Broker Dealers, Market Makers and Fiduciary Duties

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Broker Dealers, Market Makers and Fiduciary Duties

Broker-dealers occupy a commanding position in the securities market, a field where experience, sophistication and information give the knowledgeable an enormous advantage over the unwary or unwise investor. To alleviate the inherent inequities of this situation, Congress, the Securities and Exchange Commission (SEC or Commission) and the courts have developed a number of compensatory schemes designed to equalize the position of the parties. The broker-dealer’s relationship with his customers is covered by specific regulations,1 general statutory fraud provisions2 and common-law duties.3 Most of these provisions rely on disclosure to the customer of any material information in the hands of the broker-dealer;4 failure to make proper disclosure may result in regulatory action by the SEC and can also lead to civil liability.

Broker-dealers operate in two capacities—as agent (“broker”) or as principal (“dealer”). A “broker” is defined as a person engaged in the business of effecting transactions in securities for the account of others.5 A “dealer” is a person engaged in the business of buying and selling securities for his own account.6 A dealer who, with respect to a particular security, holds himself out as being willing to buy or sell for his own account on a continuous basis otherwise than on a national securities exchange, is termed a “market maker.”7

The dual role of the broker-dealer is important to the smooth functioning of the market system. However, it creates potential conflicts of interest as well as an opportunity to conceal information from the brokerage firm’s customers.8 The ability to function as

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1. Many of the regulations promulgated by the SEC pursuant to its statutory authority are narrow in scope and aimed at specific abuses. See, e.g., Exchange Act Rule 15cl-7(a), 17 C.F.R. § 240.15cl-7(a) (1977) which prohibits churning of discretionary accounts.
2. Sections 12(2) and 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77l(2) and 77g(a) (1976); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) and rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1977).
3. A broker-dealer acting as agent for his customer is a fiduciary with respect to matters within the scope of his agency. 1 Restatement of Agency 2d, § 13 (1957). See, e.g., Hall v. Paine, 224 Mass. 62, 112 N.E. 153 (1916); Batterson v. Raymond, 149 N.Y.S. 706, 711 (1914), order modified, 150 N.Y.S. 1076 (1914).
8. Section 11(e) of the Securities Exchange Act of 1934 directed the Commission to “make
agent or principal can be a powerful tool in the over-the-counter exchange, where information on the securities being traded and market conditions in a given security are not generally known and are considerably more difficult to obtain by the individual investor.9 If the broker-dealer acts as a broker, he is subject to the common-law duties of an agent to act in the best interests of his customer, coupled with the obligation of making full disclosure to his principal.10 Conversely, if a broker-dealer acts as principal in the exchange, selling the customer securities out of his own account, agency duties are not applicable and the broker-dealer must disclose only that he is acting as principal in the exchange.11

The SEC, which considers the relationship between any broker and customer to be one of "trust and confidence,"12 developed two theoretically distinct doctrines to protect that relationship—shingle and fiduciary. These two theories are designed to safeguard the trust placed by the customer in his broker, regardless of the technical status of the broker as agent or principal. Shingle theory provides that a broker, by virtue of his being in the securities business—hanging out his shingle—makes an implied representation to his customer that he will be dealt with fairly. It is essentially an implied warranty to the customer, which operates as a check on what otherwise would be an arm's-length transaction.13 Over the

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9. Most of the cases decided under shingle and fiduciary theory involve over-the-counter securities. "Unlike listed securities, there is no central trading place for securities traded over the counter. The market is established by traders in the numerous firms all over the country through a process of constant communication to one another of the latest offers to buy and sell." Silver v. New York Stock Exchange, 373 U.S. 341, 348 (1963).


13. An "arm's length" defense was frequently used by brokers in early SEC administrative proceedings. See, e.g., Bond & Goodwin, Inc., 9 S.E.C. 1043, 1053 (1941); Allender Co., 15 S.E.C. 584, 594 (1944). In hearings on a Senate Bill which would have made membership in national securities organizations mandatory, brokers maintained that such an extension
years, shingle theory has evolved to encompass a wide variety of acts and omissions. 14

Fiduciary theory is a considerably narrower doctrine, and looks to the relationship of the parties to determine whether the broker should be considered an agent of the customer. 15 The typical application of this theory involves uninformed investors whose trust has been solicited or accepted by a broker acting as principal. With the help of the minimal disclosure necessary while acting in that status, the broker is able to take advantage of his customer's ignorance. Application of this theory imposes fiduciary duties on the broker and non-disclosure of relevant facts will result in liability based on general agency principles.

Thus, whether a broker acts as principal or agent for the customer, he is subject to two theories of liability. When he acts as principal while also creating and maintaining a market for the particular security, the broker will be subject to shingle and fiduciary theories in the special status of market maker.

Recent decisions have held market maker status of the broker is a material fact requiring disclosure to the customer. However the scope of the duty to educate the customer, the degree of disclosure necessary, and the kinds of actions which might be considered violations of either shingle or fiduciary theory are questions in the process of resolution. This article will discuss and compare the shingle and fiduciary theories, and assess their impact on the special obligations of the market maker.

SHINGLE THEORY

The Securities and Exchange Commission first articulated the shingle theory in 1939 in Duker & Duker. 16 In Duker, as in the

\[\text{of regulation was not justified since “they (broker-dealers) are buyers and sellers, subject to the common law of the marketplace, as distinguished from investment advisers, who deal in opinions, recommendations and analysis, requiring ethical standards akin to the fiduciary responsibility of lawyers and accountants.” Hearings Before a Sub-Comm. of the Senate Comm. on Banking and Currency on S. 1642, 88th Cong., 1st Sess. 265 (1963). Despite these objections to fiduciary status, at least one broker has tried to make fiduciary status a defense. In Cady, Roberts & Co., 40 S.E.C. 907 (1961), the broker received inside information concerning a dividend reduction. Before the information became public, he liquidated his own and his customers' position in the stock. In administrative proceedings, the broker claimed that “he had a fiduciary duty to these accounts to continue the sales, which overrode any obligations to unsolicited purchasers on the Exchange.” Id. at 916. The Commission was unimpressed: “Clients may not expect of a broker the benefits of his inside information at the expense of the public generally.” Id. at 916.}

14. See notes 24-28 infra and accompanying text.
15. 3 Loss, SECURITIES REGULATION 1500-08 (2d ed. 1961) [hereinafter cited as Loss].
16. 6 S.E.C. 396 (1939). A companion case, Jansen & Co., 6 S.E.C. 391 (1939), was decided on identical grounds the same day. It should be noted that the term “shingle theory” is only
majority of the early cases, the broker was charging prices far above his own cost and was not revealing this fact to his customers. Because the securities were traded over-the-counter, the broker’s customers were unable to discover the extreme mark-up. The Commission held that the representation that a customer will be dealt with fairly and in accordance with professional standards was “inherent” in the dealer-customer relationship: “It is neither fair dealing, nor in accordance with such standards, to exploit trust and ignorance for profits far higher than might be realized from an informed customer.”

Judicial affirmation of the theory came four years later in Charles Hughes & Co., Inc. v. SEC. This case involved high pressure sales of over-the-counter securities to “single women or widows who knew little or nothing about securities or the devices of Wall Street.” As in Duker, the customers had paid prices exceeding market value. The court found the allegations of fraud convincing, and adopted the rationale articulated by the Commission in Duker:

When nothing was said about market price, the natural implication in the untutored minds of the purchasers was that the price asked was close to the market. The law of fraud knows no difference between express representation on the one hand and implied misrepresentation or concealment on the other.

This unqualified judicial approval of what came to be known as shingle theory encouraged the SEC to expand its application beyond unfair mark-ups to many other unfair practices which were not specifically covered by the Commission’s regulations. Fraudulent activities now covered by the shingle theory include churning of

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17. 6 S.E.C. at 389. Registrant in one transaction purchased certain bonds for its own account at a cost of $1045. It retained the bonds for several days, during which there was no substantial change in the market, and then sold them to its customer for $1506.65. 6 S.E.C. at 386-87.

18. Id. at 386, 388.

19. 139 F.2d. 434 (2d. Cir. 1943).

20. Id. at 435.

21. Id. at 436. The prices ranged from 16.1 to 40.9% over the broker’s cost. Id.

22. “An over-the-counter firm which actively solicits customers and then sells them securities at prices as far above the market as were those charged here must be deemed to commit a fraud.” Id. at 437.

23. Id.

24. Exhaustive listings of the various manipulations and devices now covered by the shingle theory can be found in Hibbard, Private Suits Against Broker-Dealers: Proposal to Limit the Availability of Rescissory Relief for Misrepresentations Implied by the Shingle Theory, 13 Harv. J. Legis. 1, 4-7 (1975) [hereinafter cited as Hibbard]; 3 Loss, supra note
customers' accounts,\textsuperscript{22} boiler-room sales,\textsuperscript{24} failure to disclose possible adverse interests\textsuperscript{27} and failure to deliver stock certificates promptly.\textsuperscript{28} In each situation, the court implies a particular representation using shingle theory as its starting point.

Recent applications of shingle theory indicate continuing vitality.\textsuperscript{29} One example of a modern approach is found in \textit{Brennan v. Midwestern United Life Ins. Co.}\textsuperscript{30} In that case, the broker was using his customers' money as working capital, and speculative losses had been sustained to the point where the brokerage house was in deep financial trouble.\textsuperscript{31} Extensive short sales, made in an attempt to regain solvency, drove the corporation deeper into debt.\textsuperscript{32} The corporation did not disclose to its customers that it engaged in transactions while insolvent and also failed to disclose the tremendous short interest it had built up in MULIC stock. The district court explicitly recognized shingle theory and held it applicable in an arm's-length transaction.\textsuperscript{33} It concluded these failures to disclose constituted a flagrant violation of the broker's implied representation that he would deal fairly with the public.\textsuperscript{34} Although an extreme case, \textit{Brennan} illustrates the broad range of shingle theory—its rationale is available for almost any act or omission of the broker-dealer which may result in harm to the customer.


\textsuperscript{25} "Churning" is excessive trading "disproportionate to the size and character of the account and primarily for the purpose of creating commissions." Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 432 (N.D. Cal. 1968).

\textsuperscript{26} A "boiler-room operation" utilizes a high-pressure sales technique, commonly by long-distance telephone. See, e.g., Best Securities, Inc., 39 S.E.C. 931 (1960).

\textsuperscript{27} See, e.g., Chaixas v. Smith, Barney & Co., 436 F.2d 1167 (2d. Cir. 1970).


\textsuperscript{29} The collapse of Penn Central led to a number of cases reiterating the applicability of shingle theory. These cases involve brokers acting as underwriters of Penn Central commercial paper. While such brokers were held to a higher standard as underwriters, the theoretical premise is the same. Alton Box Board Co. v. Goldman, Sachs & Co., 560 F.2d 916 (8th Cir. 1977); Franklin Sav. Bank v. Levy, 551 F.2d 521 (2d Cir. 1977); Welch Foods, Inc. v. Goldman, Sachs & Co., 398 F.Supp. 1393 (S.D.N.Y. 1974). In \textit{Alton Box Board}, the court held: "When Goldman, Sachs sold Penn Central notes they impliedly represented the notes were creditworthy and of high quality. Similarly ... Goldman, Sachs represented that it had made a thorough investigation on which it based its recommendation." A similar situation in the Seventh Circuit resulted in Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), \textit{vacated and remanded}, 425 U.S. 929 (1976), \textit{rev'd and remanded}, 554 F.2d 790 (7th Cir. 1977).

\textsuperscript{30} 286 F. Supp. 702 (N.D. Ind. 1968).

\textsuperscript{31} \textit{Id.} at 706.

\textsuperscript{32} \textit{Id.}

\textsuperscript{33} \textit{Id.} at 707.

\textsuperscript{34} \textit{Id.}
Some authorities have criticized use of the shingle theory. One author suggests that the availability of rescissory relief in private suits against broker-dealers is perhaps too broad. Others call the theory a fiction since a representation which the broker has no intention of making is implied, and then liability is imposed when it is breached. "A more straightforward way would be to hold a broker for violating 10b-5 if it engaged in those acts, without going through the gymnastics required by the shingle theory." While it is true that the approach has fictional qualities, it is arguable that the fiction serves a useful purpose by emphasizing the trust relationship of the broker with his customer. Shingle theory is based on the premise that unsuspecting investors must be protected from overreaching brokers. The real issue in these cases is the professional relationship.

Shingle theory thus covers a multitude of sins, and can encompass novel as well as garden-variety fraud. Its only limits are the vague boundaries of professional responsibility. While full disclosure might offer a defense, as a practical matter few brokers are likely to admit unfair trading practices to their customers.

FIDUCIARY THEORY

As shingle theory was refined and expanded, the SEC laid the groundwork for a second theory of broker liability, the fiduciary theory. This theory was introduced as an alternative basis of liability in several cases which also found liability on shingle theory grounds. An early disciplinary action using both theories is Allender Co. There the broker succeeded in winning the complete confidence of his customers, who were given the impression that he was

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35. Hibbard, supra note 24, at 23-29. Hibbard suggests that where the representation is merely commercial—an implied representation of solvency, for example, rather than investment advice—there is no unjust enrichment of the broker and the misrepresentation is not the cause of harm to the customer. Rescissory relief, putting the customer back in his original position before the transaction, is therefore inappropriate. The customer might have chosen to use a different broker, but his choice of securities, and therefore his market losses, would remain the same.

37. The SEC has maintained that even full disclosure would not constitute a defense to a shingle theory action. The recent case of Santa Fe Industries, Inc., v. Green, 97 S. Ct. 1292 (1977) may cast doubt on the SEC's position: "[O]nce full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." Id. at 1303. For the SEC approach, see, e.g., Powell & McGowen, Inc., 41 S.E.C. 933 (1964); Mac Robbins & Co., 40 S.E.C. 497 (1961).
38. This has also been called the "implied agency" theory. See, e.g., Wendell Maro Weston, 30 S.E.C. 296 (1949).
39. 9 S.E.C. 1043 (1941).
acting as their agent in the exchanges. In reality, he was selling them his own stock as principal and indulging himself in mark-ups as high as 193%. He sought to defend himself on the ground that the transactions were at arm's-length. The Commission, however, declared that "under these circumstances, we think it is clear that [the broker] became an agent for these customers." Agency status carried with it obligations to the principal. The broker's failure in Allender to disclose his adverse interests to his principal therefore was deemed fraudulent. The Commission, unwilling to rely exclusively on its fiduciary theory reasoning, proceeded to hold that "even on the assumption that the parties were not in an agency relationship but were acting as principals" they would be compelled to hold the broker liable on the shingle theory.

Several years later, in Arleen Hughes v. SEC, the fiduciary theory gained judicial approval. Arleen Hughes conducted business as an investment advisor and as a broker. Her clients signed a "Memorandum of Agreement" which purported to allow Hughes to act as principal when she was offering investment advice to them. The Commission, and then the court of appeals, held Hughes estopped from denying her fiduciary status, and determined that she had failed to make sufficient disclosure to her clients despite the fact that she had not taken advantage of her position.

The Arleen Hughes decision, however, is distinguishable from prior SEC administrative proceedings since the defendant acted as investment advisor as well as broker for her customers. Thus, it is not surprising that the court did not permit her to divorce the two roles. The defendant had statutorily imposed fiduciary duties, and it would have been inappropriate to allow her the benefits of principal status in the closely connected position of broker.

Fiduciary theory has continued to play a part in SEC administrative proceedings and in private actions against brokers. One com-

40. Id. at 1052. One witness testified that the dealer had repeatedly told her that "his commission was so small it would not even buy him a decent necktie."
41. Id. at 1045.
42. Id. at 1053.
43. Id. at 1055. The Commission's decisions in Lawrence R. Leeby, 13 S.E.C. 499 (1943) and William J. Stelmack Corp., 11 S.E.C. 601 (1942) also involved a dual basis of liability.
44. The court stated: "In a transaction between a securities dealer and an uninformed customer, a statement by the former with respect to the price . . . carries with it the clear implication that such price bears some reasonable relation to the prevailing market price." 9 S.E.C. at 1057.
45. 174 F.2d 969 (D.C. Cir. 1949), aff'd Arleen W. Hughes, 27 S.E.C. 629 (1948).
46. Id. at 971.
47. Id. at 975.
paratively recent decision, without the role complications of Arleen Hughes, is Stevens v. Abbott, Proctor & Paine. In Stevens, the plaintiff was an utterly unsophisticated investor who turned over her account to an employee of defendant's firm. Without authorization, the defendant broker transformed the account into an active, speculative one averaging a transaction daily for five years, apparently for the purpose of generating commissions. The court found that "by virtue of [defendant's] knowledge of [plaintiff's] lack of financial acumen there was a duty upon him not to use her account in such a manner as to result in a conflict of interest." The court concluded that "a fiduciary relationship in law existed between the plaintiff and [defendant] which placed upon him the duty of acting in the highest good faith toward the plaintiff."

Despite Stevens and other recent cases employing the fiduciary theory of broker-dealer liability, it appears that the SEC is gradually deemphasizing use of this theory, in favor of the more generally applicable shingle theory. While plaintiffs in private actions have continued to use fiduciary theory, its basis is considerably narrower than shingle theory. Under fiduciary theory, plaintiff must prove a close relationship between broker and customer, a heavy burden in an era when brokers are increasingly (and uncomfortably) aware of their liabilities. Plaintiff must also deal with the element of reliance: even if he succeeds in establishing that the broker solicited or accepted his trust and confidence, he still runs the risk of being labeled a "sophisticated investor." Thus, he must not only prove his reliance, but also that it was reasonable under the circumstances.

Plaintiff's case in Avern Trust v. Clarke failed on this issue of investor sophistication. It was claimed that the defendant broker-dealer had breached his fiduciary relationship by taking secret prof-

50. "To adequately describe plaintiff's lack of sophistication in financial matters would be a herculean task. Suffice it to say, on being questioned as to the difference between a stock and a bond, [plaintiff] answered in effect 'stocks have names and bonds don't.' " Id. at 838.
51. Id. at 840.
52. Id. at 842.
53. Id. at 847.
54. Cohen & Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 LAW & CONTEMP. PROBS. 691 (1964) [hereinafter cited as Cohen & Rabin]. In this article, the former Commissioner of the SEC, Manuel F. Cohen, stated: "Recent Commission decisions have tended to rely upon, and to articulate more fully, the obligations which the shingle theory imposes on broker-dealers, and to emphasize the obligations which broker-dealers owe to all customers regardless of the existence of any special reliance or dependence." Id. at 704.
its as principal and by failing to advise the investors of the risks inherent in the transactions. The court rejected the argument, saying that "although there was much evidence that the defendant . . . promoted a friendship with [plaintiff] for the purpose of selling him securities, there was also evidence that [plaintiff] acted in a manner inconsistent with his claimed financial naiveté and fiduciary reliance." The existence of a fiduciary relationship was, in the court's opinion, a question of fact properly submitted to the jury.

Another recent Seventh Circuit case, Fey v. Walston & Co., emphasized the element of investor sophistication in a churning case. The complaint contained elements of both shingle and fiduciary theory, but the case was tried and won in the district court on fiduciary grounds. The appeals court reversed because evidence bearing on plaintiff's prior and contemporaneous investment experience was excluded by the trial court. The court noted that in a churning case, the customer's independent objectives are an important standard against which claimed excessiveness should be measured. "[E]vidence bearing on the experience, sophistication or trading naiveté of the customer may be highly significant."

This rationale is applicable by analogy in virtually any claimed fiduciary violation. Plaintiff's investment aims and expectations, and thus his trading experience or naiveté, must be considered where liability depends on a difference in knowledge between the parties. There is no duty where there is no dependency.

**Analysis and Comparison of Shingle and Fiduciary Theories**

Several practical effects follow from the distinction between shingle and fiduciary theories. Reliance, an important factor in fiduciary theory, is not significant in shingle theory. Nor does shingle theory

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56. Id. at 1240.
58. 493 F.2d at 1045.
59. Id.
60. Sophistication or awareness of the investor has been raised as a defense to shingle theory proceedings. This position was rejected in Hanly v. S.E.C., 415 F.2d 589 (2d Cir. 1969). In Hanly, the court stated that a salesman "must analyze sales literature and must not blindly accept recommendations made therein. The fact that his customers may be sophisticated and knowledgeable does not warrant a less stringent standard. Even where the purchaser follows the market activity of the stock and does not rely upon the salesman's statements, remedial sanctions may be imposed since reliance is not an element of fraudulent misrepresentation in this context." Id. at 596. As the Hanly court noted, however, this was a
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require proof of a close relationship between broker and customer. Furthermore, fiduciary theory forbids taking any secret profits, while shingle theory bars only unreasonable gain.\(^1\)

Despite these differences, however, shingle and fiduciary theories tend to merge in practice.\(^2\) Similar results follow, whichever theory is used. A reading of the cases indicates that application of the two theories consistently rests on the same fact patterns: an unethical broker, an uninformed customer, and a more or less strong degree of dependency or reliance by the customer. The importance of these factors varies with the particular case. The variability of the factors can lead to a choice between use of either shingle or fiduciary theory. The effect can be analogized to a pyramidal structure. Shingle theory—more accepted, easier to establish and thus more frequently employed—covers the broadest area, the whole of the pyramid. Fiduciary theory encompasses only those cases at the upper levels of the pyramid, where the relationship between broker and customer is particularly close. There does not appear to be a logical reason for the separate existence of the two theories; the purpose of fiduciary theory remains unclear, since it imposes unwanted duties beyond those necessary to recovery.

Shingle theory cases, beginning with Charles Hughes, have relied on "the special duty imposed upon those who sell such stocks not to take advantage of customers in whom confidence has been instilled."\(^3\) Its fundamental premise, as in the fiduciary theory, is the difference in knowledge between broker and customer. The broker with greater knowledge of the market necessarily owes a professional duty to all his customers.\(^4\)

Fiduciary theory cases have often characterized the professional relationship as one of "trust and confidence." In R.H. Johnson &

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disciplinary action by the SEC; it is not clear that customer sophistication would be unimportant in a private action for damages.


62. This merger has been recognized by a former commissioner of the SEC. Although referred to as separate doctrines, these theories are, in fact, closely connected. They developed at approximately the same time in cases in which the Commission pointed out that the duty of securities dealers to treat their customers fairly resulted from holding themselves out as possessing specialized knowledge and skill and from cultivation of their customers' trust and confidence. Cohen & Rabin, *supra* note 54, at 703. Professor Loss states that "The two Hughes doctrines really blur into each other." 3 Loss, *supra* note 15, at 1508.


Co.," for example, the defendant broker's customers included a number of retired persons. None of the customers was an experienced or informed investor, and the Commission found they "generally relied upon the salesman's advice." Under these circumstances the Commission determined the defendants "occupied a position of trust and confidence with respect to these customers and were under a duty to act in their best interests."

Thus, regardless of whether shingle or fiduciary theory is employed, there is a base level of duty owed all customers. That duty becomes stricter as the broker-customer relationship becomes progressively more intimate. The key factor may be the degree of customer reliance on the broker. If the broker invites or encourages reliance, he is likely to be labelled a fiduciary. The underlying obligation, however, remains the same—the broker may not take advantage of the customer's trust.

Both theories are tools which render a failure to disclose into an actionable breach of duty. Shingle theory, while ungainly, at least has the virtue of providing a flexible standard of professional responsibility. Fiduciary theory, on the other hand, tied to common law duties of agency, is a relatively rigid concept which may be inappropriate in a broker-customer situation. The difference in theory is insufficient to support the two different legal doctrines.

**Market Makers**

A broker who assumes the status of market maker encounters special problems unique to that position. Recognizing these problems, the SEC has issued rules specifically addressed to a dealer who creates and maintains a market in a particular security. The courts have also noted the special role of the market maker, and their analysis of the obligations of such a broker involves elements of both shingle and fiduciary theories.

The question of market domination in a particular security and its relation to shingle and fiduciary theories is best illustrated by *Norris & Hirshberg Inc., v. SEC.* There the defendant broker...
specialized in five securities and the firm's transactions accounted for approximately seventy-five percent of all stock sold in these securities during the period in question.\textsuperscript{71} The underlying soundness of the securities was not in question, nor was it alleged that the broker had engaged in any of the classic manipulative schemes.\textsuperscript{72} The SEC, however, took disciplinary action because the broker had not revealed the character of the market to his customers: "That market was respondent's own creature . . . every sale to a customer carried with it the necessary representation that the sale price bore some relation to a price prevailing in a free and open market. But there was no such market."\textsuperscript{73}

The broker's misrepresentations in \textit{Norris} constituted a violation of shingle theory principles. The Commission found a violation of fiduciary duty as well: the "blind faith" expressed by the customers was inconsistent with the actual facts—"that respondent was trading against them, that they were paying respondent's and each other's profits. . . ." The Commission concluded:

To operate this system without disclosure would be inherently fraudulent even if respondent had done nothing to nurture its customers' faith. However, customers' confidence was carefully fed by the display of a spirit of helpfulness and an apparent concern with customers' welfare completely belied by the facts.\textsuperscript{74}

Thus, the broker was not entitled to act as a principal in transactions with these customers without fully revealing its total domination of the market in these securities.

\textit{Chasins v. Smith, Barney & Co.}\textsuperscript{75} emphasized the importance of disclosing the broker's status as market maker to his customer. The Second Circuit held market maker status in a particular security to be a material fact requiring disclosure to a purchaser of that security. Chasins was music director of a radio station in New York and acted as commentator on a radio program that Smith, Barney sponsored.\textsuperscript{76} Through this connection, Chasins retained the brokerage house to conduct a study of his holdings with the "objective of aggressive growth."\textsuperscript{77} Smith, Barney's written analysis included

\begin{itemize}
  \item \textsuperscript{71} 177 F.2d at 229.
  \item \textsuperscript{72} \textit{Id.} at 230. See also Bloomental, \textit{The Case of the Subtle Motive and the Delicate Art: Control and Domination in Over-the-Counter Securities Markets}, 1960 D\textit{UKE L. REV.} 196.
  \item \textsuperscript{73} 21 S.E.C. at 881.
  \item \textsuperscript{74} \textit{Id.} at 882-83.
  \item \textsuperscript{76} 438 F.2d at 1169.
  \item \textsuperscript{77} \textit{Id.} at 1170.
\end{itemize}
strong recommendations to purchase several securities in which they were making a market at the time. This status was never revealed to Chasins, who followed the advice and purchased the securities, which subsequently declined in value. Chasins sued and the district court held without discussion that Smith, Barney failed to disclose a material fact when it did not reveal at time of sale that it was making a market. Chasins' other counts, most notably one claiming breach of common-law fiduciary duties, were rejected. On appeal, the Second Circuit upheld the district court with this observation: "The question here is not whether Smith, Barney sold to Chasins at a fair price but whether disclosure of Smith, Barney's being a market maker in the . . . securities might have influenced Chasins' decision to buy the stock." The court held that disclosure could have influenced Chasins' decision, since the purchaser might have considered the possible ulterior motives of Smith, Barney important. The court reached this decision despite the fact, as Judge Friendly pointed out in dissent, that there was no SEC, NASD, or New York Stock Exchange rule which required disclosure of market maker status to a customer, that the prices charged were fair, and that proof was offered to show that "disclosure [of market maker status] would only have encouraged him in his decision to buy."

On rehearing, the panel withdrew its original opinion and substituted a nearly verbatim one which apparently limited Chasins to its facts. The substituted opinion emphasized the particular facts involved in the case and added: "We here go so far only to hold that under the particular circumstances proved in this case the court was correct in holding that the failure to disclose was the omission of a material fact."

Whether the substituted opinion significantly limited the scope of the original Chasins decision is unclear. Some commentators believe the change to be insignificant, while others are convinced that it effectively emasculates the judgment. The substitution serves as

78. 305 F. Supp. at 495.
79. Id. at 496.
80. Id. at 495.
81. Id. at 492-95.
82. 438 F.2d at 1171.
83. Id. at 1174-75 (Friendly, J., dissenting from denial of reh. en banc).
84. Id. at 1172. The original opinion may be found in the [1969-1970 Transfer Binder], FED. SEC. L. REP. (CCH) ¶92,712.
the best clue to the rationale behind the *Chasins* decision. Limitation to its facts compels consideration of whether Chasins' relationship to the brokerage house, his financial sophistication (or lack of it), and his degree of reliance on Smith, Barney's recommendations are the crucial elements of the case. The simple, sweeping holding of the original opinion apparently had not relied on these facts, but the substituted opinion's emphasis of them allows more careful analysis. The fact pattern closely parallels the situations commonly encountered in shingle and fiduciary cases.

If *Chasins* fits within the factual framework established by earlier cases involving shingle and fiduciary theories, its facts are critical to an evaluation of the holding and a consideration of what measures must be taken by brokers to guard against future liability based on market maker status. As a result of *Chasins*, brokers now disclose market maker status on the face of the confirmation slip. Such disclosure, however, may be inadequate if an action is brought based on shingle or fiduciary theory. The situation is roughly analogous to the problems presented by brokers confirming as principals. If circumstances warrant, application of shingle or fiduciary theories will result in a finding that mere confirmation as principal is inadequate disclosure of adverse interests. If similar confirmation which discloses market maker status, without more, may be inadequate. Special circumstances could mandate greater disclosure.

Later cases have split in deciding the scope of *Chasins*' applicability. Several restrictive decisions rely on the factual emphasis of the substituted opinion. These courts distinguish their cases from the factual pattern present in *Chasins*, reasoning that the rule in *Chasins* will apply only in a highly select group of cases. Other courts have given *Chasins* broader effect, though the case is rarely discussed extensively.

More restrictive decisions limit *Chasins* to factual patterns parallel to those which have given rise to the imposition of fiduciary duties. *Cant v. A.G. Becker & Co.* considered the duties imposed on a market maker where the relationship of the market maker and his customer is one of trust and confidence. Dr. Cant had employed the defendant brokerage firm for twenty-five years prior to the transactions at issue, and frequently bought securities in reliance on

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87. Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (1977), requires a broker to disclose to customer in a written confirmation whether he is acting as broker or as dealer for his own account. Cases involving rule 15c1-4 include *Cant v. A.G. Becker & Co.*, 374 F. Supp. 36 (N.D. Ill. 1974) (coded confirmation slip was insufficient disclosure to intimate customer); Walter S. Grubbs, 28 S.E.C. 323 (1948); William J. Stelmack Corp., 11 S.E.C. 601 (1942).
investment advice initiated by the defendant. The broker recommended purchase of two securities it was making a market in at the time, without disclosure of this status. Under these circumstances the court held that the doctor's long and dependent relationship with the brokerage firm created a special situation resulting in an obligation that exceeded the duties normally owed to a casual customer. The court found "a special relationship of confidence between the investor and broker" and that A.G. Becker had failed in its affirmative duty to disclose its market maker status.

Cant is a limited decision despite its finding of broker-dealer liability. Its roots lie in the Arleen Hughes fiduciary theory cases which impose liability for failure to disclose a potentially adverse situation only where special circumstances exist. Cant's strong dependence on the prior relationship of the parties implies a restrictive view of Chasins which considers investment advice critical to recovery. Liability is predicated on finding fiduciary duty or something very close to it, a significant hurdle for an injured plaintiff whose relations with a defendant broker were not so intimate.

Other cases have seen broader implications in Chasins. In Taylor v. Smith, Barney & Co. the court discussed the elements of the Chasins holding in denying plaintiff's motion for partial summary judgment. Smith, Barney (prior to the Chasins decision) had failed to disclose that it was making a market in stocks bought and sold by the plaintiffs. The court ruled that "the materiality of Smith, Barney's market making activities depends largely upon a constellation of facts which is not adequately before the court and which probably must be established at trial." Those facts included previous experience of the plaintiffs, the possibility of manipulation by Smith, Barney, and the degree of reliance by the investors. Investment advice was not a factor in the case, although the court noted the long prior relationship of the parties. The court's emphasis on the "constellation of facts" at issue reflects the same concerns dealt

89. "Almost all of the purchases of securities made by Cant during this period were based upon recommendations initiated by A.G. Becker who frequently and regularly telephoned Cant for the purpose of suggesting various purchases." [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶93,347 at 91,870.
90. 374 F. Supp. at 46.
91. Id. at 47.
92. Class actions like In re Scientific Control Corp. Securities Litigation, 71 F.R.D. 491 (S.D.N.Y. 1976), encounter virtually insurmountable difficulties when liability centers on a close broker/customer relationship; questions of fact are likely to differ widely among the plaintiff class.
94. Id. at 896.
95. Id. at 894.
with by shingle and fiduciary theories. *Taylor* implicitly accepts the possibility of liability notwithstanding the relatively low degree of reliance by the investors, since investment advice was not involved. Thus the duty owed in *Taylor* is roughly the same as that owed in shingle theory cases. As such, it is probably *Chasins'* broadest progeny.

The Supreme Court cited *Chasins* without extensive discussion in *Affiliated Ute Citizens v. U.S.* In this case, plaintiffs were mixed blood members of the Ute tribe holding shares in a corporation formed to hold the assets of the tribe, primarily oil, gas, and mineral rights. Despite the fact that the shares were difficult to transfer, two bank officials succeeded in creating an outside market in the shares by soliciting and accepting orders from non-Indians and facilitating transfers by the mixed-bloods. Justice Blackmun wrote:

> The individual defendants, in a distinct sense, were market-makers, not only for their personal purchases constituting 8 1/2% of the sales, but for the other sales their activities produced. This being so, they possessed the affirmative duty under [rule 10b-5] to disclose this fact to the mixed-blood sellers.

It is not clear to what extent market making activity alone raised the affirmative duty to disclose; other circumstances may have played a part in the decision. The sellers were unquestionably naive and the patently unethical conduct of the bank officials went far beyond failure to disclose the mere possibility of an adverse interest. While the shingle and fiduciary devices were not explicitly used, *Affiliated Ute* does involve a factual situation paralleling the patterns commonly connected with the theories. The bank officials' conduct in particular could have been characterized as a breach of fiduciary duty.

As noted above, shingle and fiduciary theories are applied in related factual situations. Both theories articulate the broker's obligation of professional responsibility. Shingle theory, however, is easier to prove, since it does not require proof of a close customer-broker relationship and it relaxes the necessity for showing the customer's reliance on the broker's representations. The narrower interpretations of *Chasins* demand the high level of proof required in fiduciary

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97. *Id.* at 134, 136.
98. *Id.* at 137-38.
theory cases. However, more relaxed standards, comparable to those involved in shingle theory, are applied in cases like *Taylor*.

However, whether the duty owed is characterized as arising from shingle or fiduciary theory, the majority of the cases subsequent to *Chasins* closely examine the factual context of the dispute, and in doing so follow the line of cases decided prior to *Chasins*. This interpretation limits *Chasins* to the reasoning of the earlier cases—its impression on the securities field, and its status as innovative precedent, have largely been erased.\(^{100}\)

**Conclusion**

The trend in recent cases is toward a more conservative approach to market maker liability, rooted in the shingle and fiduciary theories previously developed. The *Cant* line of cases in particular recalls the *Arleen Hughes* doctrine of fiduciary duty; liability for failure to disclose market maker status is imposed only on a showing of close customer-broker relations. *Chasins* does not support this heavy burden of proof on plaintiff. While the Second Circuit's decision there involved investment advice, other factors normally present in a fiduciary situation did not exist.

Thus *Chasins* appears to have been effectively discarded. Although it was the first case to find market maker status without domination material, its definition of the class of prospective plaintiffs has been largely abandoned. Market maker status may still be material, but recovery is limited to those who can establish a breach of fiduciary duty. Use of fiduciary theory eliminates the broad range of unsophisticated investors otherwise covered by the shingle theory device.

This anomalous situation does not leave market makers with clearly defined duties. Had *Chasins* been followed literally, confirmation slips simply stating that the broker was acting as market maker in the security traded would be sufficient. But the later decisions make a clear definition of disclosure requirements impossible, since they will vary with the circumstances of the individual case. Simple disclosure of status may be inadequate; further customer

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\(^{100}\) Two other cases have discussed *Chasins* peripherally. Hail v. Heyman-Christianens, Inc., 536 F.2d 908 (10th Cir. 1976) affirmed an unreported district court decision granting summary judgment for plaintiff "on the ground that the failure of a stock brokerage firm to disclose to a customer that it was making a market in the securities constitutes a violation of rule 10b-5, citing Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir.), *inter alia.*" Id. at 909. The appeal, however, was on the issue of attorney's fees, and the lower court's decision on the principal claim was not discussed. Winkelman v. Blyth & Co., 518 F.2d 530 (9th Cir. 1975) deals with a statute of limitations problem in a *Chasins* situation. While it apparently accepts the Second Circuit's reasoning in *Chasins*, the issue is not discussed in depth.
education may be necessary to ensure effective disclosure. The con-
servative reaction to Chasins only muddies the waters it hoped to settle by retreating to the established but inexact system of shingle and fiduciary theory.

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