Securities Salesmen, Investor Protection, and Professional Responsibility

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SECURITIES SALESMEN,
INVESTOR PROTECTION, AND
PROFESSIONAL RESPONSIBILITY

Solomon Spiro*

THE LAW OF MISREPRESENTATION: TORT AND WARRANTY

We shall review the common law background of tort and warranty actions for misrepresentation in order to understand the law governing salesmen's representations. Initially, the tort action of deceit included warranties given in the sale of goods, because, to a great extent, misrepresentations arose in the course of bargaining transactions between parties. The deceit action was employed as a remedy for wrongs which we would now view as breach of contract in the form of false warranty in the sale of goods. It was not until Pasley v. Freeman, in 1789,1 where the plaintiff had no dealings directly with the defendant, but was induced by his misrepresentations to deal with a third party, that a separate tort of deceit was born.2 Deceit was no longer viewed as resting on a contractual relation between the parties. Then came Derry v. Peek,3 where the House of Lords limited the tort of deceit to conscious or intentional misrepresentation. The defendants, the directors of a tramway corporation, had indicated in a prospectus for a stock issue that they had obtained statutory approval for steam tramways, when in fact they were later refused approval. The plaintiff was induced to invest in the stock on that basis. The court said that, though the directors had no reasonable grounds for this assertion, they honestly believed it, and thus could not be held liable. Lord Herschell said, “A man who forms his belief carelessly or recklessly may be blameworthy when he makes a representation on which another is to act, but he is not, in my opinion, fraudulent...”4 Thus we have three distinct categories; the tort of deceit or fraud, negligent misrepresentations which attract no liability, and warranties which, being contractual in nature, will result in the representor being held to the principle of strict liability.

An examination of Anglo-Canadian Law will show that the Derry v. Peek doctrine has gained a stranglehold on the progression of the development of negligent and innocent misrepresentation which appears to have left its residual mark on Anglo-Canadian law. In Le Lievre v. Gould,5 a surveyor was absolved from liability for issuing work completion certificates that were inaccurate and upon which the mortgagee issued money. The judgment says,

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1 (1789) 3 Term Rep. 51, 100 E.R. 450.
3 (1888), 14 A.C. 337.
4 Ibid. p. 369.
5 (1893) 1 Q.B. 491.
inferring from Derry v. Peek, supra n. 3, "the law of England . . . does not consider what a man writes on paper is like a gun or other dangerous instrument and unless he intended to deceive the law does not in the absence of contract hold him responsible". In Heilbut, Symons & Co. v. Buckleton, supra n. 3, where the seller of shares falsely represented that the company was a rubber company, the House of Lords rejected the plaintiff's claim on the basis of deceit, by invoking Derry v. Peek, supra n. 3, to the effect that the representation was not fraudulently made, and a warranty theory was struck down because it was not a term of the contract but a mere reply to a factual inquiry.

The Canadian cases slavishly followed Derry v. Peek, a typical example being Olmstead v. Pearce & Co., supra n. 3, where a stockbroker, acting gratuitously, was not found liable for providing a wrong quotation which resulted in financial loss to the plaintiff. In Candler v. Crane, Christmas & Co., supra n. 3, the accountant was not held liable when the plaintiff invested money in a company relying on his reports, which were prepared with the knowledge that they would be shown to the investor. And even Hedley, Byrne & Co. Ltd. v. Heller & Partners Ltd., supra n. 3, where a bank would have been liable for a credit reference which resulted in loss to a third party, if it were not for a disclaimer of responsibility, does not seem to have had the liberating effect that it was purported to have exerted. A Canadian author stresses the fact that the House of Lords decision still requires a special relationship between the parties; that where advice is received from one business establishment, and purchase is made from a third party, the 'adviser' would not be liable, and that the Law Lords have not been able to overcome the meaningless distinction between tort and contract, namely, consideration.

The common law view which followed from Derry v. Peek supra n. 3, firstly reflected a reluctance to hold people responsible for effects of their words as distinct from their actions, and secondly, was based on the law's reluctance to protect the plaintiff from economic loss as distinct from physical injury and property damage.

English law feared that to hold people liable for negligent words would open the dikes to a flood of complaints and actions. Lord Pearce, in Hedley Byrne & Co. v. Heller & Partners, supra n. 3, at p. 150, said that words are more volatile than deeds, and that they travel quickly and very far; are never completely expended and can have multitudinous effects. "Yet they are dangerous and

6 supra. n. 3.
7 emphasis my own.
8 supra. n. 3, at 497.
9 (1913) A.C. 30.
10 supra. n. 3.
11 (1937) 1 D.L.R. 625.
12 (1951) 2 K.B. 164, (1951) 1 All E.R., 426.
15 supra. n. 3.
16 supra. n. 13 at p. 150.
can cause vast financial damage”. If the words themselves could create proximity, in the absence of contract, there would be no limits to the number of persons to whom the speaker or writer could become liable. Lord Pierce says, “Damage by negligent acts to persons or property on the other hand is more visible and obvious; its limits are more easily defined. . .” Thus the argument runs that words can have too great an effect on too many people, and that economic loss can be too onerous for a defendant to bear. Of course, these very arguments could be used to justify recovery in these circumstances. Should not the law encourage restraint and care when the initial loss can be so vast and unbearable in terms of the potential victims as well; and since words are potent and far-reaching in their effects, do we not wish to deter recklessness and carelessness in peoples’ utterances?

Professor Goodhart has contended that it is ridiculous to differentiate between words and acts when he indicated that a pharmacist is just as culpable if he should misrepresent a bottle of pills as non-poisonous, as when he places a poisonous pill in a bottle of otherwise safe tablets. Judge Jeremiah Smith, in an oft quoted but nevertheless cogent and pertinent comment, shows that any distinction between damage caused by acts or words is purely contrived and artificial. The Judge says:

“If in handling a pen, I carelessly scratch my neighbour's face, I am liable to him for the damage thus done. If, with the same pen, I write a letter to my neighbour making statements not true in fact, whose untruth would have been known to me, if I had used reasonable care, and my neighbour is induced (as I intended he should be) to peril his fortune in reliance on my statements, why should he be denied a remedy against me in cases of financial ruin?”

In his famous dissent in Candler v. Crane, Christmas & Co., Denning L. J. limits liability for negligent misstatement causing financial loss to those who provide advice in their professional capacity. They should not be responsible only to those who pay their wages, but also to those, such as investors, who rely on their advice. This view will be particularly crucial to the question discussed below as to whether stock salesmen are to be categorized by the law as ‘professionals’.

There are a number of theories which justify recovery, some on the basis of various degrees of special relationships or proximity short of contract. The foreseeability that a certain class of people will suffer harm; the view that imposing liability will deter careless misstatement; a dependancy relationship, that is, when the representor has more expertise and access to the relevant facts than the other party; and the advantage that the defendant gains as a result of the plaintiff acting on or relying on his misrepresentation.

Derry v. Peek in seeking to protect the ‘overenthusiastic’ stock promoter, and avoid liability for economic loss for negligent or innocent misrepresentation, imposed a scienter requirement. We shall see that the

18 Liability for Negligent Language, 14 Har. L. Rev. 184 at p. 190 (1901).
19 supra. n. 12, at 184.
21 supra. n. 3.
groundwork for the liberalization of the definition of common law fraud in
the U.S. Securities Act of 1933, and Securities Exchange Act of 1934, lay
in the American development of the law, which veered decisively and sharply
away from Derry v. Peek,22 a case which asserted that an honest belief in the
veracity of the false statement is a defence in a deceit action. We shall see
that this movement to neutralize the Derry v. Peek doctrine represented a step
on the road to strict liability in many respects similar to what occurred in
the law of products liability. In a remarkably prescient statement, Professor
Shulman said,

"Once the policy questions as to the objectives of the Act (1933 Securities Act)
are answered, there is little in the civil liability provisions, which, in a less scientific
and less systematic manner, could not or would not have been quietly developed
over a period of years by courts on the basis of their own common-law
precedents."23

While we are about to draw an analogy to a conceptual development with
regard to the Sale of Goods, the relationship between the Sale of Goods
Statutes and the sale of securities laws should be noted. The Ontario Sale of
Goods Act in the definition section, clearly excludes 'things in action' from the
category of 'goods'.24 Since this Legislation represents the codification of the
common law up to the time of its enactment, there is nothing to say that the
common law principles of contract and warranty are not relevant to Securities
as well, where applicable. With regard to the American Sales Acts, Professor
Loss indicates that it is not clear whether securities are "goods" under the
Uniform Sales Act. The Uniform Commercial Code explicitly excludes
"investment securities and things in action" from the term "goods".25 How-
ever, the draftsmen were reluctant to exclude goods without qualification. Thus,
the above quoted section is followed by the comment:

"It is not intended by this exclusion, however, to prevent the application of a
particular section of this Article by analogy to securities, when the reason of
that section makes such application sensible and the situation involved is not
covered by the Article of this Act dealing specifically with such securities."26

THE PROGRESSION TOWARDS STRICT LIABILITY IN TORT

We said above that warranty and misrepresentation were originally part
of the tort of deceit. In accordance with Levi's explanation showing how the
"dangerous goods" concept was used as a kind of cover to allow for the
development of a theory of recovery for defective goods in the absence of
privity or direct contractual relations,27 we see how contract, implied warranty,
and tort, duty of care, were completely divorced. In Winterbottom v. Wright28
the defendant who suffered injury couldn't recover in contract from the

22 supra. n. 3.
23 Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 225, 253 (1933).
24 R.S.O. 1960 ch. 358, l(1)(g).
25 s. 2-105 (1).
26 UCC—1957 Official Text with Comments 45-46; cited in Loss, Securities Regu-
carriage maker because he made the contract with his employer and not with
him. The case leaves the implication that a suit in tort might have succeeded.
The conclusion in Levi's progression is *MacPherson v. Buick*\(^{29}\) where, by
the sleight of the hand of expanding the "inherently dangerous" category,
recovery was allowed despite lack of privity in the case of "dangerously
made" objects. Judge Cardozo, in effect, merged warranty and tort in order
to allow recovery. He thus initiated a process which reached its culmination
with the strict liability in tort doctrine of cases such as *Daniel Santor v. A and
M Karagheusian, Inc.*\(^{30}\)

The Court in *Corvan N. Sams v. Ezy-Way Foodliner Co.*,\(^{31}\) found that
the plaintiff had a cause of action against a retailer on an implied warranty
theory for injury suffered from glass in hot dogs, even though purchased from
the retailer in a sealed package. The common law had little difficulty in
formulating this 'strict liability' doctrine in the case of personal injury from a
defect in food. In this instance of implied warranty it is as though the
retailer is innocently asserting the wholesomeness of his food products. This
could be described as an example of innocent misrepresentation for which
the plaintiff recovers on a combined warranty-tort theory.

The plaintiff in *Randy Knitwear Inc. v. American Cyanamid Co.*,\(^{32}\) recovers from the manufacturer, in an action for breach of express warranty,
for economic loss, in the absence of direct contractual relations with him and
despite a disclaimer from the retailer. This decision was based on a policy of
protecting the public from injury or pecuniary loss when a manufacturer
represents his product as having certain qualities, and the purchaser is induced
to buy these products in reliance on these assurances. Here the representations
were express. In *Daniel Santor v. A and M Karagheusian, Inc.*,\(^{33}\) the plaintiff
recovered for his economic loss in the absence of direct contractual relations
with the manufacturer and despite the fact that there were no express
representations on tags accompanying the goods as in the *Randy Knitwear*
case. Here the court reviews the various cases which struggled to define a
basis for recovery in the non-contractual relations cases, and reviews such
theories as implied warranty and constructive warranty. Finally the judge
decides that it is best not to rely on a 'formal' or technical approach, and
instead decides to ground the decision on public policy, and calls it strict
liability in tort, because in the modern economy, when consumers rely on
the manufacturer, he is responsible for quality and fitness by virtue of placing
the goods in the stream of commerce. We have thus come full circle. War-
 ranty was separated from tort and, in this case, the two were finally merged
in a new garb. It is as though the law said to warranty, to paraphrase a

\(^{29}\) 217 N.Y., 382, 111 N.E. 1050 (1916).

\(^{30}\) 44 N.J. 52, 207 A2d 305, (1965).

\(^{31}\) 170 A. 2d 160 (1961).

\(^{32}\) 181 N.E. 2d 399 (1962) The above discussed cases, beginning with footnote 31,
relating to warranty and tort, are collected with other relevant cases and articles, in,
Contractual Basis of Sale: Product Quality and Contractual Obligations, p. 112 ff.

\(^{33}\) supra. n. 30.
Biblical phrase, "From tort art thou, and unto tort shalt thou return". And, it is as though liberalities of each have served to cure the deficiencies of the other.

To recover in tort it is not necessary to show a contractual relationship to the extent that it is obviously essential in warranty, and one is not limited by the requirement to give notice. As Dean Prosser said, "The Sales Act limited warranties expressly to 'buyer' and 'seller' and limited their scope. It required notice of the breach of the warranty within a reasonable time after the buyer knew, or ought to have known, of the breach." 34 It also made the warranty subject to disclaimer by the seller. 35

At the same time, warranty imparts to the tort character the advantage of strict liability, eliminating the need to prove fault. Professor Kessler says:

"Finally, to give the injured party the best of all possible worlds, the tort character of responsibility for quality was often emphasized, encouraged by the happy circumstance that warranty liability had never lost its tort character altogether." 36

We would suggest that a similar progression of development towards strict liability took place in relation to misrepresentation in the law of Securities Sales and that it is in these terms that we can understand the fraud provisions of the U.S. Securities Act of 1933 and the Securities Exchange Act of 1934.

We shall thus examine the American movement towards strict liability in the area of sales representations, with particular emphasis on their ramifications in the specific area of securities sales. We shall then examine the particular 'fraud' rules in the Securities Exchange Act of 1934 and thus learn how the legislative solution codified and went beyond the Common Law in the area of investor protection.

We have seen the classical form of fraudulent misrepresentation expounded in Derry v. Peek 37 and that is confined to a case where the seller is well aware that his statement is false. Then the courts, to escape from this limiting doctrine, started to qualify it. It is not necessary for the speaker to know that the misstatement is false before he is liable. As long as he himself simply isn't convinced of its truth it is fraudulent. When the speaker doesn't know whether the statement is true or false he may still be liable for misrepresentation, because once he affirms a certain fact, that constitutes a clear assertion that what he says is indeed true.

Furthermore, when one makes a false statement believing in its truth, and its truth could have been ascertained, he is also liable. 38

Thus we have intentional misrepresentation and negligent misrepresentation. The American Courts also staked out a strict liability area for

34 cf. The Sale of Goods Act supra. n. 25, s. 34.
35 The Sale of Goods Act, supra. n. 24, s. 53.
36 Kessler, Products Liability, 76 Yale L.J. 887, 899, 900 see esp. n. 68 (1967).
37 supra. n. 3.
In Haddock v. Osmer, 153 N.Y. 604, 47 N.E. 923-924 (1897) the court says that even where he believes the statement to be true, as long as he made it to induce one to act upon it, and he acts upon it to his detriment, then it is actionable.
misrepresentation, even where it was honestly made and where reasonable care is not a defense. In *Chatham Furnace Co. v. Moffat*, where the seller of a mineral lease misrepresented the amount of ore in the mine, the Court said:

"Liability is imposed irrespective of fault because it is felt that in view of the relation of the parties and the nature of the misrepresentations the speaker ought not to be permitted to profit by the mutual mistake since the plaintiff's erroneous belief was inspired by the defendant's misstatements."

The law reserves its greatest measure of strictness for the instance where the speaker is in a position which gives him almost exclusive access to the facts, and where his statement carries with it such a pretense of authority so as to neutralize any psychological resistance to the sales talk which would otherwise be forthcoming. This is in the case of a professional who is expected to exhibit the competence which he professes.

While, admittedly, the plaintiff can't expect complete infallibility of judgment, he has a right to expect "a reasonable degree of competency in the formulation of an opinion and in the care with which the data upon which the judgment is based have been collected".

The professional, by virtue of providing advice in the course of his business, holds himself out to the public as one who has the normal qualifications and the degree of competence that one should expect of one who offers his services to the public. Anything less than the normal degree of skill, competence and care in the representations he makes to the public, makes him liable for his misrepresentations, regardless of the fact that they may be honest or innocent. The plaintiff is not required to bear the risk of unreasonable error in judgment.

Judge Cardozo said in *Ultramares v. Touche*:

"There is a class of cases where a person within whose special province it lay to know a particular fact, has given an erroneous answer to an inquiry made with regard to it by a person desirous of ascertaining the fact for the purpose of determining his course accordingly, and has been held bound to make good the assurance he has given."

In this case, however, Judge Cardozo refrained from making the accountant liable to a remote or 'indeterminate' third party for negligently prepared financial statements, whereas he would if it were construed as fraudulently prepared.

There is a second category which imparts a strict warranty type of liability to representations, which emerges from the professional assertion of skill and competence. This is where one speaks, in a business transaction, conveying an air of certainty of knowledge, which, by force of conviction, induces the other party to act on the representation. "The speaker speaks at his peril. The risk of falsity is his. He must guarantee the truth of the

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39 147 Mass. 403, 18 N.E. 168 (1888).
40 Harper and James, *supra*. n. 38 pp. 541, 546.
41 *supra*. n. 38 p. 550.
42 *supra*. n. 38 p. 550.
43 255 N.Y. 170, 183, 184, 174 N.E. 441, 466 (1931).
information which he gives". Thus, the insurance salesman who misrepresented the type of policy, and the seller who wrongly represented that the car was the latest model were liable. The same principle is apparent in the modern cases, where a vendor represented that a GMC truck was in first-class condition and suitable for vendee's purposes, and a salesman gave a positive assurance that the slip covers were washable.

We notice how, by this time, innocent misrepresentation has been assimilated into fraud, and that when one speaks with apparent authority, firmness and deliberateness, his words assume the aura of authority, similar to those spoken with the backing of professional authority, so as to induce justifiable reliance.

The concept of the special responsibility of a professional will be particularly helpful in arriving at a rationale for holding the representor responsible when he states an 'opinion' which induces action resulting in loss to the representee. The issue of the status of assertion of 'fact' versus 'opinion' is of special importance with regard to sales representations of those who offer securities. While they most certainly deal with factual material, much of their competence will be reflected in the manner in which they are able to distill a plethora of facts into a sound reasonable judgment or opinion.

Normally, courts did not rule that a seller's statements of opinion justified the buyer's reliance as distinct from statements of fact. In Squyres v. Christian we are told that "it is fundamental that fraud cannot be predicated upon what amounts to a mere expression of opinion". However, the general principle that statements of opinion are not actionable applies only when the parties are on an equal footing with respect to experience, knowledge and access to the facts. Thus

"...In the case of a professional adviser liability for fraud may be imposed upon him if he expresses to another who depends on him an opinion within the scope of his professional capacity which he knows not to be true... if made under such circumstances that the law must necessarily impute such knowledge to the party at the time he made it."61

44 supra. n. 38 p. 551.

The principle is clearly stated in Lerner v. Riverside Citrus Assn. 115 Cal. App. 2d 544; 252 p. 2d. 744, 746 (1953).

"If therefore, one asserts that a thing is true within his personal knowledge, or makes a statement as of his own knowledge, or makes such an absolute, unqualified and positive statement as implies knowledge on his part, when in fact he has no knowledge whether his assertion is true or false, and his statement proves to be false, he is culpable as if he had wilfully asserted that to be true which he knew to be false and is equally guilty of fraud."

The above cases are cited in Harper and James, supra. n. 38, 551, 552.

49 242 S.W. 2d 786, 789 (1951) cited in Harper and James supra. n. 38, 559, n. 3.


51 Squyres v. Christian, supra. fn. 49 at 790.
Gray, in a recent article, shows how American Law has, in the interests of consumer protection, narrowed the scope of opinion and broadened the category of promise or affirmation of fact. The Uniform Sales Act eliminated the need to find intention as a prerequisite to viewing the seller's representations as warranties. The requirements were reduced to, firstly, the affirmation of fact or promise of the kind that would induce people to buy, and the buyer's reliance on it. Then, according to the Uniform Commercial Code, as long as the statement or promise was "part of the basis of the bargain" it constituted an express warranty. Thus the realm of 'mere' opinion is reduced to a narrower range. For now a statement of opinion can be "part of the basis of the bargain", the only question being which opinion will so qualify.

This is a significant advance if applied to securities sales, where opinion, presumed to be well founded, is an important weapon in the salesman's arsenal. The problem now will be to determine which opinions will qualify as warranties and will consequently be subsumed under the 'basis of the bargain' test. By now it is at least clear that, with the passing of the clear cut delineation between fact and opinion, the cautious and elusive salesman can no longer preface his boldest factual statements with the term 'opinion' or 'estimate' and expect it thereby to fall in the 'mere opinion or puffing' category.

To give content to the 'basis of the bargain' approach, we must determine what criteria the courts employ to distinguish opinion from fact, or to give legal effect to a representation. Gray delineates three levels of interpretation of representations, each one more liberal than the previous one, in ascribing legal consequences to them.

When it is any word or affirmation of fact which the representing party expects the other to view as a factual statement instead of accepting it as a mere expression of opinion then it is a warranty. This appears to be a subjective test which however prevents the salesman from hiding behind a smokescreen of "opinion" or "estimate".

The next test, which Gray extrapolates from a Wisconsin case (White v. Stelloh) 51, a more objective one, asserts that when the buyer has an 'equal opportunity' to form his own opinion, then the seller's statement, carrying no comparatively superior authority, does not achieve the status of warranty. Gray refers to a Texas case for clarification, explaining the key factor to be "whether or not its (the statement of opinion's) correctness is a matter of

52 supra. n. 50.
53 supra. n. 50 p. 91.
54 As cited, in the Gray article, supra. n. 50 p. 92, n. 37:
"Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise." (Emphasis added) U.C.C. 2-313 (1) (a).
55 supra. n. 50. p. 93.
56 Gray, supra. n. 50 p. 95.
57 74 Wis. 435, 43 N.W. 99 (1899).
which either of the parties can judge as well as the other, upon which the buyer can and may reasonably be expected, in the exercise of ordinary diligence, to have formed his own opinion". And to further clarify, the court indicates that the seller's superior knowledge "in conjunction with the buyer's relative ignorance operates to make the slightest divergence from mere praise into representations of fact effective as warranty". Thus the special liability of professionals who hold themselves out to the public as experts. The representee's dependency relationship is crucial in ascribing a warranty effect to the words of the expert.

In citing Wedding v. Duncan Gray suggests a test even more liberal than the previous one, because it will apply even when the seller does not speak on the basis of any professional qualifications. This test does not depend on the opinion being based on the seller's expert knowledge as against the buyer's ignorance, but rather on the fact that the seller offers his opinion with an air of knowledgeable ability. This test affords even more protection to the buyer. Thus, it is not for the buyer to respond to any formal pretense to expertise on the part of the seller, but instead, merely to be impressed with the knowledgeable ability which that type of statement presumes. The courts, Gray shows, have applied this test with reasonableness. Where a seller said that a ladder was strong, and the buyer could examine it, the seller's statement was not held to be a warranty for, after all, the law cannot absolve a buyer from using common sense and his own powers of observation. The latter caveat however is not as applicable to the securities sale because, for the most part, the buyer may be considered as though 'in the dark' in this 'mysterious' and highly specialized area. Buying a stock is indeed different from buying a ladder.

The above-mentioned concepts can perhaps help us to rationalize some of the aspects of the perplexing case of Oscar Chess, Ltd. v. Williams where the seller, a private individual, was not held to have given a warranty when he told the buyer, an automobile dealer, that the car was a model of a particular year when, in reality, it was not and he himself did not know that it was not. We can better understand Denning L. J.'s reasoning because, in this instance, the professional ability and access to the facts were on the buyer's side, and the buyer would in fact know better how to verify the model year. Thus, the statement of the 'ignorant' seller is an innocent misrepresentation and he is not liable. It is not a warranty. Furthermore, the 'basis of the bargain' approach, which is essentially the reasoning of the dissenting judgment, provides the most equitable solution to the buyer.

To further illustrate the expanding perimeter of liability for intentional, negligent, honest or innocent misrepresentation, the American cases have

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58 Gray, supra. n. 50 p. 96.
59 Ibid n. 58.
60 310 Ky. 374, 220 S.W. 2d 574 (1949).
61 supra. n. 50 p. 95, 96.
63 Suggested by Professor William A. W. Nielson, Lecture 6, Commercial Law, Osgoode Hall Law School, September 17, 1968.
tended to give legal weight to the professional seller's statements, even in the face of the buyer's opportunities to investigate his statements.

Harper and James describe an earlier tendency in the American cases that asserted a laissez-faire principle to the effect that the buyer cannot be protected from his own naivete, and that the law should assume his ability to exercise a requisite degree of business caution. The result would be that if he loses in a business deal he has nobody else but himself to blame. We should, however, note that to substantiate this, the authors refer to a real estate transaction case, where we can assume that both vendee and vendor are normally equally matched in terms of resources. Whereas, in securities sales, for example, an unsophisticated investor is usually pitted against an experienced broker or salesman, who has all of the advantages of securities research resources at his disposal.

Harper and James conclude that this original placing of responsibility to beware on the buyer's shoulders has been modified, so that "the plaintiff's neglect to follow what is supposed to be reasonable business practice and to take ordinary precautions" will not prove fatal to an action based on the defendant's fraud as well as to his innocently made representations.

It has been held that even where the plaintiff could have determined the true facts on the basis of a reasonable search, the defendant cannot employ this fact as a defence. Where the plaintiff purchased stock, with defendant officers and stockholder misrepresenting that the corporation was solvent, the fact that the purchaser had an opportunity to inspect the books of the corporation was not a defense.

64 supra. n. 38 at p. 553.
65 supra. n. 38, p. 533, note 4.
66 supra. n. 38 p. 544.
67 Harper and James, supra. n. 38 p. 554 n. 7 for substantiation.

In a more modern case we are told, that "Plaintiff's right to recover damages cannot be defeated by a showing that the plaintiff by making an independent investigation could have ascertained the falsity of the representations . . . even honesty in making a mistake is no defense . . ." Lanning v. Sprague, 71 Idaho 138, 143, 227 p. 347, 350 (1941) And, " . . . it has long been settled that representations are considered to be fraudulent if made by one who 'either knows them to be false, or else, not knowing asserts them to be true' . . . The recipient in a business transaction of a fraudulent misrepresentation of fact is justified in relying on its truth although he might have ascertained the falsity of the representation had he made an investigation." Fausett & Co., Inc. v. Bullard, 217 Ark. 176, 179-180, 229 S.W. 2d 490, 491-492 (1950).

Furthermore, even when the misrepresentor is motivated by the highest ideals of humanity, and is convinced that he is making the representation to benefit the representee, he is still liable for the results. Here, the American courts follow the principle of an old English decision, Smith v. Chadwick 9 A.C. 187, 201, where the defendant was held liable in deceit though he believed he was doing the plaintiff a kindness in tricking the plaintiff to buy the shares. Roome v. Sonora Petroleum Co. 111 Kan. 633, 635, 208 Pac. 255, 256 supra. footnote 38, 532. As long as he intends action on his misrepresentation, though he not only does not intend harm to the other person, but does not stand to gain as a result of the action, he is yet liable. Harper and James refer to the Restatement of Torts 531 Comment b, which says that when A, believing his brother an overcautious investor, persuades him to buy a security which he herself holds, the fact that A's motive is to benefit his brother, without gaining anything himself, he is nevertheless liable for misrepresentation.
SECURITIES SALESMEN'S REPRESENTATIONS AND THE U.S. ANTI-FRAUD STATUTES

A highpoint in this progression towards strict warranty liability was the passage of the U.S. Securities Act, 1933 (SA) and the Securities Exchange Act of 1934 (SEA) with its anti-fraud provisions together with the rules subsequently promulgated to implement the statutes. The Securities Act 1933 sections, refer primarily to the preparation of the prospectus, while the Securities Exchange Act 1934 deals with the distribution of the securities.

We shall see that SEA Rule 10b-5, promulgated by the authority of SEA s. 10(b), has the broadest and strictest application of all the anti-fraud sections and rules. The text of the rule with its three sections is as follows:

Rule 10b-5 Employment of Manipulative and Deceptive Devices. 69

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,
(1) to employ any device, scheme or artifice to defraud
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

To illustrate briefly the relative effectiveness of Rule 10b-5 as an embracing weapon in the hands of a plaintiff we shall compare its coverage with that of Rule 15c1-2, promulgated under SEA s. 15 (c) (1). The SEA Rule 15c1-2 is directed to a broker or dealer, that is one who effects transactions in the over-the-counter market. 70 While Rule 10b-5 includes Stock Exchange transactions as well, SEA 10b-5 refers to "any facility of any national securities exchange". Rule 15c1-2 gives the wrongdoer the most protection, by predicating liability on his knowledge or reasonable ground to believe that his statement is untrue or misleading. SEA Rule 15c1-2 (b) includes the defense . . . "which statement or omission is made with knowledge or reasonable ground to believe that it is untrue or misleading". Thus, a form of scienter and a shifting of the burden of proof to the plaintiff. 71 A literal reading of Rule 10b-5 shows no statutory defences available and clause

69 The importance of the Rule 10b-5 jurisprudence is underscored by the numerous articles that have been spawned by its judicial extension, most particularly in recent years. For a comprehensive bibliography of these articles, cf. Bromberg, infra n. 72, Appendix H, p. 340 ff.

70 Section 15 of the S.E.A., headed "Over-the-Counter Markets", applies to 'broker-dealers' that is, members of the National Association of Securities Dealers, as opposed to those who execute securities transactions on the registered Stock Exchanges.

1. of this rule does not appear in Rule 15c1-2 altogether, while in other respects the texts are similar. As indicated above, Rule 15c1-2 refers to a transaction with a broker-dealer, whereas Rule 10b-5 is directed to 'any person'. It was meant to include purchase of securities where it involves fraud and thus has been employed in actions against insiders who 'fraudulently' purchase from shareholders. In view of the rule's application to insider transactions, it is apparent that this Rule has abolished any semblance of a privity requirement:

"(If privity were applied) it would allow a corporation whose stock is issued publicly to make misrepresentations concerning the stock without any fear of liability so long as its stock was only sold to the public by underwriters or others. Such a rule would ignore the realities of the public securities market and such was certainly not the intention of Congress."

Furthermore, clause three of Rule 10b-5 requires only that the misrepresentation be "in connection with" the purchase or sale. Thus, in the operation of this Rule, we need not be concerned with whether a representation is a term of the contract, and with formulating an artificial construct such as collateral contract, to justify recovery.

While Rule 10b-5 was designed to protect the seller, it has been applied to buyers as well. Professor Bromberg concludes that there was "an absorption into 10b-5 of most of the general anti-fraud provisions (of the Securities Act, 1933 and the Securities Exchange Act, 1934) and a number of the special ones". The courts have found an implied civil liability in Rule 10b-5 under a number of theories: among them Statutory Tort, which says that when a statute is designed to protect a certain person and that person suffers injury as a result of the violation of the statute, he is entitled to recover damages. Thus, "of course, the legislature may withhold from parties injured the right to recover damages arising by reason of violation of a statute but the right is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very plainly and clearly".

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72 "The new rule (10b-5) closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942).


75 supra. n. 71, 2.5 (1), p. 100.

76 Karden v. National Gypsum Co. 69 F. Supp. 512, 514 (1946). In other cases relating to provisions of the SEA 1934, the courts find a private right of recovery, based on the policy of the act which is to protect the investor. With regard to a different provision of the SEA, we find ... "One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public ... If these aims are to be followed by the Act, then if the investing public is to be completely and effectively protected 6 (b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges." Baird v. Franklin, 141 F. 2d 238, 244-245 (1944). For a discussion of these and other theories, see Bromberg, supra. n. 71, 2.4 (1)-2.4 (3) pp. 27-39.
Included in Rule 10b-5 are, firstly, affirmative misrepresentations, that is, when the defendant makes a material representation which is patently false. For example, a representation that a corporation's affairs were being managed by someone who was not the true manager, was a material misrepresentation under similar language in section 12 (2) of SA 1933.77 Secondly, half-truths: that is, where the defendant makes a true statement but omits to mention material facts which, in context, would make his statement misleading. For example, where a defendant-seller allegedly omitted mention of outstanding mortgages on corporate property in his estimation of profits and rate of return to a plaintiff-buyer.78 Thirdly, complete omission, where the defendant fails to state material facts which would influence the plaintiff in his action. For example, where a seller of securities in the open market made no mention of inside information regarding a dividend cut, which would assure the subsequent decrease of the value of the stock upon announcement.79

Since 10b-5 does not include the defense allowed in 15c1-2 we can assume that the former was intended to assert a strict liability principle. Thus, the matter of proving the plaintiff's case is simplified because it is frequently difficult for the plaintiff to prove intent or failure to make a reasonable search, in view of the fact that he must prove it from the mouth of a hostile witness. The American Legislative solution to the problem of sharp, glib and ingenious salesmanship is clearly designed to move beyond the common law definitions of fraud and deceit.

"10b-5 greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentations and deceit, the requirements of privity, proof of specific damage..."80

Thus we have statutory enactment of a strict liability standard.

Though not a case of a broker's sale, Ellis v. Carter81 illustrates the strict construction view of SEA (Securities Exchange Act 1934) 10b and Rule 10b-5 that the courts have generally taken. The Plaintiff claimed that he bought the Republic Pictures stock from the defendants in a private sale at a price higher than the market price and that the sellers fraudulently represented that this stock carried a voice in management when it didn't. The defendants claimed that he must ultimately prove genuine fraud, as distinct from "a mere misstatement or omission," paraphrasing clause two of Rule 10b-5, thus claiming that this prohibition against material misstatements and half-truths, without the use of fraud or scienter language is an improper implementation of the original statute 10b. Thus they would challenge the SEC's formulation of the rule implementing 10b, in its strictest form, in clause 2 with its clear strict liability assertion. The Court emphatically supports the rule saying that it is a logical extension and within the terms of "any manipulative device or

77 Murphy v. Cady, 30 F. Supp. 455 (1939).
78 Royal Air Properties, Inc. v. Smith, 312 F. 2d 210 (9th Cir. 1960).
80 Hooper v. Mountain States Securities Corp., 282 F. 2d 195, 201 (5th Cir. 1960).
81 291 F. 2d 270 (9th Cir. 1961).
contrivance” of SEA s.10(b) which is the source of the Commission’s mandate to prescribe rules and regulations under this particular category. The judgment says it would have been difficult to frame the Commission’s authority in broader terms. The court, with reference to clause 3 of Rule 10b-5, says that any deceptive devices or contrivances “of whatever kind may be forbidden”. “Had Congress intended to limit this authority to regulations prescribing common-law fraud it would probably have said so.” Stevens v. Vowell follows this case and formulates the principle this way:

“It is not necessary to allege or prove common law fraud to make out a case under the statute and rule (10(b) and 10b-5). It is only necessary to prove one of the prohibited actions such as the material misstatements of fact or the omission to state a material fact.”

Since the Supreme Court has not spoken on Rule 10b-5 we will have to examine a decision of that court on a similar misrepresentation section which is included in the Investment Advisers Act.

The SEC v. Capital Gains Research Bureau dealt with an investment advisory service which would purchase a security in advance of recommending it in its publication and, immediately following the recommendation, and a resultant price increase on the basis of the subscribers’ purchases for the long term as suggested by the service, the service would sell for a profit. The high court reversed two lower courts in granting the SEC an injunction to stop publication of the service unless it includes a notice of this practice, known as ‘scalping’, in order that the subscribers be informed. The respondents (defendants) argued that nondisclosure was not specifically included in the Investment Advisers Act (omission of a clause analogous to clause 2 of 10b-5), as it was in the Securities Act of 1933, and that their advice to the subscribers was given honestly and that their recommendations were sound and were not offered with a view to personal gain. Mr. Justice Goldberg rejects these con-

82 Ibid., 274.
83 343 F. 2d 374, 379 (10th Cir. 1965).
84 Bromberg, supra. n. 71, 1.3(2), p. 10.
85 Investment Advisers Act, 1940, Sec. 206.
87 It should be noted that because of the Constitutional separation of powers between the federal and provincial governments, the Ontario Securities Act, 1966, includes no embracing anti-fraud provision similar to SEA s. 10(b) and Rule 10b-5. Because of the predominant jurisdiction of the federal government in the field of criminal legislation, an anti-fraud provision in a provincial Securities Act might be challenged as being ultra vires. For a discussion of the Constitutional issue in relation to the criminal law problem in securities legislation, cf. J. Peter Williamson, Supplement to Securities Regulation in Canada, Ch. VI, p. 181 ff., esp. pp. 208-212. The Porter Report recommendation for the establishment of a Federal Securities Agency, would go a long way towards filling the apparent gap with reference to effective anti-fraud laws. Cf. Report of the Royal Commission On Banking And Finance, pp. 348, 349, 355; (1964).
intentions by arguing that the statute employs equitable categories in granting relief in the face of non-disclosure or misrepresentation, which are equated in equity. When Congress enjoined any practice which operates "as a fraud or deceit" upon a client it "did not intend to require proof of intent to injure and actual injury to the client". The judgment cites from a text on equity, "Fraud has broader meaning in equity (than at law) and intention to defraud or to misrepresent is not a necessary element".

The underlying reasoning of this decision is based on providing for the protection of the client, who should have the opportunity to evaluate the disinterestedness of the one who recommends the security and, to further the dispensation of unbiased investment advice, without the colouring of conflict of interest. We then have a clear instance where the Supreme Court overcomes the barrier of the absence of a clause (2) type of nondisclosure provision in order to grant the SEC an injunction to force the respondent to disclose its practice of taking advantage of the market effect of its own stock recommendation, which in effect means that it must terminate the practise because very few subscribers will want to retain such an advisory service. The Court had little difficulty in finding for the SEC even in the absence of not only intent to injure but in the absence of evidence of actual injury or loss to any of the subscribers as a result of this practise.

THE SECURITIES SALESMAN, THE SHINGLE THEORY AND IMPLIED WARRANTY OF PROFESSIONAL CONDUCT

We may gain an understanding of the heavy onus imposed on the salesman to properly inform the client when we examine the SEC administrative proceedings, and court decisions, in cases involving misrepresentations. A salesman sold convertible debentures to his clients, indicating that the issuer was a sound and prosperous company, when in fact it had never earned a profit and the offering was made to raise funds to meet current obligations. Though he made inquiries about the company they were held to be inadequate. In the case of a speculative issue, and where the clients are uninformed and stand in a dependency relationship to the salesman, he is responsible to obtain reliable and firsthand knowledge about the issuer.88

In another case89 we see a salesman, without adequate knowledge of the company, together with the failure to disclose adverse facts, making extravagant predictions of future price and as to the issuer's assets and prospects. Referring to a thirty-four cent stock, he said that it would "something like double and had the possibility of increasing to five or six dollars a share". Despite the fact that it was not a completely unqualified statement, because 'anything is possible', the Commission (SEC) called it a misleading statement and said,

"Predictions of substantial price increases within a relatively short period of time

with respect to a promotional and speculative security of an unseasoned company are a 'hallmark' of fraud and cannot be justified."

The Commission held that once the salesman had made favourable mention of the company, he had an overriding duty to mention the negative factors, such as that the company had an operating loss for the last few years. This would be an example of the omission to state a material fact in clause two of Rule 10b-5.

The salesman had mentioned to some customers that the stock was 'speculative' but this was inadequate and could not excuse the misleading predictions. Furthermore, the fact that the customers could afford the risk was not a factor, because the law is designed not only to protect poor widows.

Miller then claimed that he had no prior experience in the securities business and that he had worked at it part-time for only less than a year and that this should excuse any modicum of naivete about the issuer which he might have exhibited.

The Commission retorted with a principle based on professional responsibility. In essence, as long as he holds himself out to the public as a securities salesman, this in itself carries with it an implication that he is prepared to deal with clients competently. Those who deal with him have every right to rely on his expertise and integrity.

"The protection from fraud to which investors are entitled can't be dissipated by claims of naivete or gullibility on the part of those who hold themselves out as professionals with specialized knowledge and skill and undertake to furnish guidance but nevertheless participate in a high-pressure campaign, to sell speculative securities."90

This is a variation of a basic theme that the SEC has inferred and extrapolated from the anti-fraud provisions of the Securities Act, known as the "shingle theory". This theory has been extended so as to increase the area of a broker's liability. Heller explains the view of Manuel F. Cohen, the former Chairman of the U.S. Securities and Exchange Commission, as follows: "The theory is that when a broker-dealer goes into business he \textit{impliedly warrants} that he will deal fairly with customers in accordance with the standards of the profession as they then exist".91 While Chairman Cohen's adoption of an 'implied warranty' concept may appear to be casual it does substantiate the theory that the anti-fraud regulations represent a codification of the strict liability of warranty with regard to the representations of the securities salesman. Mr. Cohen would thus predicate the warranty on the basis of a combination of professionalism, expertise and honesty which a broker asserts simply by acting as a broker. This is why, in broker misrepresentation cases, the plaintiff or the Commission need not even point to specific statements which induce reliance. The wearing of the professional mantle of a 'broker' is sufficient to induce it without the necessity of analyzing each statement

90 supra. n. 89. 82,852.
separately to find customer reliance. This is why in the Miller case the Commission says, “Moreover, it is unnecessary to show that respondents' customers in fact relied on the representations in order to establish violations of the anti-fraud provisions”.

Heller explains that the 'shingle theory' has been expanded to create rules of conduct for brokers with reference to their opinions and recommendations. He enumerates three requirements, citing from SEC adjudications. Firstly, the broker must make an adequate investigation of the company and its security. Secondly, he must explain to the customer the material facts upon which he bases his counsel. Thirdly, he must be prepared to provide the customer with adequate information. Thus, the 'shingle theory' is really the same as the assertion of a professional standard, which the SEC uses to, in effect, make the broker responsible for 'opinion' and even 'omission', no less than for a purely factual or statistical statement. This is in consonance with the discussion above, where we saw that opinion offered by a professional carries great weight and is viewed by the law as nothing less than a factual statement.

In a recent case, where the Securities and Exchange Commission suspended a salesman for six months from employment with a broker (the sanction was mitigated because he told a customer to cooperate with the Attorney-General's investigation), we see that the Commission unqualifiedly rejected a number of defenses; with the result of a very strict construction of the anti-fraud rules, particularly 10b-5 and S.A. 17(a). A broker, Bickart, had said that "Kent" had "terrific potential", was an "excellent buy", and that the stock would at least double in value. In reality, the company was in serious financial difficulty. Bickart mentioned that there would be profits in the near future, but failed to note the relevant element of the company's current economic adversity.

His factual representations were false, and at the very least misleading. His predictions had no reasonable basis.

The salesman contended that he did investigate the stock. It is true that he inquired of a financial service and spoke to other brokers and informants. But the Commission viewed the information obtained as inadequate. Thus, the requirement is that the investigation be solid and thorough.

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92 supra. n. 91.

93 It should be noted that Professor Shulman, in discussing the SA 1933 anti-fraud provisions, says that the plaintiff is not expected to prove reliance, and that this should be apparent because it is difficult to single out particular statements and to show exactly what impelled him to act as he did; additionally the plaintiff can easily make the claim that he relied, and, at any rate, the 'materiality' requirement should suffice, so that we could easily dispense with a showing of reliance. Shulman said this even before the passage of SEA 10b. Shulman, Civil liability and the Securities Act, 46 Yale Law Journal 227, 248-250, (1933).

94 Mundheim text, supra. n. 91.

95 With special reference to the Gray article, supra, n. 50.

The Commission referred to the principle it had established in previous cases, that predictions of a price rise of a speculative security within a short period of time are inherently fraudulent. It rejects the contention that a salesman’s statements as to future price are mere predictions and opinions and thus are not fraudulent.

The fact that the customers were experienced and aware of the risk does not absolve him from the responsibility to exercise care and caution in making predictions. This represents an advance from the position that the broker’s accountability was predicated on the fact that the customer was unsophisticated in this area. Here, the Commission appears to go further, and can be said to view any client as ‘uninformed’ compared to the broker who simply has more resources available to him than what the client could muster. We thus have another branch of the extension of the “shingle theory” which, as we have seen, has broad application and wide ramifications.

The salesman further argued that prior to his leaving the firm’s employ the customers still could have sold the stock without suffering a loss. The loss did not result until some time after the initial recommendations. The Commission would not accept this explanation, and said that his misrepresentations and omissions came within the categories of the fraud rules of the Securities Acts. Mr. Manuel Cohen, in a discussion on securities regulation, said that even if following misrepresentation in selling, the security rose in price, the broker was nevertheless liable. This is an expression of the deterrent function of regulation and also encompasses the cases where the stock may rally after initial recommendation, only to fall flat subsequently. The investor needs protection in the latter instances as well.

We shall now examine the case of a civil suit where a salesman induced a client, held by the court to be an investor with business sophistication, (we should be careful not to view him as a sophisticated investor, as did the court) to employ a specialized speculative approach. The Court arrived at a remarkable extension of the principle that an investor with a certain degree of knowledgeability is not protected from a salesman’s misleading representations or, as in this case, from his material omissions.

Bocock had dealt with Pearce, the salesman, in buying and selling shares of Clevite, a company that acquired the manufacturing concern which Bocock had founded. The Plaintiff was not familiar with short selling, and at one point Pearce suggested it to him, saying that he should try it. After a while, when the plaintiff became pessimistic about Clevite’s prospects, he followed Pearce’s advice and sold short 8100 shares. Eventually the stock rose and the firm had to ‘buy him in’ at a loss of $13,000. The Plaintiff claimed that

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97 Mundheim, editor, supra, n. 91, p. 83.
98 It would be a mistake to assume that high-pressure salesmanship in the securities field is limited to the small broker-dealer firms. Cf. Report of The Special Study of Securities Markets, p. 280 ff. (1963), for an account of the heavy promotion and sale of ‘defective’ merchandise to unsuspecting clients, on the part of a large New York Stock Exchange member firm.
Pearce told him that if he put up 100% of the value of the stock, at the time, he would not have to put up any more money. Of course, that is not so, because if the stock rises a short seller must at a certain point, deposit money to maintain it at a certain margin level.

The Court did find that the salesman initiated him in short selling and induced the sale; that he should have explained to him that his potential loss was limitless unless he entered a stop-loss order at a specific limit, that is, so that, for example, in the event of a five point rally the stock will be bought in and his loss will be limited to that amount. But, since the plaintiff had demonstrated his financial acumen in the formation and successful management of his own company, and had profitably engaged in the sale of stock on previous occasions, he was suitable and prudent enough to engage in a short sale of 8100 shares of Clevite. This was then, not a dependency relation between broker and client. Thus, the holding that there was no fraud in the defendant's procurement of the short sale. The Court considered such factors as plaintiff's age, education, intelligence, business experience, familiarity with stock transactions.

Here we can discern the difference between the SEC adjudications, where the Commission would not allow the defendant to use the argument that the clients were knowledgeable and experienced in business, and were aware of the risks. Here the judge seems to lack an elementary familiarity with the nature of the transaction he was evaluating, or perhaps the plaintiff's lawyers failed to articulate the issues in this case.

Firstly, experience in business has no carryover or transference to a specialized trading technique such as short selling. One cannot say that the experience of buying and selling a few hundred shares of one stock, provides the requisite professionalism to indulge in massive short selling operations. It is relevant to ask who are the individuals who engage in short selling? In 1961, 83 per cent of all short selling was done by members of the Exchange and only 17 per cent by the trading public.\(^{100}\) It is simply too risky for the public.

Secondly, since Pearce was initiating him in this area he had the duty to provide him with the requisite cautionary principles. A basic text on investment warns, "In picking stocks for short sale it is wise to choose those with poor prospects and paying little or no dividends. Avoid stocks that are closely held or companies which have only a limited number of shares outstanding".\(^{101}\) The reasons for avoiding dividend paying stocks for short sales, is because dividends indicate quality, and because the short seller is liable to pay them to the one from whom he borrowed the stock to sell short. Clevite has a record of having paid cash dividends each year since 1922! Pearce should have checked the investment manuals to inform himself and his client on this fact. Furthermore, adding to the risk factor in the case of Clevite is the fact that it is considered a 'thin' issue with only 1,900,000 shares outstanding,

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which is very small for a listed stock where, for example, General Motors has close to 300,000,000 common shares outstanding. Since it has a small capitalization, movements either way tend to be extreme. This makes Clevite inordinately risky for purposes of selling short.

Any good broker should be aware of these facts and is clearly obligated and expected to communicate them to his client, particularly when he is a neophyte in this area. This is an example where clause 2 of Rule 10b-5, regarding omission to state a material fact, should be invoked. The client must be able to depend on the broker to tell the whole truth instead of half-truths. The above-mentioned factors that Pearce omitted to mention to the plaintiff are those which even a sophisticated businessman would not be expected to consider or be attuned to investigate. 102

We have seen the strict liability principle of the anti-fraud statutes applied to the actual selling situations in the course of examining adjudications before the Securities and Exchange Commission. We have also noted reasons for strict liability in terms of the "shingle theory", the inequivalence between buyer and seller with reference to access to resource materials and information, and the high degree of responsibility that professional standing entails. We have seen, in some instances, the ease with which the sharp, glib tongues of fast-talking salesmen have broken down the barriers of sales-resistance of the public in order to sell questionable wares.

POLICY CONSIDERATIONS UNDERLYING A STRICT STANDARD IN THE LAW OF SALESMA N S’ REPRESENTATIONS

The foreword to a booklet entitled "The Work of the Securities and Exchange Commission" explains, "Securities are by their very nature much different from almost any other type of 'merchandise' for which there are established public markets. A person who wishes to purchase a new car or household appliance...can pretty well determine from personal inspection the quality of the product and the reasonableness of the price in relation to other competing products. But this is not so with respect to a bond or a share of a stock". 103

It is indeed true that the extent of potential loss that a gullible investor will suffer at the hands of an unscrupulous securities salesman may stagger the imagination. The salesman might give him ill-considered advice, covering up his lack of knowledge about the securities he recommends with a smoke-screen of self-assurance. The investor may follow his advice for a long time until he realizes that he has put his trust in the wrong man. By that time, however, he has probably lost a large sum of money. In a recent book, "Wiped Out", an investor tells the sad story of how his resources declined from $62,000 in October 1957 to $297.78 in May 1964, during one of the most impressive

102 The Court, supra. n. 99, also held that the plaintiff waited too long to repudiate the transaction. It is clear from the Court's reasoning that even if the plaintiff had repudiated promptly, the Court would not have decided otherwise.
bull markets in history. He changed brokers a number of times, but in each instance, only after the passage of time had told him that he had lost a considerable sum of money. While the theme of this book appears sensational, the story, as recounted, appears entirely plausible. The same story with minor variations is probably occurring again, today, in many instances. Few investors, however, are sufficiently candid or humble to tell about it.

The investor may even be counselled to sell short a stock which has great appreciation potential. His loss can thus be infinite, clearly even more than the price of the stock itself. Whereas, when one buys a car and finds that it is not what it is "cracked-up" to be, he may lose a portion only of the $4,000 purchase price. However, as the many cases against automobile dealers testify, it is amazing how easily people may be misled even when they have the opportunity to view the goods or the item being purchased.

When we realize the amount of distortion and sharp dealing that finds its way into the sale of goods, despite the fact that we are dealing with tangibles, we can well imagine the greater opportunity for fraudulent dealings when we are concerned with intangibles, where the average person is somewhat 'in the dark'.

We must concede that the quest for bargains traps people into bad 'deals' in the sale of goods. Yet greed and the desire for quick profits, more effectively ensnares the stock investor and serves to make him a ready victim for the subtle salesman who manipulates the 'something-for-nothing' syndrome. The Special Study refers to strident advertisements by some NYSE member firms, such as, firm X "reviews a farm equipment maker whose 1961 earnings should double and an agricultural chemical company with the promise of a later earnings 'explosion'". The Special Study criticizes these approaches to sales because of their "unrestrained appeal to gambling instincts and because they can fan the flames of such speculations as existed in 1961". We note that the above-mentioned advertisement, criticized by the Special Study, appears more conservative than some of the oral representations we found in the SEC adjudications.

We shall examine some of the policy considerations which motivated the U.S. Congress to enact comprehensive anti-fraud legislation. It should be noted that the same policy reasons are operative in the case of the capital-hungry Canadian securities markets, which must be managed in a way that fosters public confidence in their integrity.

The dependency theory has been articulated by those actively involved in the passage of the SEA legislation in the U.S. Congress. Representative Rayburn said,

"As a complex society so diffuses and differentiates the financial interests of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a

105 Woods v. Borstel (1962) 34 D.L.R. (2d) 68, where the buyer thought he was buying a 1959 Thunderbird, when in reality it was a 1958 model.
condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. 107

In one of the securities fraud cases, we find a very clear and unequivocal policy statement, "... the policy of the federal securities laws is to protect investors, including the uninformed, the ignorant and the gullible". 108 This view represents a reaction against the laissez-faire view which averred that we cannot save people from their own folly and ignorance.

A statement by President Roosevelt in a special Presidential Message, 109 adds to our understanding of the social policy behind this legislation. He condemned the fact that "outside the field of legitimate investment naked speculation has been made far too alluring and far too easy for those who could and those who could not afford to gamble".

This was an expression of the feeling current at that time, that speculation, the inflation of share prices, with the attendant "bust" or "break" was a contributing factor in the 1929 market crash and the general demoralization of the economy. This concern persists even in the 1960's because the Special Study was initiated as a result of concern over uninformed speculation particularly in the New-Issues market. 110 The Special Study, in discussing the basic issues, tries to relate the regulatory failings to the 1962 market break. To permit unscrupulous salesmen free reign to promote low-quality issues will detract from investment in the deserving, good quality equities. Firstly, those who suffer heavy losses in the gambling arena will be loath to return to the market at all, and the unfavourable publicity places all the securities, including those that merit serious attention, under a pall of suspicion. The stock market, as a sensitive barometer of the growth of American industry and technological genius, must be retained in its pristine purity, so that it will give an accurate reading of the state of the economy. When the gambling virus infects the markets, the sensitive apparatus goes awry, and the needle may start pointing down, even while the economy is soaring upwards. 111

When the market points precipitously downwards, new industrial investment is deferred and consumer enthusiasm is dampened. Thus, it is in the overall public interest that the markets be firmly regulated, so that speculative excesses, and misrepresentations of salesmen, not cause a lack of confidence in the security markets and in their integrity and veracity. 112

108 Surowitz v. Hilton Hotels Corp. 342 F. 2d 596 (7th Cir. 1965).
109 February 9, 1934, quoted in the article cited in n. 107.
111 This, is what occurred during the 1962 market break, when the economy in fact started a new phase of growth, while the stock averages were plummeting.
112 Clear expression of this in S.E.A. 2 (4) "National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."
The second inference we may make from President Roosevelt’s statement, is based on an understanding of the significance of the distinction he makes between investing and gambling. It is apparent that President Roosevelt uses the term “naked speculation” as an equivalent to “gambling”. To understand the distinction between investing and gambling we must first clarify the distinction between speculation and gambling. The latter two are frequently interchanged, and without justification. The gambler knows nothing in a substantial sense, about what he is buying. He is shooting darts in the dark, with a hope that ‘lady luck’ will guide his dart so that it will hit the bull’s-eye. In the case of an intelligent speculator, he knows, for example, that when he invests in an infant industry, he is assuming a certain degree of risk. He is aware of the pros and cons of the investment and simply feels that the pros outweigh the cons. He purchases the stock because his analysis of the factors indicates that there is a good chance, for example, that management will create a market for the new product and that it will meet with consumer acceptance. He carefully weighs the odds for and against. The only difference between investment and speculation is the degree of risk that the stock purchaser is willing to assume. The investor will seek out the companies that have a long record of earning profits and paying dividends, and will choose his investments on the basis of minimizing risk to the narrowest degree possible.

It is important to stress that the investor and speculator both purchase for the long term. The investor is participating in the long term growth of the country and the upward trend of the economy. He will sell when the security becomes grossly overvalued, or when there is some radical change in the fortunes of the company or the industry. The speculator too must hold for the long term, which is usually a minimum of two years, because that is frequently how long it takes for the factors and processes of growth, which he has analyzed intelligently, to come to fruition. For example, it will take time to produce and distribute the new product and for the stock market to anticipate and discount the newly developing factors in the company. However, in the case of a gambling operation one buys the stock in order to sell it as soon as possible, preferably within the week. This is commonly known as ‘trading’. One may trade with investment grade stocks when they are bought, not on the basis of informed security analysis but because of a tip, hunch or ‘good tape action’, for the sake of selling to make a quick profit. The stock salesman who misrepresents, and is responsible for material omissions is encouraging a form of activity known as gambling but euphemistically called ‘trading’. Gambling requires no material information about a company’s earnings, progress and so on. In fact, the gambler says, ‘don’t confuse me with the facts’. The underlying strata of policy justifying the strict liability framework of the anti-fraud regulations, is an unconscious and unarticulated goal of restricting trading or gambling activity. Thus we perceive two of the goals of the anti-fraud legislation, deterrence and compensation for the innocent victim. President Roosevelt’s statement shows concern for those who gamble but cannot afford it. In deterring sales trickery and misstatements, we are

[113 Cf. Graham, Dodd and Cottle, Security Analysis 1962, Ch. 4, pp. 47-58 for discussion of investment as reducing risk.]
preventing gambling losses, discouraging a deleterious pattern of behaviour, helping to “insure the maintenance of fair and honest markets”114 and preventing the demoralization of securities markets.

With this explanation we will realize that a particular concern about securities regulation expressed by Harry Heller, appears to have little basis in fact.115 Heller explains that at common law, as long as the seller explained all the material facts with no significant omissions, he was free to present predictions and opinions. In the case of speculative securities (loosely defined to include ‘gambling’), the SEC has set a higher standard and will not allow predictions and opinions, that is, anything other than completely factual statements. The Commission fears that such opinions will be based on enthusiasm and optimism alone. He surmises that the reason for this limitation is that newly organized companies do not provide an opportunity for analysis because of insufficient history and, in fact, they usually operate at a loss in the early years. However, he hopes that no limitations will be imposed in the selling of seasoned securities where the salesman should feel free to use the past performance of the company as a guide to predictions and opinions. Heller suggests that this is the principle behind the Commission’s strictures on opinion and prediction with reference to speculative securities. He reasons this way to avoid the conclusions that limitations should be placed on the selling of seasoned issues. I would suggest that the reason is not precisely as Heller avers. One can indeed analyze a speculative security on the basis of, for example, evaluating management, the adequacy of the capital structure, the demand for the product and the nature of the competition; and even on the basis of a determination as to whether the operating losses are in a descending or ascending trend. The SEC merely wants the salesman to encourage intelligent speculation based on analysis rather than on fond hopes. The SEC wants to discourage, and even deter, uninformed speculation, which is nothing more than gambling. The salesman can not present factual material and then say that the company should earn two dollars a share next year, and four dollars in 1970, and that the stock will therefore double within the next few weeks. However, he may say, to give an example of a well-balanced sales talk, that despite the fact that there is a great deal of risk in buying shares of a young company — since the management has “such and such” qualities, and the company has a strong cash position (and substantiates on the basis of financial reports), and the manufacturing facilities are favourably located providing access to ready markets — the stock merits consideration as a long term (he must may this, since there is no such entity as a short term speculation, because that is, by definition, gambling. It takes time for these factors to materialize.) speculative purchase. There is no reason for the SEC not to expect this same type of well-reasoned presentation in the case of an investment grade security. The danger in the case of an investment grade stock, is that the salesman may present some bare facts, but then place his stress on rash opinions and predictions with a sales talk designed to encourage purchase of the stock on a short-term trading basis.

114 SEA 1934 s.2.
He is then in the realm of pure conjecture and is involving his client in a short-term transaction which is, in effect, a gambling operation. Thus a salesman can use a high-grade security to involve his customer in a trading operation. Therefore, the rash predictions and flamboyant opinions should be curbed in the case of investment type securities no less than in the case of speculative shares.

The system of salesman's compensation, however, subverts the goals of the SEC. With rare exceptions, the salesman is compensated on a commission basis, which militates in favour of motivating the salesman to encourage gambling instead of investing. Since the salesman is paid a commission on the sale as well as on the purchase of a stock it is, from an economic viewpoint, best for him to encourage a transaction where the aim is to sell within a short period of time and to have the client continue to 'turn over' his capital in numerous transactions. To urge investment or intelligent speculation would entail fewer transactions. Thus many brokers will encourage the 'trading' and allow a client to sell in a short time, even on a small profit, without explaining the hazards that by law of averages, the client must confront the possibility of a losing 'trade'. And the losses can be substantial, so that taking small profits is not adequate to protect against potential large losses. When a client buys an investment or speculative security to hold for a long period of time, the salesman will lose out on a commission basis, because the funds invested are tied up and the client may not have the resources to proceed with additional buying. Furthermore, the minimum commission schedule of the N.Y.S.E. and the N.A.S.D. (National Association of Security Dealers) makes the purchase of low priced speculative securities far more profitable for the salesman than that of the higher priced better quality stocks. For example, if a client invests $5000 to buy 10,000 shares of a stock, the commission is $300, while if he uses the same $5000 to buy 100 shares of a stock, the commission is $44.116

One sometimes wonders whether the legislators and regulators aren't merely shadow boxing with peripheral issues while failing to grapple with the basic issues. We shall deal with some of the problems created by the commission structure below.

The book *Wiped Out*,117 which tells how a trader lost over $61,000 in the market over a seven-year period of trading in listed issues, is eloquent testimony to the hazards of trading which few brokers bother to explain to their clients. The author concludes with a word of advice,118 which is to "put your money into a conservative mutual fund or let a cautious broker pick out a portfolio of unimpeachable quality", which means, in essence, to be an investor rather than a gambler. He says that he wishes someone had given him this advice, but concludes that he probably would not have taken it because "cupidity is seldom circumspect".

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116 N.Y.S.E. Commission schedule. The same bias exists in The Toronto Stock Exchange minimum commission schedule.
117 supra. n. 104.
118 supra. n. 104, p. 124.
In explaining why he followed the advice of brokers, though their advice led only to losses, he explains, with reference to the broker, "He is the expert. Yet investors shouldn't be oversold by insistent brokers. I was so eager to follow their direction because they held out promises of great and easy wealth". And, "It is very hard for an investor to resist the advice of the 'expert' who is his broker. You always ask yourself, 'What can I know, I, who am only an outsider reading the newspapers, when he reads countless financial journals, converses daily with other brokers and analysts, has his company's experts and managers to advise him?'." This individual viewed the brokers he dealt with as experts offering professional advice but, instead of receiving that, he was led down the path of gambling, with its inevitable results. Also, note the image of the broker created in the mind of a member of the public.

THE SECURITIES SALESMAN: 'PROFESSIONAL' OR 'HUCKSTER'?

Against this background it's interesting to analyze the reaction of Heller, to the concept that the SEC compels the brokerage community to adopt the image of professionalism with reference to controlling the Registered Representative's representations and encouraging adherence to a strict construction of the 'suitability rule', that is, to the effect that the broker's recommendation must take into account the particular financial situation and unique needs of the individual client. In striking out against the SEC regulatory concept, Heller says,

“Basically the industry is a merchandising industry, and it's hard to consider it professional no matter how well qualified its personnel may be, because there is an ever present conflict of interest. This is true even in pure brokerage transactions. By stressing the idea of, living up to a professional image, the regulatory authorities may be doing a disservice to the investing public if that professional status is not there.”

It appears that Heller fears more for the exposed position of the salesman than for the public. Who deserves more commiseration — the salesman or the investing public? The Special Study reports a number of examples of unprofessional behaviour on the part of brokers. In one of the situations involving a widow, the broker called her one evening in June at 9:30 to tell her to sell everything because the market was going lower. The next day she came to the office, where he showed her charts to convince her that the market was about to decline, and he sold almost one-half million dollars of her blue-chip securities. That day the market rallied fifteen points! The widow said, "this man truly frightened me to death". The widow, with regard to her husband's estate, was clearly an investor, but he treated her as a 'gambler' and since he 'guessed' the market was headed downward, probably convinced her she would be able to repurchase the securities at a lower point. As long as the securities are of good quality and the company's prospects have not deteriorated, the investor should not sell on the basis of a guess as to the current short

120 Mundheim, editor, supra. n. 91, p. 100.
121 Supra. n. 106, Part 1, pp. 270, 271.
term direction of the market. At the very least, even a gambler would hedge and sell part. But he would not sell everything at one time. It is important to note that this transaction was effected by a broker in one of the “large firms”. The Special Study explains, “On the basis of field complaints it would appear that the trusting widow who is taken advantage of by her securities salesman is no mere figment of fiction nor a figure of a bygone era”. These types of occurrences ought to give Mr. Heller cause to wonder on whom the “dis-service” is being perpetrated.

When it suits their purpose brokers like to claim they are merely innocent merchandisers. In reality, though, what do they believe to be their true identity? In the trade journal addressed to those in the securities industry, the publisher in an article, “The Challenge of Professionalism”, tells the brokers,

“Judgment and suitability form a considerable part of knowledge, a part of knowing your business, knowing your customers, being aware of customer needs, and being informed of appropriate opportunities available. Knowledge properly directed and assimilated breeds integrity and professionalism. You may have a handful of professional traders who place orders and never ask for your advice. With these customers you function mainly as a standard-bearer for moral support. The average customer, however, considers you an enlightened professional, and demands competent advice based on your understanding of his situation. He expects conscientious and professional treatment. Be sure you are equipped to meet his demands.”

This is a clear statement as to how the industry views customer expectations.

This brings us to a basic issue which makes many of the discussions about the fine points of the regulation of sales representations almost peripheral. If the Registered Representative is a “hustler” like the automobile salesman, then it becomes difficult to apply the “shingle theory”, the “suitability requirement”, because regulation is then flying in the face of a system which militates against the care and thoroughness that the SEC would like to inculcate in the Registered Representative. If, on the other hand, the Registered Representative is a professional, then we may assume that he possesses a requisite degree of specialized knowledge and intensive preparation, and comports himself in accordance with the highest professional standards.

The Special Study tells that the executive of one large firm described a “professional” in the securities industry as “a dedicated man, a well-trained man, a man of highest intellect, a man of highest caliber, morally — then the man who puts the customer’s interest first”. Thus, in a conflict between earning commission and advising in accord with the customer’s best interests, the latter must come first. The two concepts, ‘professional’ and ‘super-salesman’, are clearly incompatible.

An examination of the techniques now employed, particularly by some of the larger brokerage houses, will indicate that many of them have opted in

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121A Ibid. p. 270.
favour of training the registered representative to employ a pure and simple ‘sales’ approach, while effectively discouraging him from functioning as a true professional adviser. At the same time, somewhat cynically, the brokerage firm often strives to create, in the mind of the public, the impression that the registered representative is a highly skilled adviser, groomed to counsel with the client. The securities salesman creates the appearance that he is involving himself in an investment operation requiring a degree of skill, instead of indiscriminately passing out cursory information about stocks as a race-horse buff would distribute guesses about the winner in the next race. A text on selling stocks, widely used in training programs, advises the salesman never to employ terms such as “play the market”, “inside tip”, “tout”, “gamble”; and to use the term “security” instead of “stock”, and “invest” instead of “speculate” because the latter terms connote “risk” which tends to frighten people, and will tend to compromise the image of the salesman. The paternalistic brokerage house research department, in essence, funnels to the registered representative its conclusions in the precise, simple terms which he is to employ in making recommendations to clients. The system is one whereby the registered representative is divested of any meaningful responsibility to engage in securities research, analysis, assessing suitability as well as exercising judgment in other relevant matters. This system leaves the registered representative bereft of any judgmental function, opportunity or incentive to engage in original and independent thinking.

Some of the large and prominent brokerage firms have devised methods whereby research assessments of various companies can be coded and categorized in simple terms and related to clients who are also coded and categorized. Though we are not overly concerned with the mechanics of the system’s operation, we will briefly describe a hypothetical system which is typical of some of those in operation. In order to function, the registered representative requires two files, one black and one white. The black file contains a one page description of each stock that has been recommended by the research department. This one page contains the current status of the recommendation, whether it is a ‘buy’, ‘hold’ or a ‘sell’. It is a very simple, superficial statement about the company, with everything that a salesman requires in order to ‘sell’ a stock over the telephone. In many instances he need only open his file to the appropriate sheet and merely read off the facts to the client, thereby posing as something of an investment genius. This single sheet, with its basic and simplified facts printed in bold easy to read type, is not to be seen by the client. A different version of the research report is mailed to the client as a follow-up. The single page is revised periodically, either when important new information becomes available or when the recommended action regarding the stock is changed by the research department. In the interim the registered representative may receive inter-office memos commenting on new developments affecting the company or reported by the company.

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The company reports or evaluations are divided into various categories of 'Basic Investment Objective', such as 'Income', 'Growth', 'Speculative' and 'Trading', with a designation in numerical or alphabetical terms for rating it in terms of various attributes. Each of the categories may be designated by being placed in a sub-file so that separate sub-files are maintained for securities that are suitable for 'Trading', 'Income', and so on.

The white file contains a page for the recording of each client's holdings with a one word description of his category, i.e., whether he is a 'Growth' or 'Speculative' account. The crucial operation in this system is the diagnosis, that is, to determine the client's category: This is usually accomplished by having the client complete a questionnaire form by answering a few simple questions which are designed to reveal whether his goals are in the area of 'investment', 'speculation', etc. Generally these tests are too cursory to indicate anything of significance about the client's proper investment objectives. This can only be accurately gauged through the medium of an interview conducted by a perceptive investment analyst. However, one may hypothesize that inviting the client to answer the questionnaire is designed to accomplish two subtle purposes, both for the benefit of the brokerage firm. Firstly, it makes the investor believe that the brokerage firm is highly professional and thorough, employing the latest methods for determining what is best for him. It also creates the impression that he is receiving individualized attention. The second reason is that if his investment objectives seem to be wrong in the context of a particular market phase, he will not have reason to blame the broker. If the market favours growth stocks over a period, the client will find it difficult to criticize his broker for advising him to purchase income stocks. For that was his own choice, and the fact that he filled out the questionnaire the way he did is proof positive that it was ultimately his own decision.

We have noted above that recommendations in the salesman's black file may be changed, for example, from 'buy' to 'sell', by means of inter-office communication. While the brokerage firm will circulate 'buy' recommendations in letters to clients, it seldom circulates the 'sell' recommendation in the form of a market letter to be mailed to the client. The Special Study has criticized brokerage firms for recommending stocks to buy without recommending sales. The Special Study explains that the firm fears that it will lose the management of the company recommended for sale as a source of information, and that it will lose potential underwriting business. There is an additional, reason to the effect that psychologically, if a client purchases a stock only to see it decline, he is not as perturbed as he might be for the reason that he is sufficiently optimistic to hope that if he holds it long enough it will 'come back'. However, when a client is advised by a broker, in writing, to sell a security, he tends to react negatively in the event that it rises following the sale. But, this is not completely fair to a client when the brokerage firm purports to undertake to keep his investments under surveillance. It is not enough to rely solely on oral communications from the registered representative. If the advice to purchase reached the client in a written publication prepared by the firm, this should be the case in the event of a 'sell' recommendation.

125 Supra. n. 106, Part 1, p. 348.
The role of the registered representative is reduced in essence to that of matching the designations of the companies in the black file with the corresponding one-word, over-simplified descriptions of the clients' objectives in the white file. Thus he does not function as an analyst or adviser. The research department feeds coded descriptions into the registered representative files, thereby treating him as a human computer who need only read from a simple script and juxtapose data and codes in his various files.

Since he is absolved from any creative research or advisory function, what is the registered representative expected to do with his time? The answer is, to operate as a 'salesman' in the fullest sense of the word and to concentrate on promotional activities. The brokerage firms are attempting to motivate their salesmen to use the hard-sell approach as they equip them, in the finest kindergarten style, with slogans that are designed to persuade and entice. The techniques used to sell soap, toothpaste and automobiles are being used to sell securities! This method, however, is wholly inappropriate in the case of securities, because investment decisions may involve the placement of thousands of dollars of people's money, and frequently determine the future financial security of many families and individuals. It is unfortunate that in this context, which calls for a serious and responsible approach, we have the spectacle of brokerage firms motivating salesmen to 'turn over a lot of money' by offering them colour TV sets, free trips to Bermuda, as well as honorable mention in the firm's newsletter, which brings pride and joy to the salesmen mentioned. Status in the office is used to manipulate salesmen, because those who do not receive awards or honorable mention are made to appear as though they belong to a lower order of humanity! In reality, it may be that those who fail to ring the bell of 'high commission production' are performing a more honest service for their clients, because their advice and counsel is not being coloured by an inordinate disproportionate desire to generate commission business.

There is ample reason to believe that the selection process, including interviews and psychological tests, is designed to attract the type of candidate for registered representative who will conform to the image of the promotion-minded salesman which brokerage firms tend to prefer. There is a premium in the testing process for a finding of competitiveness and aggressiveness, and such other qualities that are associated with salesmanship. Attributes such as independent thinking or creative talent are viewed as negative factors. The emphasis in hiring registered representatives is clearly on sales power over analytic ability.

We recall the above-mentioned conclusion that the principles of public policy, such as the protection of the customer, the inequivalence between buyer and seller as to availability of information, etc., impelled the progression towards strict liability in assessing salesmen's representations, and led to the passage of the anti-fraud provisions in the SEA, 1934. These very same policy considerations make it imperative that the regulatory bodies, such as the U.S. SEC and the Ontario Securities Commission, cope with this covert phenomenon of hucksterism and strident salesmanship which is infecting the industry, and which carries far-reaching implications. There is little doubt
about the importance of the *Special Study* as a report which carefully uncovers and documents many of the sales practices in the industry which are of scandalous and shocking proportions. However, the *Special Study* in its specific recommendations calls merely for a patchwork approach, a repair operation, in place of the complete overhaul which is really needed.

THE COMMISSION STRUCTURE AND SALESMAN COMPENSATION

The *Special Study* concerns itself with two aspects of the problems created by the fact that securities salesmen are compensated on the basis of a percentage of the commission business which they generate. As a consequence they are constantly under economic pressure to produce business, that is, to encourage and solicit orders to buy or sell stock, either transaction resulting in commission to the credit of the salesman. Secondly, there are significant variations in the percentage portion of the total commission granted to the salesman as well as the total commission produced by transactions of a similar dollar sum, depending on the nature of the transaction. For example, on a special distribution, or an underwriting, the salesman often receives as much as three times the compensation he would receive in executing a regular agency order for a listed stock. There are also incentives for those producing more than a certain amount of gross commission business a month. Upon reaching certain maximum levels the salesman's percentage of the commission is increased. The *Special Study* criticizes these practices and would eliminate the variations and incentives for higher production levels. The *Special Study*, however, does not deal with the problem resulting from the fact that the commission schedule provides a disproportionately larger brokerage fee for a lower price share than for a share of a higher price constituting a similar dollar amount.

It is indeed unfortunate that the *Special Study* in its recommendations accepts the compensation on the basis of commission as "inherent in the nature of the business" and would only deal with "particular aspects (which) may tend to introduce undue pressures or biases into the selling process".  

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126 Supra. n. 106, especially Part 1, pp. 47-330.

127 Even in the few instances where the brokerage firm claims to pay the registered representative a salary, that salary too is adjusted a few times a year, so that it comports with the commission business credited to the registered representative's account. It should be noted again that there is little difference between the practices regarding commissions, and the commission scales and biases, as between the New York Stock Exchange, and that of the Toronto Stock Exchange. While the rates are essentially the same, and the bias as between low price and high price shares exists in the commission schedules of both exchanges, there may be slight dollar differences in individual instances. However, the TSE generally follows the policy set by the NYSE.

128 Supra. n. 106, Part 1, pp.253-258, 330. The overall reduction in the salesman's compensation, referred to, below, footnotes 142, 143, is designed to heighten the incentives for high levels of production, at the expense of penalizing average production with generally lower percentage compensation. Cf. also, text accompanying n. 116.

STANDARDS FOR THE SELECTION AND TRAINING OF REGISTERED REPRESENTATIVES

In the U.S. the selection, training and supervision of the Registered Representatives has been left to the self-regulatory agencies — the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) — while the SEC itself has no legislative authorization for registration of salesmen in its own right and thus does not even maintain a file on the salesmen. The Special Study recommends improvement and refinement of the registration examination, which is now administered by the NASD. It suggests that this function be taken over by a Board of Securities Examiners established by the self-regulatory agencies, which means the NASD and the NYSE; and that the self-regulatory agencies exercise strict controls over selling activities with the assumption of a more direct role by the SEC.

It is important to note that the U.S. regulatory apparatus bears important consequences with respect to the Canadian securities markets. Many large U.S. brokerage firms hold seats on the Toronto Stock Exchange (TSE) and have established a large network of branch offices in Canada. There is also a trend in motion for large Canadian brokerage firms to acquire seats on the NYSE. It should be appreciated that in both instances all the registered representatives of these firms, including those working in Canadian branch offices, must comply with the NYSE regulatory requirements. Aside from this direct impact, the American system exerts an important influence on the Canadian pattern, because in recent years it has served as a pacesetter in the formulation of policy for Ontario.

We may say that, in general outline, the Ontario system operates as does the American. In Canada the Registered Representative, where the brokerage firm is a TSE member, must be approved by the TSE while the Investment Dealers' Association of Canada (IDAC) administers the educational requirements for registered representatives with its correspondence course known as the Canadian Securities Course. The requirement imposed by the Ontario Securities Act that securities salesmen register with the Securities Commission, represents something of a departure from the U.S. system which relies...
essentially on the self-regulatory authorities to process the applications and perform the registration function.\textsuperscript{136} Though the registration with the Ontario Securities Commission may only be viewed as salutary, in that it, at least, provides for a check of people named as references and an inquiry with the Ontario Provincial Police, in addition to an interview with the registrar of the Commission, this medium has not been used sufficiently to significantly raise standards of admission to the industry.\textsuperscript{137} This, in essence, is left to the self-regulatory bodies. However, the existence of this mechanism, built into the Ontario Securities Act could be employed as a means of strengthening admission standards and the assertion of a more active overseer role on the part of the OSC in place of reliance on the self-regulatory bodies. This possibility is especially apparent in view of the requirement in the Securities Act regulations to the effect that the registrant must apply for annual renewal of his registration\textsuperscript{138} and that his registration may be cancelled by the Commission.\textsuperscript{139} Thus the Ontario Securities Commission has the authority to play a more direct and active role in raising the standard and status of the registered representative within the existing legislative framework.

Our approach must be to question some of the assumptions that underlie the current system which have become sacrosanct. The industry clearly resents any degree of interference with its current mode of operations, and prefers to keep on doing things as they have been doing them heretofore. For example, we need only recall the strident protests when the U.S. Justice Department suggested that minimum fixed commissions may not be in accord with the anti-trust regulations. The members of the NYSE complained vociferously. It is indeed a spectacle to see these exponents of the free enterprise and competition "that made America great", threaten that the introduction of free enterprise in Wall Street's commission system would mean their exodus from the Exchange, and its demise. The Exchange member appears to favour governmental protection from competition in rate-making, while

\textsuperscript{136} The Ontario Securities Act, 1966, section 6, especially 6(1) (c).
\textsuperscript{138} Regulations Under the Securities Act, 1966 O. Reg. 101/67. s. 4 (3) (4).
\textsuperscript{139} Supra. n. 136, s. 8 (1).
extolling the virtues of free enterprise as it relates to giving the members and partners free rein to exploit\textsuperscript{140} the registered representatives.\textsuperscript{141}

A PROPOSAL

I would therefore make the following suggestions designed to enhance the dignity and professional standing of the Registered Representative. One must remember that a worker in a unionized factory has more status, higher standing, more independence than a Registered Representative simply because he has an organization designed to protect his interests.\textsuperscript{142} Yet securities salesmen, who during the course of a week may advise people with regard to hundreds and thousands of dollars of their life’s savings, do not even have the professional standing that would call for a strong organization with official recognition to speak for them.\textsuperscript{143} To achieve true professional standing, the Registered Representatives must have an officially recognized professional organization to set standards for admission to practice, set ethical and educational standards, and even organize a school to prepare candidates for the profession, as did the Law Society of Upper Canada in the case of Osgoode

\textsuperscript{140} During the course of the 1969-70 bear market, a number of prominent U.S. brokerage firms arbitrarily reduced the registered representative’s portion of the gross commission, from the usual 33\%\% to approximately 28\%. Wall Street Journal, January 12, 1970, “Chicago Brokers Study Unionization, Irked by Commission Cuts.” It is important to remember that the salesman is then expected to carry an additional burden during the currency of the bear market, in view of the fact that, since he is compensated on the basis of commissions, the decline in trading attendant upon a bear market, already causes him a severe loss of income.

\textsuperscript{141} A letter written to a New York Times reporter, by a sensitive registered representative, indicates the extent to which the registered representative is frequently dealt with unfairly and summarily by the brokerage firm partners. He explains, “Now that the back-office help is unionized the young partners drawing high salaries have turned on the R.R. to cut costs. He is helpless due to a lack of organization. In the current market (bear market) he is fearful that if he speaks out he will be liquidated.” He explains that the R.R. (registered representative) gets no paid vacations; and that the brokerage firm, which receives more than \% of the gross commissions produced by the R.R., compels the R.R. to pay his telephone bills “out of his net production”; “and there is an ‘arbitrary’ fine of $30 if a client fails to deliver stock or pay for it before a second extension of time.”

The pertinent point is that the R.R. “has a profound influence on his customer’s financial well being. An unhappy or harassed broker is probably less effective in behalf of his customers than one who is operating in a pleasant and constructive environment.” The New York Times, January 13, 1970, “Drop in Stocks Hurts a Broker.” Our conclusion would be that a harassed broker, may tend to be reckless in his advice to his clients, because of the increased pressure to produce commission business, against a background of a reduction in compensation in an inflationary period. The R.R. “estimates that under new commission schedules a broker will have to increase production by 20 to 25 per cent in 1970 to earn as much as he did in 1969 under the old schedules.”

\textsuperscript{142} The Association of Customer’s Brokers is a loose Association with no official status, and no relationship with the licensing of Brokers.

\textsuperscript{143} Because of recent developments regarding the compensation of R.R.’s, a number of American R.R.’s have felt impelled to attempt to form a union. In Detroit, Michigan, it was reported that, “A national Labour Relations Board official here ruled that registered securities salesmen have the right to form unions and bargain collectively with brokerage-house managements.” The Wall Street Journal, March 13, 1970, “Detroit NLRB Office Rules Stockbrokers Have Right to Join Union: Orders Election.”
Hall Law School. The Ontario legislation, The Solicitors Act and The Law Society Act provide official recognition to the Law Society as a body with authority to set the standards for the profession, educational and professional, and, similarly, the Medical Act delegates the authority to The College of Physicians and Surgeons to certify medical practitioners and to enforce the educational requirements.

In the present system, with NYSE and NASD making the rules under which Registered Representatives are trained, licensed and practice, it is really the members of these associations, namely the Registered Representatives' employers, who are making and enforcing the rules and they tend to do so in such a manner that will favour their particular interests, which frequently tend to be narrow. As long as it is in their interest to maintain the present method of compensating salesmen by commission, they will do so. As long as it is in their interest to allow for ease of entry into positions as salesmen, with only a brief six month training period designed primarily to teach the candidate to sell and to pass a relatively superficial examination, they will do so.

The suggested Registered Brokers' Association could be under the aegis of the SEC in the U.S. and the OSC in Ontario, while financed on the basis of specified formulae of compulsory contributions by the Exchange members and the NASD and IDAC members. Its first order of business would be to raise the ethical standards of applicants and members, and to organize a rigorous educational program based on a two year training program, with possible revision upward, in place of the current six month combined apprenticeship and training period. The Association would set up training schools in the large centers, and would allow for correspondence courses only in exceptional circumstances or hardship cases. The program would consist of training in political science, economics, business cycle theory, portfolio management, the legal background of estate and financial planning relevant to the jurisdiction where the candidate will practice, and intensive training in security analysis. The program would grant a degree such as R.F.A. (Registered Financial Analyst).

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144 R.S.O. 1960 Ch. 207.
145 R.S.O. 1960 Ch. 378.
145A Supra. n. 144.
146 R.S.O. 1960 Ch. 234.
147 These Statutes may to an extent be employed as models for giving statutory authority to a Registered Broker's Association.
148 The situation hardly differs in Ontario, despite s. 6 of the Ontario Securities Act, 1966. The TSE and IDAC, make policy in Canada, with probable prodding from the Ontario Securities Commission.
149 This is similar to the C.F.A., Chartered Financial Analyst, which is now offered on the basis of correspondence courses, to security analysts only. It would not be far fetched to suggest that a large University, such as York University in Toronto, with its vast educational resources, including a school of business and a law school, could set up a school for brokers, which could be comprised of a broad curriculum, including courses in business, economics and the relevant areas in law. For example, if brokers are to advise clients in areas relating to estate planning, let them at least receive a good survey course on estate planning and taxation.
This training would rapidly eliminate those who are not interested in applying themselves to proper preparation for a professional career in guiding and advising the public and who expect to 'get by' with a glib tongue and sales gimmickry. The Special Study indicates with reference to the current NASD exam that with an increase in the passing grade during the latter part of 1962 and part of 1963, the failure rate rose to 34.1% of those taking the exam. This is not a high rate, when one remembers that it includes an across-the-board population group, involving many who have not even finished high school, and many only aspiring to sell mutual funds. Furthermore, many of this 34.1% will have been granted an opportunity to repeat the exam a number of times. Thus, the present educational standard is relatively low. The new system will be designed to solve the ease of entry problem.

The suggested association will award the degree and license to practice, and when a brokerage firm requires new Registered Representatives it will have to apply to the Association. It will also have to show sufficient cause for firing a Registered Representative. This will mean that the Registered Representative will be able to function with a feeling of independence and will be secure in counselling the client in terms of the client's best interests without having to fear the firm's censure. He will not be easily pressured into selling a firm's underwriting if he feels it is not suitable for his particular clientele.

The Association will set the standards for the Registered Representative's working conditions, for example, requiring something more than the crowded working conditions in board rooms where the Registered Representatives are bunched together, not even providing adequate facilities for performing research duties. With the successful operation of this Association the brokerage firms would not be able to initiate their new policies designed to change the function of the Registered Representative and de-professionalize him without a semblance of dissent from those who are affected. With the support of the proposed organization, the Registered Representative will have the true pride that accompanies professional status.

Additionally, the system herein proposed, if administered efficiently, can even lower costs because it would remove the tasks of engaging and training of brokers from the hands of the firm's partners and managers, and centralize it where it can be handled more efficiently.

The problems created by the commission system are two-fold. Firstly, as indicated above, without the security of a salary the effect of compensation based on commission is to impose pressure on the Registered Representative to encourage his clients to constantly buy and sell stocks in order that he will simply earn his 'bread and butter'. Sometimes this may lead to 'churning', which is turning over the portfolio frequently, or even recommending unsuitable securities to his clients and other such unsavory

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150 Supra. n. 135.

151 A visit to many brokerage offices will convey the impression of crowded and inadequate working conditions, with the firms trying to extract the maximum in commissions out of the minimum in office space.
practices. Even if a firm will pay a base salary, the Registered Representative will not be able to operate with a feeling of relative security, because if he fails to generate sufficient commissions over a period of time, to enable his employer to earn a significant profit on his work, he will still be left with a pressure that may colour his buy and sell advice.

Secondly, the fact that the Registered Representative may be discussing portfolios with clients and offering evaluations of stocks means very little in terms of his income, because he is not financially compensated unless that advice results in buy or sell orders. Since he is paid ultimately, not principally for his advice, but for orders executed, he may find it more profitable, comparatively speaking, to concentrate on simply buying and selling, sometimes indiscriminately, in order to produce commissions. A compensation plan that fails to consider these two issues can not be viewed as grappling with the root of the problem, but merely with the symptoms. Additionally, the Registered Representative is paid on the basis of executing orders. The more he transacts the more he is paid. On a random basis his 'buying and selling' may succeed in satisfying 50% of his customers, and he may even suffer the loss of the other 50%, who become disenchanted customers because of poor results. The 'losers' will have suffered loss, while the Registered Representative may, from an economic point of view, remain indifferent to an extent, because he has, in the meantime, earned the commissions resulting from their transactions. He will merely have to solicit new clientele to make up the slack of the 50% of clients who have left him. Thus, the pressure that management places on the Registered Representative to strive to open many new accounts each month. For the abovementioned reason, management assumes that there will always be a significant turnover of customers. As a basis for discussions, I would like to suggest an entirely new system of compensation, designed to enhance the professional status of the Registered Representative, and to place a premium on his professional advice and competence.

The Registered Representative should be paid on a salary basis without regard to the amount of commission business he places. It should be considered a violation of the rules of the N.Y.S.E., the N.A.S.D., the O.S.C., T.S.E., I.D.A.C. and the proposed Registered Brokers Association, to adjust a salary in accordance with a Registered Representative's production of commission business. To answer the objection of employers, to the effect that it would be unfair to expect them to subsidize a Registered Representative who fails to 'bring in the business' we suggest the following plan. The commission schedule will be reduced from the current level by one-third or more, and the brokerage firms will be compensated on an 'advisory' basis. Thus they would be paid a fee for providing advice on portfolio analysis, and on advice on individual stocks, somewhat similar to the basis on which doctors and lawyers are paid consultation fees. This would eliminate the pressure on the Registered Representative to buy and sell; and would, despite the slight extra cost to the

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152 We are now discussing the salesman with enhanced training and capability in security analysis.
investor,\textsuperscript{153} constitute something of a gain, because he would be able to assume that the advice is not as biased in favour of producing commission business as is the case of the current system.

Sometimes it may be said that apparently ‘gratuitous’ advice is only worth what one pays for it. Under the proposed system, the Registered Representative would have an incentive to perform his research duties, keep abreast of new developments, and he himself would place a premium on the ‘advisory service’ that he offers to clients.

An additional suggestion in this context is in order, in view of our overall goal of investor protection. It should be noted that brokerage firms send monthly and quarterly statements to the client, indicating his stock position and his credit and debit balance.\textsuperscript{164} It is suggested that, every six months, a portfolio performance record should be appended to this statement. This would indicate at what price the client’s stocks were purchased, and what they are worth as of today, with a computation of percentage capital gain or capital loss, plus dividend income. This provision would be similar in principle, to what is known as the “truth in lending” provision of The Consumer Protection Act\textsuperscript{155} where disclosure of the true rate of interest, on a prescribed percentage basis, is required in the case of sales by itinerant sellers. The assumption we make is that the investor seldom stops to evaluate the performance of his investment on a total basis; that his selective memory impels him to only think about the one stock that has risen two points, but not about the ones that have declined ten points. Sometimes the Registered Representative helps to foster this process of self-delusion by only quoting the price of the “winner”, and allowing the investor to forget the “loser”.

Furthermore, few investors approach their investments on the basis of percentage gains or losses. Thus when a ten dollar stock declines by ‘only’ one point, that is a 10\% loss, while when a one hundred dollar stock declines five points, that is only a 5\% loss. The average investor would tend to be more discomfited by the latter than by the former. Thus, making the mailing of the ‘six month performance record’ mandatory will further the general principles which are the basis of securities regulation, that of investor protection through the medium of proper and adequate disclosure. There is ample precedent for this. For example, the N.Y.S.E. rules require that a confirmation of every transaction be mailed to the customer. It must be mailed to his home, and it is not normally permissible for the customer to collect it at the brokerage firm office.\textsuperscript{165} Further to this recommendation, I would suggest that at the end of a year (or perhaps even two years) or when the securities are sold, whichever comes sooner, that a small percentage charge be added to the client’s debit account on the basis of the capital appreciation of his portfolio, and that the charge increase progressively with the increase in capital gain. This will

\textsuperscript{153} He receives some compensation in the form of a lower commission rate.

\textsuperscript{154} NYSE Constitution and Rules, 2409; Rule 409 (a) to the effect that member firms are required to send out quarterly statements of account where there has been some change in the account during the preceding quarter.

\textsuperscript{155} Statutes of Ontario, 1966, Ch. 23, as amended by 1967, Ch. 13, sec. 22,23.

\textsuperscript{156} Supra. n. 154, 2411.20.
be in lieu of the one-third decrease in the current commission charge, which was suggested above. The customer will be satisfied to pay this charge, because he will be happy to benefit from a capital gain. The brokerage firm and the Registered Representative should share this charge on the basis of 50% for each. Thus an incentive to the Registered Representative to engage in sound research work, and to the firm to employ Registered Representatives who are more than simply salesmen who are casual about the loss of other people’s money. The result will be a raising of standards in the industry.

These new regulations and procedures could be effected in one of two ways. Either the OSC could encourage the TSE and IDAC to enact them into their rules, or the OSC could formulate them into legislation. The OSC could most likely persuade the self-regulatory organization to enact them because, in this manner, it would be accomplished through negotiations between them and the OSC, and thus they would feel that they could make it less onerous than it would be if they had to swallow the ‘bitter pill’ in the form of legislation.  

Though one may disagree with the various details in these proposals, they are all based on the same public policy principles which impelled the law to develop the approach of strict liability in the case of seller’s misrepresentations in the area of securities. Words are far more than innocent opinions, when a securities salesman is advising a client. Recommending and selling securities is a serious and highly specialized business which requires those who are selling to be professionals in security analysis rather than professionals in promotion and sales techniques. With the growing complexity of society and technology, and the increasing sophistication in the movements of security markets, it is incumbent on the investment industry and the regulatory bodies to provide the investor with the high level professional talent that is needed to advise people who are living in a busy word. For people rely on those who hold themselves out as experts. If, however, the securities sellers are mere amateurs with a little bit of sales polish then the result could be astronomical losses to the innocent and trusting investor. Society cannot wait! It is incumbent on our legal institutions to be in the forefront of inspiring reform to provide the investor with the protection he has every right to expect.

157 Similarly in the U.S., with regard to the SEC and the NYSE and NASD.