "base price" charged the clients shall be ". . . the mean between the bid and asked price on the day of sale or purchase; or if no bid and asked price on that day, then the actual purchase or sale price." The Agreement further provides that there is to be added to the "base price" registrant's investment advisory charge as specified in the schedule of rates set forth in the Agreement. The charges specified in the Agreement, however, are merely maximums and the registrant frequently charges a lesser rate. In no case does she inform the client of the actual charge in a particular transaction.

As we have also pointed out, the confirmation merely shows a "net price" which is the total of the price of the security to the client and the investment advisory charge. A client cannot determine definitely from the combination of the Memorandum of Agreement and the confirmation the market price of securities sold to him. Furthermore, since the investment advisory charge may and does vary from the fixed schedule of maximum charges, it is impossible for the client to ascertain from the agreement and confirmation either (1) the investment advisory charge, (2) the actual price which the client is paying for the security itself, or (3) the registrant's cost. Moreover, even if a client were

[17] The discussion in the text is, of course, confined to the requirements of the cited provisions of the Securities Act and the Securities Exchange Act. It may also be noted, however, that Section 206 (3) of the Investment Advisers Act makes it unlawful for a registered investment adviser "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client . . . without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction." While this section is not in issue in this proceeding and our disposition herein is in no way based on any separate requirement imposed by it, we note that the registrant, as a registered investment adviser, must comply with its provisions. As we interpret these provisions they impose an obligation upon a registered investment adviser proposing to act as principal to disclose in writing before the completion of each transaction of purchase or sale the fact that he is acting as principal and to obtain the consent of his client to his acting in such capacity. This disclosure prescribed by the statute, other than the requirement that the disclosure be made in writing, is merely declaratory of the common law principles we have enunciated.

able to ascertain the investment advisory charge and subtracted such charge from the "net price" shown in the confirmation, he would obtain a remainder which, even under the terms of the Agreement, would not necessarily be the registrant's cost. Furthermore, while such remainder should represent the so-called "base price," as defined in the Memorandum of Agreement, under registrant's actual practice which does not adhere to these provisions of the Agreement, the client has no way of knowing whether it does in fact represent the "base price" as so defined. Depending on what technique for determining "base price" registrant actually uses in a particular transaction, the remainder after deduction of the investment advisory charge may represent either (1) the price at which an actual transaction has been effected in the open market, or (2) the price at which the registrant could, in her opinion, effect the transaction, or (3) the mean between the bid and asked quotations, or (4) registrant's cost in the case of a sale other than from inventory. A client has no way of knowing which of these methods has been employed by the registrant in the particular transaction, and as we have previously pointed out, registrant does not inform her clients as to the method she uses. For that matter, clients apparently do not even know that she departs from the base price formula set forth in the Agreement.

The testimony of registrant's clients demonstrates clearly that the Agreement is not an effective means of communicating the information which the registrant is under a duty to disclose. One client testified as follows:

"Q. Do you know what that base price is with respect to any of the securities which you have purchased?

"A. No, but I suppose I could figure it according to the agreement. I can figure out how much it should be.

"Q. Have you ever attempted to do that?

"A. No."

Another client when asked whether he could determine from the Agreement registrant's cost of certain securities she had sold to him stated: "I wouldn't attempt to. I wouldn't attempt to go into that, never paid any special attention. That is what I would call a rather technical question." Subsequently, the same witness stated that he could not determine registrant's cost from the Agreement. There were several clients who at first thought they could compute registrant's cost from the schedule in the Agreement; however, they were unable to do more than subtract the maximum charges permitted under the Agreement from the net prices at which the transactions were confirmed to them.

In other words, registrant's clients did not know and could not determine either registrant's cost or the current market price with respect to the securities they purchased from her in a particular transaction. All they could know from the Agreement, assuming they examined it, and there were those who did not, is that the registrant might be making some profit on the transactions. However, as we stated in Allender & Company, *supra*: "The customers' knowledge that the respondent was making some profit did not constitute adequate disclosure . . ."[18]

[18] *9 S.E.C. at 1054.* See also Norris v. Beyer, note 6 *supra*.

On the basis of the foregoing we conclude that registrant, after establishing a fiduciary relationship with her clients, has omitted to disclose material facts to such clients and has not obtained the informed consent which would provide the only possible justification for her dealing with such clients for her own account and under circumstances in which her self-interest might conflict with her fiduciary obligations to them. Her omissions and failure in this respect constitute violations of Section 17 (a) of the Securities Act, Sections 10 (b) and 15 (c) (1) of the Securities Exchange Act and Rules X-10B-5 and X-15C1-2 (a) and (b) adopted under the latter Act.

4. Propriety of Proceedings under Securities Exchange Act.

The registrant argues that her activities cannot form the basis for a violation of the Securities Act or the Securities Exchange Act, since she acts as an investment adviser in her dealings with clients and is, therefore, she contends, subject only to the provisions of the Investment Advisers Act of 1940. We find no merit in this contention.

A broker-dealer who engages in the purchase or sale of securities, whether or not he renders investment advice in connection with such activities and whether or not he is registered under the Investment Advisers Act, is subject, for any fraud which he commits, to the anti-fraud provisions of the Securities Act and the Securities Exchange Act and the sanctions provided for in those statutes. Registrant's contention would produce the anomalous result of permitting a broker-dealer who registers as an investment adviser to escape these anti-fraud provisions in trading with his clients, and thus avoid, as a fiduciary, obligations which would have been his as an ordinary trader. The Investment Advisers Act was intended to produce no such result. As a person registered under both the Securities Exchange Act and the Investment Advisers Act and whose activities fall within the scope of the two Acts, registrant is amenable to regulation under both statutes.[19]

Registrant further contends that this proceeding is an attempt by indirection to attack the propriety and validity of her investment adviser's Memorandum of Agreement. We are not concerned in this proceeding with, nor do we criticize, the Agreement; its terms are relevant, only because registrant points to it as a defense to the charge of non-disclosure.[20]

5. Willfulness and Public Interest.

Registrant contends that, in any event, she has not committed a "willful" violation of the Securities Act or the Securities Exchange Act since, she asserts, this Commission has at no time by rule, decision or order imposed the disclosure requirements previously discussed.

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[19] Registrant affirmatively represents in the Memorandum of Agreement that she acts both as adviser and dealer in dealing with her clients. In the actual operation of her business both functions are inseparable, for she sells the securities which she recommends to her clients and, pursuant to the Agreement, she is entitled to compensation for investment advice only when her recommendation is adopted and a transaction is effected.

[20] Registrant points out that the Agreement was incorporated in her application for registration as an investment adviser, which was permitted to become effective as of November 25, 1942. The fact that registrant's application became effective by operation of law under Section 203 (c) of the Investment Advisers Act does not indicate any approval on our part of the contract as an effective medium for making the required disclosures. Furthermore, there was no reason to assume at that time she would not make full disclosure at the time of specific transactions and that she intended to rely solely on the Agreement as embodying such disclosure.

The premise of this contention would seem to be in direct conflict with the cases heretofore cited in our discussion of the statutory violations. In addition, it may be noted that, on many occasions prior to the institution of these proceedings, registrant was personally advised by our staff that, in its opinion, she was violating the anti-fraud provisions of the statutes and that she was also referred to a formal Opinion of the Director of our Trading and Exchange Division, issued in February 1945, which deals with the precise issue presented here and reaches the same conclusion. Investment Advisers Act Release No. 40, Securities Exchange Act Release No. 3653, Securities Act Release No. 3043 (February 5, 1945). Although registrant was free to take issue with these views, it is clear that she did so having full knowledge of the position asserted by the Trading and Exchange Division. Finally, we have held in a long line of cases that "a 'willful' act, as that term is used in Section 15 (b) of the Securities Exchange Act of 1934, does not mean that the registrant must be aware of the fact that he is violating the law, he may willfully violate the law even though he is completely ignorant of the legal consequences of his act. *American Surety Co. v. Sullivan, 7 F. 2d 605* (C.C.A. 2d, 1925).[21]

Since we have found that registrant willfully violated the cited provisions of the statutes and our rules, we must determine whether it is in the public interest to revoke registrant's registration. Her violations are not technical infractions. She has breached the basic obligation owed by a fiduciary to his principal and her profits are secret profits.[22] Protection of the public interest will not permit the continuance of such abuses and we find that revocation of registrant's broker-dealer registration is compelled in the public interest unless we can be otherwise assured that such abuses will be immediately discontinued.

The record shows that registrant has apparently acted in the conviction that her method of doing business is lawful, that she has never attempted to conceal such business methods from our investigators, and that she has fully cooperated in presenting the facts in this proceeding. For these reasons, counsel for the Trading and Exchange Division have suggested that, before an order of revocation is issued, registrant be afforded an additional opportunity, in the light of our opinion, to revise her method of doing business to comply with such opinion, and that if registrant does announce her intention to comply, the proceeding should be dismissed without prejudice to its reinstitution if further violations occur.

We believe that we may appropriately adopt this suggestion and withhold the entry of an order of revocation for a period of thirty days from the date of these findings. If, during that period, the registrant shall submit satisfactory proof that she has corrected her methods of business operation to conform to the views expressed herein, we shall thereupon enter an order dismissing this proceeding. If, at the end of the thirty-day period, registrant has not effected appropriate changes in her business methods, we shall forthwith enter an order revoking her registration as a broker and dealer.

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[21] *Thompson Ross Securities Co., 6 S.E.C. 1111, 1122-3 (1940).* See also Ira Haupt & Company, S.E.C. (1946), Exchange Act Release No. 3845 at p. 19 and additional cases there cited.

[22] In *Trost & Company, Inc., 12 S.E.C. 531, 540 (1942),* we pointed out that the violations inherent in the taking of secret profits "touch the core of decent relations between broker-dealers and their customers."

In making changes in her method of doing business to conform with the views expressed herein, registrant is free to adopt such measures as will afford investors the required disclosures. We have already pointed out that the nature and extent of disclosure with respect to capacity will vary with the particular client involved. In some cases, use of the term "principal" may suffice. In others a more detailed explanation will be required. In all cases, however, the burden is on the registrant to make certain that the client understands that she is selling her own securities. In arriving at her cost of the securities she sells, registrant may employ any recognized method used in determining cost, provided she uses the method consistently. In disclosing market price, where it is more favorable than cost, it is registrant's responsibility to make certain that the quotations she furnishes to clients are reliable and truly indicative of the current market. These quotations need not be taken from any particular source. They must be, however, true reflections of the market price at which the transaction could be effected with reasonable diligence. Finally, as we have already stated, the required disclosures must be made before the completion of the transaction so that the client can, in fact, give his informed consent to the proposed sale or purchase.

By the Commission

(Commissioners McConnaughey, McEntire, Hanrahan, and McDonald).