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COMMENTS

BROKERAGE FIRM'S LIABILITY FOR SALESMAN'S FRAUDULENT PRACTICES

"The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present."¹ In a special report issued in 1963, the Securities and Exchange Commission noted that the recent influx of inexperienced salesmen or "customer's men,"² together with a steady increase in the number of new and unsophisticated investors, has created special problems for the various government agencies responsible for protecting the investing public.³ When fraudulent conduct occurs, often the active wrongdoer is not a partner or other member of high management in a brokerage firm but a salesman employed by the firm.⁴

Many brokerage firms, unfortunately, emphasize sales potential over ability to offer sound investment advice.⁵ Consequently, few firms impose "conditions of character or competence upon employment as a salesman."⁶ Most firms, moreover, pay on a commission basis, and when salary adjustments and promotion opportunities depend on high production, the danger of "churning"⁷ or "overpricing"⁸ is understandably increased.⁹

1. *Archer v. SEC*, 133 F.2d 795, 803 (8th Cir.), cert. denied, 319 U.S. 767 (1943).

2. Between 1950 and 1962, the number of customer's men registered with the National Association of Securities Dealers (NASD) increased from 28,794 to over 100,000. Jackson, *Stock Broker's Liability Under Customs, Usages, and Rules*, 12 *Clev.-Mar. L. Rev.* 111 (1963).

3. I SEC, Report of Special Study of Securities Markets of the Securities & Exchange Commission 47 (1963) [Hereinafter cited as Special Study]. The SEC was especially critical of the "whiz kids of finance," the account executives or customer's men, who work short hours and reap large salaries after six months training. *Id.* at 94.

4. E.g., *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941); *Wilko v. Swan*, 127 F. Supp. 55 (S.D.N.Y. 1955); *Murphy v. Cady*, 30 F. Supp. 466 (D. Me. 1939), *aff'd*, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940); *Reynolds & Co.*, 39 S.E.C. 902 (1960).

5. Special Study at 99.

6. *Id.* at 115.

7. "Churning" is causing an unreasonable amount of purchases and sales in a client's account "in order to obtain profits or commissions . . . contrary to the best interest of the customer." Loomis, *Enforcement Problems Under the Federal Securities Laws*, 14 *Bus. Lawyer* 665, 676 (1959). See generally Cohn, "Truth in Securities" Revisited, 79 *Harv. L. Rev.* 1340 (1966). For examples of churning see *Carr v. Warner*, 137 F. Supp. 611 (D. Mass. 1955); *Reynolds & Co.*, 39 S.E.C. 902 (1960); *Looper & Co.*, 38 S.E.C. 294 (1958); *Thomson & McKinnon*, 35 S.E.C. 451 (1953).

8. "Overpricing" is simply charging more than the market price of the stock. E.g., *Weber-Millican & Co.*, 35 S.E.C. 663 (1954), *aff'd*, 222 F.2d 822 (2d Cir. 1955), cert. denied, 350 U.S. 947 (1956); *Charles Hughes & Co.*, 13 S.E.C. 676, *aff'd*, 139 F.2d 434 (2d Cir. 1943); *William J. Stelmack Corp.*, 11 S.E.C. 601 (1942).

9. Special Study at 254.

I. APPLICATION OF THE SECURITIES ACTS

Both the Securities Act of 1933¹⁰ and the Securities Exchange Act of 1934¹¹ met with opposition from the securities industry. It was the fear of many that the broad coverage of the civil liability sections would shackle the economy by unduly inhibiting business transactions.¹² In striking a balance between this fear and the necessity of protecting the public,¹³ Congress inserted, as adjuncts to the general anti-fraud provisions of each statute,¹⁴ a section that rendered a "controlling person" liable for the misconduct of the parties he controlled.¹⁵

10. 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1964).

11. 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-jj (1964).

12. See, e.g., 73 Cong. Rec. 8283 (1934); *id.* at 3058; 73 Cong. Rec. 3801 (1933).

13. "To require them [directors, as one example of controlling persons] to guarantee the absolute accuracy of every statement that they are called upon to make, would be . . . to fall afoul of the . . . [desire] that the protection of the public should be achieved with the least possible interference to honest business." H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933). "The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business." 73 Cong. Rec. 937 (1933) (message from the President).

When the 1933 Act was still in committee, the Senate version called for an insurer's or absolute liability for controlling parties, whereas the House version afforded a controlling person the opportunity to exonerate himself from liability upon a showing that he could not reasonably have been expected to know of the wrongdoing of the controlled party. H.R. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933). The ultimate acceptance of the House version (see note 15 *infra*) left little doubt that Congress intended to alleviate controlling parties from a strict application of respondeat superior. But see *Paul H. Aschkar & Co. v. Kamen & Co.*, [1964-1966 transfer binder] CCH Fed. Sec. L. Rep. ¶ 91565, at 95134 (S.D. Cal. 1964), discussed in text and accompanying notes 53-56 *infra*.

14. In the Securities Act, 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1964), section 11 imposes liability for a materially misleading or defective registration statement. 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964). Section 12(e) imposes liability on anyone who offers or sells a security in violation of the registration requirements of the Act. 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77l(1) (1964). Section 12(2) imposes liability on anyone who offers or sells a security by means of a material misstatement or omission. 48 Stat. 84 (1933) as amended, 15 U.S.C. § 77l(2) (1964).

In the Exchange Act, 48 Stat. 881 (1934), as amended, 15 U.S.C. § 78a-78h-1 (1964), section 10b makes it unlawful "directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—(a) to effect a short sale . . . (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulation as the Commission may prescribe . . ." 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964). This section must be read in conjunction with its corresponding rule, 10(b)-5, which makes it unlawful: "(a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1967).

15. In the 1933 Act, section 770 provides: "Every person who . . . controls any person

These controlling persons sections permit a buyer to "pierce the 'privity' requirement . . . to the extent of reaching . . . controlling persons,"¹⁶ subject to a "special defense which varies in the two statutes."¹⁷ Generally speaking, this defense would exempt a controlling person from liability if he were both uninvolved in the illegal transaction and acting in good faith throughout.¹⁸

Since it is clear that the relationship between a brokerage firm and its salesmen is one of controlling person to controlled person,¹⁹ it would appear that if the firm is to be held liable for the wrongdoing of one of its salesmen the source of this liability should rest in an application of a controlling person section. To hold a passive, legitimate broker²⁰ liable under the general anti-fraud provisions renders the controlling persons sections superfluous, and thereby deprives the firm of the defenses that these sections afford. To employ the doctrine of respondeat superior to hold the firm liable not only ignores precedent to the effect that the customer's man "cannot be regarded as a general agent"²¹ but renders the defenses of the controlling persons sections nugatory. Yet, the

liable under sections 77k or 77l [the anti-fraud sections] of this title shall also be liable jointly and severally with and to the same extent as such controlled person . . . is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist." 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77o (1964).

Section 20 of the 1934 Act provides that "Every person who, directly or indirectly, controls any person liable under any provision of this title . . . shall also be liable jointly and severally with and to the same extent as such controlled person . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 48 Stat. 899 (1934), as amended, 15 U.S.C. § 78t (1964).

16. 3 L. Loss, *Securities Regulation* 1704 (2d ed. 1961).

17. *Id.* at 1808.

18. See note 15 *supra*.

19. E.g., *Lorenz v. Watson*, 258 F. Supp. 724 (E.D. Pa. 1966); *Paul H. Aschkar & Co. v. Kamen & Co.*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91565, at 95134 (S.D. Cal. 1964). It has been held that the statutory "control" should be interpreted liberally. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269, 275 (10th Cir. 1957); *Zachman v. Erwin*, 186 F. Supp. 681, 685 (S.D. Tex. 1959).

20. The legitimate broker is to be distinguished from the operator of a "boiler room." One description of such an operation is "specialization in one stock, use of misleading brochures, a large volume of sales over the long distance telephone, and lack of knowledge or disclosure of the real condition of the company." *Berko v. SEC*, 297 F.2d 116, 117 (2d Cir. 1961). For further discussion of the "boiler room" see Special Study at 265-68; Note, 72 *Yale L.J.* 1411-16 (1963). See also *Mac Robbins & Co.*, 40 S.E.C. 497 (1961); *Best Securities Inc.*, 39 S.E.C. 931 (1960).

21. *C. Meyer, The Law of Stockbrokers & Stock Exchanges* 482 (1931). "Nor is it within the scope of his duties to warrant the value of stock which he sells . . ." *Id.* at 483. For further examples of the limitations on the scope of the customer's man's authority, see *New England Trust Co. v. Farr.*, 57 F.2d 103 (1st Cir. 1932); *Bosak v. Parish*, 252 N.Y. 212, 169 N.E. 280 (1929); *Oppenheimer v. Irvin*, 166 App. Div. 233, 151 N.Y.S. 54 (3d Dep't 1915).

courts and the Securities and Exchange Commission have in several instances adopted each of these approaches.

Although it did not involve a broker-salesman relationship, *Merrill Lynch, Pierce, Fenner & Beane*²² is one of the most influential decisions in this area. Here, the perpetrator of the fraud was a wire correspondent,²³ named Waddy, who used the broker's facilities. Merrill Lynch supplied Waddy with various office materials (e.g., rubber stamps, forms, publications), and generally permitted "the prominent display of its name"²⁴ by Waddy. The Commission found²⁵ that the natural result of this was that investors who dealt with Waddy thought they were dealing with Merrill Lynch,²⁶ and that Merrill Lynch "should have been aware of the fact that Waddy's customers were of the opinion that they were in reality dealing with it."²⁷ The Commission concluded that the firm's failure

to rectify the features of its relationship with Waddy that formed the means for abuse by him must be deemed to have contributed effectively to Waddy's ability to defraud the customers. . . . [Merrill Lynch's] course of business thus indirectly "operated as a fraud or deceit . . . and constituted a violation . . . of Section 10(b) [of the Securities Exchange Act of 1934] . . . and Rule X-10B-5 thereunder."²⁸

It is important to note that the Commission made no reference to the controlling persons section.²⁹

The decision is certainly reconcilable with rule X-10b-5, which the Commission has promulgated. Specifically, this rule makes it "unlawful for any person, directly or indirectly . . . (c) to engage in any course of business which operates or would operate as a fraud or deceit upon any person"³⁰ The Commission apparently deemed the firm's failure to apprise Waddy's customers that Waddy was not representing the firm to be itself a violation of rule X-10b-5. In this view, the nature of the relationship between Waddy and Merrill Lynch would be irrelevant.

22. 31 S.E.C. 494 (1950).

23. A wire correspondent is a broker who uses the wire facilities of a major firm to complete his transactions.

24. 31 S.E.C. at 496.

25. A violation of one of the anti-fraud provisions, in addition to giving the defrauded party a cause of action, subjects the broker to revocation of his registration by the SEC. The Merrill Lynch case was such a revocation proceeding. See note 62 *infra*.

26. 31 S.E.C. at 497.

27. *Id.*

28. *Id.* at 498.

29. The Commission stated that "it is not necessary for the purposes of these proceedings to determine whether the relationship between respondent and Waddy was technically one of principal and agent so as to make appropriate the application of the doctrine of respondeat superior." *Id.* at 497 n.3. This would indicate that the Commission did not deem the control sections as negating respondeat superior if a principal-agent relationship were found. Such a view would appear to be contrary to the intent of Congress in passing the statutes. See note 13 *supra*.

30. 17 C.F.R. § 240.10b-5 (1967).

It seems, however, that the Commission deemed the relationship between Merrill Lynch and Waddy to be one of controlling person to controlled person.³¹ Further, the Commission stated that the firm "was under a duty to exercise a high degree of vigilance to prevent injury to . . . [the customers of Waddy]."³² Thus, it may well be that a latent consideration in this decision was the control relationship, or, more specifically, a breach of an apparent duty to prevent the fraud of a controlled person. In this view, it is the firm's status as a controlling person that connected it with the illegal transaction so as to bring its conduct within the ambit of rule X-10b-5 and thus within section 10(b).³³

But the very existence of the controlling persons sections would appear to indicate that it was Congress' intention, in such cases, to test the firm's liability under these sections. Since the Commission made no mention of the controlling persons section, it is clear that the decision should not be used as a precedent for finding liability under that section, as it later was.³⁴ Instead, reference should be made to it only when a firm's actions are themselves so tainted as to render them liable under the general anti-fraud provisions.

Nevertheless, subsequent decisions have found brokerage firms liable under section 10(b) when there was little more basis for such liability than the firm's control relationship to the active wrongdoer. Thus, in *R.H. Johnson & Co.*,³⁵ a salesman in a branch office³⁶ churned a client's account. The SEC pointed out

31. The Commission referred to *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949), a civil case arising from the same transaction, in which a district court found the firm liable under the controlling persons section of the Exchange Act. 31 S.E.C. at 497 n.3.

32. *Id.* at 497.

33. Section 10(b) makes it unlawful to employ, in connection with the purchase or sale of certain securities, any deceptive device in contravention of the rules. 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964).

34. On the facts of the Merrill Lynch proceeding, it should be noted, the firm apparently would not have been exonerated even if the controlling persons sections had been applied. Thus, in *Hawkins v. Merrill Lynch, Pierce, Fenner & Beane*, 85 F. Supp. 104 (W.D. Ark. 1949), an action by the buyer on the same facts, the court held that the firm had violated section 20 (the controlling persons section) of the Exchange Act. The finding of a section 20 violation was predicated on the theory that the firm's failure to supervise constituted "inducing" the correspondent's misconduct, thereby negating the availability of the section 20 defense. *Id.* at 123. It is arguable that the term "induce" in section 20 requires some affirmative action by the controlling person. But even if this is not the case, the Commission's failure to mention the section is not excused by the fact that its application would have yielded the same holding. It will be seen that the Commission's neglect of the controlling persons sections has not always had inconsequential results.

35. 36 S.E.C. 467 (1955), *aff'd per curiam*, 231 F.2d 523 (D.C. Cir.), cert. denied, 352 U.S. 844 (1956). In this case a widow was defrauded by a salesman whose name, aptly enough, was Sharpe. For another decision involving the same Mr. Sharpe, see *R.H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir. 1952).

36. The existence of branch offices presents great control or supervisory problems for the larger firms, as the distance between the branch and home office makes central supervision impractical. The branch manager, while being responsible for the supervision of all

that the firm's permanent records were kept in New York, and details of each branch transaction were sent to the New York office on a daily basis. Unfortunately for the firm, these records were never reviewed. Since the firm was put "on notice of the need for effective corrective measures to prevent overtrading . . ." ³⁷ but failed to implement such measures, the SEC concluded that it had "willfully violated . . . the Securities Act and . . . the Exchange Act." ³⁸ As in *Merrill Lynch*, which *Johnson* did not cite, there was present a lack of supervision and notice to the brokerage firm that something was "going on." Again, however, there was no mention of the controlling person provisions and the defenses that they provide.

Both *Johnson* and *Merrill Lynch* were relied upon in *Reynolds & Co.*,³⁹ which involved fraudulent acts of salesmen in four of the respondent's branch offices. These acts varied from churning accounts⁴⁰ to forging customers' signatures. In each instance the management of the firm had been put on notice of the wrongdoing but had failed to take corrective action. The SEC ruled that: "where the failure of a securities firm and its responsible personnel to maintain and diligently enforce a proper system of supervision and internal control results in the perpetration of fraud upon customers or in other misconduct in wilful violation of the Securities Act or the Exchange Act . . . such failure constitutes participation in such misconduct, and wilful violations are committed not only by the person who performed the misconduct but also by those who did not properly perform their duty to prevent it."⁴¹

In referring to *Merrill Lynch*, *Reynolds* noted that "customers were led to believe that they were in reality dealing with the [firm] Under these circumstances we held that the failure of the registrant adequately to supervise . . . contributed to the ability of the correspondent to defraud customers and thus indirectly operated as a fraud or deceit on customers in violation of Section 10(b). . . ." ⁴² This language could be interpreted so as to indicate that *Reynolds* deemed *Merrill Lynch* to turn on the fact that the firm failed to disclose the true nature of its relationship with the correspondent. It has already been suggested that this is the only proper justification for *Merrill Lynch*.

In *Lorenz v. Watson*⁴³ the viable remnants of the controlling persons sections were effectively rendered impotent. There the plaintiff-buyer sought recovery from the defendant-firm for churning by the defendant's salesman. Plaintiff expressly alleged liability under the control section of the Exchange Act.⁴⁴ In

salesman in his branch, is also charged with the task of increasing sales in his particular territory. Often these responsibilities conflict. See Special Study at 291-96.

37. 36 S.E.C. at 486.

38. *Id.* at 487.

39. 39 S.E.C. 902 (1960). This case has been termed the leading case on the problem of supervision. Special Study at 290.

40. See note 7 *supra*.

41. 39 S.E.C. at 917.

42. *Id.* at 917 n.30.

43. 258 F. Supp. 724 (E.D. Pa. 1966).

44. *Id.* at 728.

denying the defendant's motion to dismiss, the court ruled that: "to satisfy the requirement of good faith [a control section defense] it is necessary for the defendants to show that some precautionary measures were taken to prevent the injury suffered."⁴⁵ The *Lorenz* court then cited *Reynolds* for the proposition that where a firm's failure to maintain a proper system of supervision results in a fraud upon a customer, "wilful violations are committed not only by the person who performed the misconduct but also by those who did not perform their duty to prevent it."⁴⁶ *Lorenz* concluded that failure of the brokerage firm to prevent the fraudulent conduct of its employees is sufficient to support an action under section 10(b).⁴⁷

The ruling in *Lorenz* that invocation of the good faith defense of the controlling persons sections requires a showing of a system of supervision and internal control is novel. When the *Reynolds* case discussed liability for failure to supervise, it referred to liability under the general anti-fraud provisions, not the controlling persons sections.⁴⁸ Moreover, *Reynolds* predicated the brokerage firm's liability on its failure to maintain proper supervision and to inquire into questionable conduct of its employees which had already come to its attention.⁴⁹ Even if its resort to the general anti-fraud provisions were justified, arguably, *Reynolds* holds that a failure to supervise or inquire constitutes a violation only when such failure occurs in the face of indications that misconduct was actually transpiring. *Lorenz*, on the other hand, seems to hold that affirmative supervision is an absolute prerequisite for avoidance of liability under the general anti-fraud sections or the controlling persons sections. The *Lorenz* court noted that: "A contrary ruling would substantially diminish the protection afforded by Section 20 of the Act, and would amount to an invitation to avoid the burden and responsibility of supervising the activities of one's employees."⁵⁰ It would seem, moreover, that *Reynolds* properly included causation as an element of liability, i.e., but for the non-supervision no fraud would have occurred.⁵¹ *Lorenz'* ruling that a showing of supervision is a prerequisite to a successful defense, however, would appear to negate causation as a necessary element of liability.⁵²

Whereas *Lorenz* substantially narrows the gap through which a brokerage firm may escape liability for misconduct by its employees, the earlier case of *Paul H. Aschkar & Co. v. Kamen & Co.*⁵³ attempted to eliminate it completely.

45. *Id.* at 732.

46. *Id.* at 733.

47. *Id.*

48. Although Merrill Lynch did mention a duty to use care to prevent injury, its reference to that duty was not made in the context of the controlling persons section. See note 27 *supra* and accompanying text.

49. 39 S.E.C. at 916.

50. 258 F. Supp. at 733.

51. See text accompanying notes 41-42 *supra*.

52. This negation of causation is in direct conflict with Congressional intent. "The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based." 78 Cong. Rec. 8185 (1934).

53. CCH Fed. Sec. L. Rep. ¶ 91565, at 95134 (S.D. Cal. 1964).

Here, the court expressly exonerated the defendant firm⁵⁴ from liability under both controlling persons sections on the ground that it had come within the defenses that the sections provide. But, the court went on to say that although "the defendant . . . and its partners are not liable under the controlling persons provisions . . . [they] are liable to plaintiff by reason of the fact that their employees perpetrated the fraud . . . while acting within the scope of their employment and in exercise of their ostensible authority."⁵⁵ The *Aschkar* court cited no authority for its application of respondeat superior, and apparently was unconcerned with the fact that the application of the doctrine to brokerage firms would not only render the control sections virtually meaningless, but would, in the usual case, render any discussion of supervision irrelevant.⁵⁶ Resort to respondeat superior in determining a brokerage firm's liability for the acts of its employees, moreover, lacks foundation in the terms of the statute and in its legislative history.

II. SEC SUPERVISION REQUIREMENTS

Since "proper supervision" is what the Commission and the courts apparently look for in considering whether a firm will escape liability, the remaining discussion will assume, arguendo, that such affirmative duty does exist. In that light, there follows an examination of what supervisory measures will suffice as performance of the duty.⁵⁷

The duty to prevent employee misconduct is based on the "shingle theory." That is, like the attorney or physician, the broker warrants to the public that he is an expert in his field and can be trusted more than the average merchant attempting to sell goods.⁵⁸ Since the broker attempts to convey, and profits

54. The fraudulent scheme in this case was based on the basic "chain letter" device. The defendant's employee would persuade B to buy a stock from A (which he had persuaded A to buy) by assuring B that C would buy from him at a higher price. The employee would then phone C and induce him to buy it from B by assuring that he could sell it to D. The employee would induce D, etc.

55. CCH Fed. Sec. L. Rep. ¶ 91565, at 95139 (S.D. Cal. 1964).

56. Compare *Merrill Lynch* where respondeat superior was held not applicable. See note 29 *supra*.

57. One commentator has stated: "that a broker-dealer violates the anti-fraud provisions when his employees engage in misconduct which violates the . . . provisions of the act and the broker-dealer did not perform his duty to prevent such misconduct." Cohen & Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 *Law & Contemp. Prob.* 691, 705 (1964).

58. "The essence of this theory is that in certain circumstances one who sells securities to the public—who hangs out his shingle—explicitly warrants the soundness of statements. . . . When such a person conceals known information inconsistent with this 'implicit warranty of soundness' he has omitted a material fact without which the statements made would be misleading." *Kahn v. SEC*, 297 F.2d 112, 115 (2d Cir. 1961). See also 3 L. Loss, *Securities Regulation* 1490 (2d ed. 1961); C. Meyer, *The Law of Stockbrokers and Stockexchanges* 265-67 (1931). For example, if a broker is being paid to advise clients to buy by one anxious to sell a stock, he must disclose this fact to the buyer. *SEC v. Torr*, 15 F. Supp. 315, 317 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937). In

by this image of trust, he must also bear the duties that accompany it.⁵⁹ The result is a "higher standard of fair dealing than is found in almost any other field of buying and selling."⁶⁰

In *Thompson & McKinnon*⁶¹ the SEC, in deciding on the possible revocation of a brokerage firm's registration,⁶² noted with approval that subsequent to the start of the proceeding, the firm had set up the following controls: (1) it specified a number of transactions that could be legitimately completed in any one account (if the customer insisted on exceeding this limit, the account would be closed); (2) it required the preparation of a monthly analysis, to be reviewed by a partner, showing the amount of trading in each account and the commissions derived from each account; and (3) it required branch managers to make a daily review of all transactions.⁶³

In *Bond & Goodwin Inc.*,⁶⁴ the SEC called for a review of all incoming and outgoing correspondence,⁶⁵ close scrutiny of trading tickets to insure the correct price was being charged,⁶⁶ and a daily review of all buying and selling prices of each salesman.⁶⁷ In *E. H. Rollins & Sons Inc.*,⁶⁸ after the institution of

Berko v. SEC, 297 F.2d 116 (2d Cir. 1961), the firm predicted a stock would rise 15 points, and true to the prediction, it did. Even so, the SEC attempted to revoke its registration claiming that since there was no adequate basis for the prediction, the firm had breached its duty.

59. Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 Geo. Wash. L. Rev. 214, 240 (1959).

60. *Id.* at 240. See generally Levin & Evan, *Professionalism and the Stockbroker*, 21 Bus. Lawyer 337, 338-39 (1966).

61. 35 S.E.C. 451 (1953).

62. Under Section 15(b) of the Securities & Exchange Act the Commission may revoke the broker's registration if it finds that such a penalty is in the public interest. If it feels the punishment is not warranted, even though it has decided an infraction existed, it can, in its discretion, decline to apply it. 78 Stat. 570, 15 U.S.C. § 780(b)(5) (1964).

63. 35 S.E.C. at 460. The monthly review would be a task of formidable proportions. For example, a partner in a firm like Merrill Lynch would have to review the transactions of over 2,000 salesmen. Special Study at 22. The firm of Kidder & Peabody has almost 300 salesmen and completes 1,500 transactions a day. *Id.* at 294. Also, requiring a branch manager, in addition to his sales and administration duties, personally to examine each transaction daily, is quite burdensome.

64. 15 S.E.C. 584 (1944). In this case the defense of lack of knowledge of the fraudulent acts was raised, together with assertions that the firm "employed intelligent, experienced men, and relied on their judgment." *Id.* at 599. The Commission noted that the firm had failed to have incoming mail directed to the attention of particular employees, interrupted and read, to have an officer of the firm personally review each piece of outgoing mail, and to screen all long distance calls and telegrams. *Id.*

65. *Id.* at 599-600.

66. *Id.* at 600.

67. *Id.*

68. 18 S.E.C. 347 (1945). This case held that a broker might be liable for fraudulent acts even where the victim, in this case a religious organization, has knowledge of, or purported to authorize the acts. *Id.* Accord, *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941). The Commission recognized that in a large organization many transactions would neces-

the proceeding, the firm submitted a proposed set of new supervisory controls which were accepted by the Commission. One of these required that all letters written by salesmen be reviewed, before mailing, "by a person designated by the vice president in charge."⁶⁹ Another control required that copies of all letters written by branch managers be forwarded to the home office for review.⁷⁰

The necessary supervision, before the broker will be exonerated, entails more than management review, however. It must include affirmative instruction to members of the staff to watch for, and report, any irregularities. In *R.H. Johnson & Co.*,⁷¹ the firm was held responsible for the salesman's acts since, among other things, the branch manager was not instructed to check for excessive trading.⁷² He was told to "watch out" for anything irregular, but he was not specifically instructed on how to discover churning.⁷³

The SEC,⁷⁴ in its Special Study, has also discussed the creation, by the broker, of a separate department in the brokerage firm, the sole function of which would be to investigate and prevent fraudulent practices.⁷⁵ The SEC has also advocated the implementation of "surprise audits" in which a team of firm auditors would, without notice, appear at a branch office and insure that the office is utilizing proper detection procedures,⁷⁶ and a more extensive use of electronic data processing for closer review of all the firm's transactions.⁷⁷

sarily be carried on by subordinates, and that it would be virtually impossible for management to be aware of everything that transpired. It concluded that it was imperative that adequate controls be initiated so that any irregularity would be discovered. 18 S.E.C. at 391.

69. *Id.* at 395. The Commission did not specify who was to check on the person so designated.

70. *Id.*

71. 36 S.E.C. 467 (1955). See also note 35 *supra*.

72. 36 S.E.C. at 481.

73. *Id.* at 482. The Commission has also specifically called for certain records to be kept: "A daily journal should be kept recording all purchases and sales of securities with certificate numbers, all receipts and disbursements of cash, and all other debits and credits. Ledger accounts should be maintained for each cash and each margin account of every customer and of the broker or dealer and its partners or officers, as well as ledger accounts for all asset, liability, income, expense, and capital accounts. A separate record should be maintained for each security as of the clearance dates showing all 'long' and all 'short' positions A memorandum should be kept of each brokerage order whether executed or unexecuted, and a memorandum of each purchase and sale for the account of the broker or dealer." Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 *Geo. Wash. L. Rev.* 214, 238 n.74 (1959).

74. For a critical discussion of the SEC's problems in effectively regulating its "own shop" see Cary, *Administrative Agencies and the Securities & Exchange Commission*, 29 *Law & Contemp. Prob.* 653, 653-54 (1964); Jennings, *Self Regulation in the Securities Industry, The Role of the Securities & Exchange Commission*, 29 *Law & Contemp. Prob.* 663, 664-65 (1964).

75. Special Study at 293-94.

76. *Id.* at 296.

77. *Id.* at 295.

III. CONCLUSION

In view of the detailed nature of the controls approved by the SEC, it is difficult to imagine how any misconduct can occur undetected. If each transaction is reviewed on a daily basis, if each customer's account is reviewed monthly to ascertain the amount of trading and resulting commissions, if all correspondence is constantly checked, and if all trading tickets are reviewed to insure proper charging, it would appear virtually impossible for a salesman to act outside the cognizance of his employer.

As a practical matter, a brokerage firm cannot escape liability for fraudulent acts of its salesmen.⁷⁸ Judicial and administrative interpretation of the controlling persons sections of the Securities Act and the Exchange Act has resulted in a stringent standard of liability.⁷⁹ A showing of affirmative supervision has emerged as a requisite to a successful defense by a firm in an action for the fraud of its employees. The exercise of such supervision as the SEC deems adequate would virtually preclude the occurrence of fraud by a salesman without the broker's knowledge. The mere occurrence of fraud, moreover, might raise the presumption of a lack of adequate supervision.

78. It is interesting to note that while a broker is responsible for his employee's act because he "controls" him, an Exchange is not liable for misconduct of the member firm, even though it has a duty to police the broker. In *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944), plaintiff sued the New York Stock Exchange for failing to properly supervise a member firm whose misconduct injured the plaintiff. The court stated "we can see no substantial resemblance between the duties of bailees or other fiduciaries and those of the stock exchange." 141 F.2d at 239. Whether this will continue to be the rule is questionable as traditional immunities of the Exchange are under heavy fire in the courts. E.g., *Silver v. New York Stock Exchange*, 373 U.S. 341 (1963), where, for the first time, a court held that the antitrust laws apply to the stock exchanges. For a detailed discussion of this point, see Jennings, *The New York Exchange and the Commission Rate Struggle*, 53 Calif. L. Rev. 1119 (1965); Orrick, *The Recent Erosion of Certain Antitrust Exemptions*, 10 Antitrust Bull. 667, 677-78 (1965).

79. For instances in which federal courts have ignored the controlling persons sections, see, e.g., *SEC v. Rapp*, 304 F.2d 786 (2d Cir. 1962); *Kahn v. SEC*, 297 F.2d 112 (2d Cir. 1961); *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir.), cert. denied, 321 U.S. 786 (1944); *Rosenberg v. Hano*, 121 F.2d 818 (3d Cir. 1941); *Murphy v. Cady*, 30 F. Supp. 466 (D.C. Me. 1939), aff'd, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940).