ADDRESS

of

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Before the

Annual Convention of the

NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS

St. Louis, Missouri
December 12, 1944

Both the courtesy of your president and the title given to my remarks on the program give me considerable latitude to select my own subject. I am going to take advantage of the opportunity to give you my views concerning some current problems arising out of the regulation of the securities business. These views are my own and should not be taken as a statement of the views of the Commission. Although my remarks will not be specifically limited to dealings in any particular type of security, I do not intend to include in them dealings in government or municipal securities, which are classified as 'exempt securities' by the Securities Exchange Act of 1934.

Many of the problems which currently confront both the regulator and the regulated arise from the failure of some of those engaged in the securities business to recognize the responsibilities which they have created and fostered. Let me be more specific. As you know, a number of persons who are engaged in the securities business and who are in fact brokers seek to do business with the public as dealers, and many dealers, by leading their customers to believe that they are disinterested brokers, seek to conceal the adverse interest which they have in every transaction. They ignore the judicial admonition of Justice Rutledge that "he who would deal at arm's length must stand at arm's length. And he must do so openly as an adversary, not disguised as confidant and protector." 1/

Everyone close to the securities business has frequently been confronted with this problem. John J. Bennett, Jr., when Attorney General of the State of New York, spoke out vigorously on the subject. He said:

> ". . . recent investigations have indicated a general tendency in the securities business to eliminate . . . distinctions between brokers and dealers. In other words, dealers have purported to act as brokers when they, in fact, were dealers; on the other hand, brokers, or those who hold themselves out as brokers, have in fact acted as dealers. There are indications that this practice has become so widespread that the matter is now of grave concern."

The parallel problems created by brokers who would be dealers and dealers who would be brokers have a common origin in the fear of some professionals that their profits would be jeopardized by a complete and honest assumption of the responsibilities which the common law fastens on those who undertake to furnish expert counsel and guidance to the uninformed or uninitiated. That the public customers with whom the professional does business are usually uninformed and in need of expert advice has been emphasized time and again by persons engaged in the securities business. Indeed the enormous growth of investment companies is due in large measure to the success of hundreds of dealers who, in selling such shares, have persuaded investors of their inability to safeguard their own capital. Moreover this disposition of the average

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1/ *Erroll* vs. *Picken*, 113 Fed. (2d) 150 (1940).

man in the street to have others manage his own investment affairs is evidenced by the rapid growth of the trust departments of banks and other institutions whose business it is to guide the public in the complicated task of intelligent investment.

The reasons why some brokers seek to escape their responsibilities and why some dealers disguise their occupation is apparent from a consideration of the differences between the responsibilities of a broker and a dealer. Once a professional becomes a broker he can have no interest in the transaction which is adverse to the interest of his customer unless he makes the fullest disclosure of the nature and extent of that adverse interest. When the broker buys securities from others on the customer's behalf, he must disclose to the customer the price of the security and, as a separate item, the amount of the commission which he is charging the customer. When the broker sells securities to the customer which are his own property, he must disclose all the facts the customer needs in order to measure the extent of his agent's adverse interest in the transaction. In practice, this means that the broker has to disclose the profit which he makes and the market price of the security which he sells. A dealer, on the other hand, is not the agent of his customer. He may have an undisclosed interest in the transaction which is adverse to the interest of the customer. When he sells a security to the customer, he need not indicate to him the amount of profit which he makes.

I do not emphasize this difference for the purpose of criticising the dealer for making a profit. He is, of course, entitled to one commensurate with the value of his services and the risk he takes for the benefit of his customers. I point out this distinction only for the purpose of indicating the basis for the frequent preference of the professional for the dealer capacity.

Now many firms which in fact are brokers, in practice purport to act as dealers. Their explanation is simple. They say that if they were to act as brokers they could not make enough money to stay in business because if they revealed to their customers the amount of their compensation, the customers would rebel. The classic case that is usually presented is the one of the salesman who travels 50 miles out in the country to try to sell some securities to a customer. Says the firm which employs the salesman, "If we told the customer how much we had to charge him to cover the cost of sending our salesman out to see him he would not buy any securities from us. Since it would not be good business to tell him the amount of that charge we will act not as a broker in filling any orders which our salesman may receive, but will act as a dealer.

This explanation is understandable enough but it ignores the realities of the relation between the customer and the salesman. A salesman seeks to convince the customer of the expertness in securities matters of the firm which he represents. He invites the customer to disclose to him the state of his funds; the extent of his obligations both to his family and to others; the hopes and fears which he has for his future security — in

general he invites and usually obtains an intimate picture of his customer's financial resources and needs. On the basis of such knowledge the salesman seeks to advise. This is as it should be, for usually the relative value and merits of the thousands of securities outstanding can be understood by the layman only if he has the advice and guidance of a professional. And it is just that that such a salesman and his firm become: a professional whose counsel is given as surely as is that of a lawyer. Such a salesman is not a purveyor of pieces of pretty paper any more than a legal draftsman sells the paper on which a will is written. By choice he has become the financial advisor of his customer. Here the parties are not bargaining at arm's length. Rather, one has become the agent of the other. In this setting the law makes plain the agent's duty. He must act with an eye single to the customer's welfare. Being human he must not be led into any of those human temptations which are so well-known and which the law recognizes by requiring the fullest disclosure of any adverse interest which an agent may have in a transaction. I know of lawyers who have so advised their clients. Moreover, I know firms who ignore that advice and seek to act as dealers when they are, and should act as, agents.

It is unnecessary to labor the point any further that the securities firm is typically in a professional relationship with its customer. Before leaving the subject, let me point out, however, that brokers sometimes mistakenly assume that they can avoid the obligations of their position simply by confirming a transaction in language which technically discloses that the professional has acted in the capacity of a dealer. Experience has shown that the language of the confirmation slip is not understood by most customers. For that reason courts will usually disregard the technical language of the written confirmation and will look to other facts to discover the true relationship between the parties.

This improper practice of some brokers to act as dealers is one which requires no new rules and regulations of the Commission because the common law is plain. It is fraud for an agent to sell his own property to his principal without the fullest kind of disclosure. Since it is fraud, those firms which follow that practice not only deceive their customers but also jeopardize their financial stability, for every transaction into which they enter on this fraudulent basis is voidable at the election of the customer. As a result, the contingent liabilities of these firms grow with every new transaction. The possibility of such contingent liabilities is one which is disturbing not only to the proprietors of a business which misinterprets its true relationship to its customers but also to those who by law are charged with a duty to take steps to safeguard the financial responsibility of brokers and dealers. It is a contingent liability for which it is difficult to make provision. The firm which does so in effect confesses that it is not doing business with its customers on a proper basis.

No rules or regulations of the Commission can speak any plainer to the agent of his obligations to his principal than does the common law. Yet in my experience no canon of the common law is more widely ignored by brokers than that which we have been discussing. When brokers generally recognize their responsibilities as brokers and when dealers seek to assume no other role than that of a dealer, a long step forward will have been taken in the protection of the public in matters involving the purchase and sale of securities.

Fortunately, there is evidence of a growing awareness of some firms of their obligations to their customers. This has been manifested in two ways. Some firms who until recently confirmed most of their trades as principals have given recognition to their true status by adopting a policy of acting only as brokers for their customers; others, although continuing to act as dealers, now undertake to advise their customers of the market for the security at the time the transaction is effected. These are some of the most wholesome developments which I have observed. In my opinion the agency method of doing business more nearly represents the true relationship which usually exists between a security firm and the average public customer. Nevertheless market disclosure by a dealer is a long step forward.

Those of us whose duties require us to enforce the various statutes designed to protect investors know of the many fraudulent transactions between dealer and customer which were possible only because the customer was kept in ignorance of the market value of the security dealt in. Those among you who are in the securities business know how dealers have been plagued for years with the problem of what price to charge for a security. The administrative decisions of the Commission and the recent decision of the Circuit Court of Appeals in the Hughes case have held that a dealer must do business with his customer at a price which bears a reasonable relationship to the current market value of the security dealt in. You know the difficulties which have been encountered in determining what is a reasonable relationship to the current market in a specific transaction. I believe that this is a matter which generally should be left to informed negotiation between the dealer and the customer. I believe that a dealer should be required to inform his customer of the market value of the security involved in a transaction so that the customer may have an effective voice in establishing the price at which the transaction is to take place. This is at once the most simple and the least meddlesome way of solving a complex problem. It is the very negation of bureaucracy because it requires nothing of the administrator. It would leave to an informed judgment of the parties to the transaction the determination of the price at which it would take place.

There is a discernible tendency toward making this kind of disclosure. This is a development which I believe should be fostered by the Commission by the adoption of a rule requiring that all dealers make such disclosure of market value in transactions with public customers. I have had many discussions of the merits of a market disclosure rule. I have talked to professionals and non-professionals who favor it. I have talked with many

professionals who are opposed. Fundamentally, the opposition springs from the fear of some dealers that they cannot justify to their customers the amount of their charges. This is an argument which will hardly commend itself to the customer whose money is at stake, nor is it an objection which impairs in the slightest the merits of such a rule. On the contrary, I believe that the proposition that the customer will be unwilling to compensate some dealers in an amount satisfactory to them is one of the best arguments that can be made for such a rule. It is an admission that the added amount above market value which some dealers now exact from their customers is more than the traffic should bear. That the traffic will bear a reasonable charge is indicated by the example of those firms who do business with their customers on the basis of the fullest kind of disclosure.

I know that there are those who will say that the proponents of a market disclosure rule do not understand the over-the-counter business. Passing over the obvious answer that persons engaged in that very business can be found who are in favor of market disclosure, let's examine this argument and see where it gets us. We are told that we do not understand that the over-the-counter market is a negotiated market resulting from purchases and sales by informed individuals; that it differs from the exchange markets which operate upon the auction principle. It is said that in the over-the-counter market it is not a case of the best bid seeking out the best offer. Rather, we are told, it is a case of two informed individuals, one desiring to buy and the other to sell, who meet face to face and strike a bargain. This description of the over-the-counter business sometimes holds good when the professional bargains with the professional or with the institutional investor or with that rare bird, the sophisticated individual investor; that is, with those persons whose knowledge of the security and its market is equal to or approximates that of the professional. It is sheer nonsense when used to describe transactions involving those persons whom a market disclosure rule is designed to protect. What kind of informed negotiation can take place when only one party to the transaction has all the facts, or when the other party has only those facts which the first sees fit to give him? What kind of informed negotiation is there when a sophisticated dealer advises an inexperienced woman how her life savings should be invested? He who contends that the transactions which take place between a dealer and the average man in the street are the result of informed negotiation either does not speak from experience or ignores its teaching.

Consider for a moment the way the over-the-counter business is conducted with the public. There are, generally speaking, two types of orders received by dealers. There are some orders which are unsolicited; that is, persons desiring to buy or sell a security will go to a firm and seek to effect a transaction. Frequently such transactions are as a result of informed negotiation. Here disclosure causes no difficulties, for in such a setting the honest dealer's price deviates but little from the prevailing market price. Except for transactions with other dealers

or with institutional investors, however, we know that most over-the-counter transactions are as a result of the solicitation of business by a firm. It usually works about this way. A firm learns of a particular security which it thinks would make an attractive investment for certain of its customers. Sometimes it spends a considerable amount of time and money in acquiring information concerning this security. Sometimes it will take a position. Sometimes, and probably more often, it will not take a position but will know where the security can be obtained. Salesmen representing the firm approach its customers and bring to their attention the merits of the security.

Frequently a customer will not have heard of the security before. Invariably if he had heard of it he knows little about it. He therefore depends upon the salesman to tell him all about the security and its issuer. Invariably the salesman will impart investment advice to the customer, sometimes voluntarily and sometimes in response to the customer's questions. The desirability of the investment will be stressed by the salesman, who for that purpose will draw on his knowledge of the customer's affairs and investment program. Now here is a situation in which the salesman has undertaken to bring to the attention of his customer a recommended investment. He undertakes to educate the customer concerning the desirability of that investment and to advise its purchase. He will seek to convinced him of its value. In making the sale the salesman will present material facts concerning the security to the customer.

A disclosure rule would aim to give the customer material facts concerning the market's appraisal of the value of the security under consideration. While it would require that the current quotations be given the customer, it would not prevent the salesman or his firm from giving more detailed information concerning the size of the market, its availability, or such other facts as may be deemed material.

Now I believe that in making retail sales to a customer the firm in the eyes of the common law is usually an agent for the customer. Let us pass over the delicate question of agency, however, and concede for argument's sake that in the kind of transaction which I have just described the firm is a true dealer; that is, that it is selling its merchandise in a genuine arm's length transaction. If the customer is informed on security matters I am sure that one of the first questions which he will ask is, what is the market value of the security? I take it that no one will dispute that he is entitled to an honest answer to that question. Let us assume, however, that the prospective buyer is not fully alive to the situation and is ignorant of the factors which enter into a determination of the price which he should pay for the security. Again I take it that no one will be found who will argue that the dealer should take advantage of that ignorance. Should the uninformed customer be kept in a poorer position to protect himself than his more sophisticated brother? Not if the theory is sound on which our federal securities legislation is grounded. As a Commission we are dedicated to the disclosure principle. We believe that there are no material facts which should be withheld from investors or potential investors.

Indeed, in connection with those offerings of securities as to which registration is required under the Securities Act of 1933 disclosure of the market quotations prevailing at the time of registration is always required where the terms of the offering make such disclosure material. Moreover, as you know, detailed information is always contained in such statements concerning the extent of the interest in the distribution of underwriters and all other persons who are participating therein.

Moreover, it is unlawful under Section 17 of the Securities Act to omit to state a material fact if the omission makes misleading the facts which are stated. Value is, of course, a material fact. Every time a dealer makes a sale of a security he places a value on it and if that value is at material variance from the market value, the dealer is under an obligation to disclose that market value. If the failure of the dealer to make disclosure becomes the subject of litigation, what is a material variation will usually be a question of fact for the jury. It is not too much to suggest that a jury might find any variation a material one. As the Second Circuit Court recently stated in the Hughes case:

> "The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do. Such protection will mean little if it stops short of the point of ultimate consequence, namely, the price charged for the securities." 2/

Apart from legal arguments, however, everyone is agreed that the dealer should not take advantage of his customer's ignorance. This would seem to destroy the validity of one of the most common objections urged against a disclosure rule, namely, that customers if informed will not pay more than the current market price. For if it is true that customers who are informed of the market value would refuse to pay a higher price, then it must follow that the dealers who charge more than the current market are taking advantage of their customers' ignorance.

Another objection which is urged against a market disclosure rule is that it will put some dealers out of business. If you go back into history, this argument has been brought out whenever anyone proposed that the investing public be given a break in security matters. Originally it was urged against the state blue-sky laws. It was urged against the Securities Act and the Securities Exchange Act. It is getting somewhat shopworn. Nevertheless, there may be something to it. A market disclosure rule may put some firms out of business. I am told that the blue-sky laws did. I am sure that the Securities Act and the Securities Exchange Act did. I have no reason to believe that a market disclosure

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2/ *Charles Hughes & Company, Inc.* vs *Securities and Exchange Commission*, 139 F. (2d) 434, 437 (C.C.A. 2d, 1943).

rule will not. However, I cannot lament the firms which were closed down by the blue-sky laws, the Securities Act and the Securities Exchange Act; and I cannot mourn those who, it is said, will not survive if they take their customers into their confidence to the extent of informing them of the market value of the securities which they are solicited to buy or sell. There are, and will remain, hundreds of firms who make an even more complete disclosure to their customers.

No one who is familiar with the work of the state securities commissions or with the work of the SEC can fail to be impressed by the value of the legal safeguards which have been devised for the protection of investors since the sad experience of the late 1920's. In the federal field, however, these safeguards are most in evidence with respect to new offerings and to those securities which are listed upon national securities exchanges. In spite of the various provisions of state laws and of the Securities Exchange Act and the adoption of rules and regulations relating to the over-the-counter market there is not yet adequate regulation of that market, nor will such regulation come with the adoption of a market disclosure rule alone. The same spotlight of disclosure which did so much to restore public confidence in our exchanges and in the securities listed thereon should be placed upon the over-the-counter market as well. This spotlight should be upon those securities which are not listed on a national securities exchange as well as upon the transactions which are effected in the over-the-counter market.

As you know, the Securities Act requires the registration of new offerings and the Securities Exchange Act the registration of those securities which are listed on national securities exchanges. There are thousands of securities now outstanding, however, as to which registration is not required and concerning which little public information is available. Most of these securities are traded exclusively in the over-the-counter market, although there are some which are admitted to unlisted trading privileges upon national securities exchanges. Here is a unique opportunity for all brokers and dealers to serve the interests of the investors of America. This they can do by promoting standards of disclosure to which unregistered issuers of corporate securities must adhere. In this connection there comes to my mind at once the example of the New York Stock Exchange which many years ago began to insist upon certain disclosures by issuers whose securities were traded on its board. Those familiar with the pioneering work of the New York Stock Exchange in this respect agree with Adolph Berle who has stated that the most forward looking steps taken in Wall Street during the late 20's were taken by the Listing Committee of the New York Stock Exchange in order to promote the public disclosure of material facts concerning the issuers of the securities listed on that exchange.

Much of the work of that committee has been superseded and augmented by the registration requirements of the Securities Exchange Act of 1934. The Senate Committee which reported favorably on that statute said of its registration requirements that they contain the minimum protections which security holders are entitled to receive. These requirements plus the other statutory protections now operating to safeguard investors have combined to increase the faith of the American investor in the operation of certain segments of our securities markets.

It is a matter of concern to those of use who represent agencies of the government that the minimum protections afforded by these registration requirements are not available to all investors. It should be of even greater concern to those whose responsibility it is to supervise the investments of their clients. Just as it is true that confidence cannot exist in a market in which values are concealed, so it is also true that public confidence cannot long continue in those issuers of securities who pursue a policy of withholding material facts from their public security holders. It is difficult to understand how a broker or dealer can advise the purchase of the securities of an issuer which does not give recognition to its obligations to its security holders by keeping them fully and fairly informed at reasonable intervals concerning the progress of the enterprise. Not only is there little basis for confidence in the securities of such an issuer, but also there is bound to be some lessening of public confidence in a security firm which encourages its customers to invest their funds blindly. It must be borne in mind that in times of stress the public often lays the acts of an issuer at the door of the firm which underwrote or otherwise sponsored an interest in its securities.

It would seem to be both appropriate and feasible for professional organizations of brokers and dealers to establish high standards of disclosure for all issuers of publicly held securities, and for the individual members of those organizations to enforce observance of those standards by refusing to recommend to their customers the securities of those issuers who fail to comply. Those standards should strive to approach those required of registered companies by federal law, for as I have already remarked, the Senate Committee on Banking and Currency after months of hearings and study stated that the registration provisions of the Securities Exchange Act represent the minimum protections which stockholders should have. Those issuers of publicly-owned securities who studiously sidestep their obligations to their shareholders will have no just ground for complaint if they find their securities ignored by responsible brokers and dealers. History has recorded too many instances of tragic consequences to investors by reason of the failure of those managing an enterprise to take its owners into their confidence concerning the progress of the business.

The inauguration of a program to compel such disclosure cannot help but raise the confidence of investors in those engaged in the securities business. I do not mean to suggest that brokers or dealers can, without the aid of additional legislation, achieve for their customers who buy

unregistered securities protections equal to those now enjoyed by the owners of registered securities. I do mean to say, however, that because there is so much room for improvement in the field of unregistered securities, brokers and dealers can greatly advance their interests and the interests of investors by promoting more adequate disclosure by the issuers of unregistered securities pending the adoption of appropriate legislation, the need for which is pretty generally recognized.

I believe that it is of paramount importance for those of us in government as well as for those who are in the securities business, and investors generally, to promote the observance of those standards of corporate morality which are embodied in the state and federal laws relating to securities. To the extent that issuers or transactions are not covered by these laws it is in the self-interest of brokers and dealers to seek to extend the wholesome benefits of the disclosure statutes to all issuers. I know that this philosophy runs counter to the current thinking of some professionals engaged in the securities business. I know some who see in the current disparity of responsibility between registered and unregistered companies an opportunity to build a business confined to dealing in unregistered issues. I know of professionals who to promote their own self-interest have sought to persuade issuers to avoid or escape the responsibilities of registration, and to withhold from the American investors those protections which the Senate Committee described as minimum protections. These are the professionals who mistakenly believe that they are in competition with their customers and who find in public ignorance an opportunity for profits based upon inside knowledge of the affairs of an issuer. Such professionals are blind -- blind to their own responsibilities to their customers and blind to the responsibilities of the securities business to that segment of our national economy which it professes to serve.

In making the suggestions which I have advanced here today I have been influenced by the conviction that those engaged in the securities business are not hucksters. It is not doing violence to the truth to state that the public relies upon them for investment advice, largely because of the efforts of those engaged in the business to achieve that objective. Moreover, this reliance of the individual upon the professional is the natural result of public bewilderment in the field of finance, a bewilderment which is born of a recognition that the choice of proper investments from the thousands of securities outstanding is one which can best be made by experts in the field. Since the securities business has successfully sought to foster this dependence of the public customer on the professional with whom he deals, it is time for all those engaged in that business to give recognition to those responsibilities which spring from that dependence.

The true role of persons engaged in the securities business is one of service -- service to the issuer who needs capital as well as to the investor who has capital seeking employment. To suggest that persons engaged in work of such importance to our economy should depend for their livelihood on the concealment of material facts is to underestimate

their place in the field of modern finance as well as to belittle the dignity of their occupation. An enormous amount of our savings is invested in securities. That dealers by concealing markets should seek to withhold from the public the most practical gauge of the value of these investments is as shortsighted as it would be for a bank to seek to conceal the facts concerning its ability to repay its depositors. Confidence exists when facts are known. Confidence, however, must be earned and to be earned must be deserved. It is not deserved by those who would make market value a trade secret.

If they have not already attained it, persons engaged in the securities business approach a professional standing, and as professionals or quasi-professionals must be judged by standards worthy of their status. It is not consistent with the public interest or their own pretensions to judge them by any other standard. They must not compete with their customers for trading profits, for such competition would be so weighted against the individual as to be unfair. They must not be permitted to take a hidden toll of that part of the public's savings which is invested in securities. They are of course entitled to profit from their calling by being fairly compensated for their services. But that compensation should not come from hidden charges which are made possible by the concealment of material facts. As Congress said in 1934:

> "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy . . ." 3/

The laggards in the securities business must quicken their pace and fall in step with the progressive elements which correctly interpret their obligations to their customers and to the nation. In the long run this is the only way to retain the public confidence on which the securities business depends.

Because of the concealment of material facts from investors, that confidence was once lost. It can be lost again.

3/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).