TO: Mr. Anthon H. Lund, Director

FROM: Olga M. Steig, Assistant Director

SUBJECT: Proposed Rule regarding fiduciary obligations of a broker or dealer

Following our original proposal for a market disclosure rule in July, 1942 the staff of the Division considered a number of other rules directed at particular problems. You undoubtedly recall that considerable time was spent in search for a solution of the riskless transaction problem. Similarly, much time was spent in trying to find means for curbing abuses on the part of brokers and dealers whose relationship with at least certain customers had most, if not all, of the charactertistics of a fiduciary relationship.

From February, 1943 to March, 1944, many drafts of the proposed rule applying to brokers and dealers in a fiduciary relationship with customers were considered. The first drafts contemplated a requirement that the firm act as agent in all transactions with customers to whom the relationship applied. We concluded later, however, that the proposed rule should require disclosure of adverse interest instead of requiring execution of orders on an agency basis. Our discussions concerning the proposed rule stemmed, of course, from information obtained from inspection reports and investigations, among them the Arleen Hughes situation. Early in 1945 Release No. 40 was issued under the Investment Advisers Act, and when later the Commission turned down the disclosure rule we abandoned further efforts on these particular rules.

However, now that the Arleen Hughes and the Norris & Hirshberg cases have been sustained by the Court of Appeals, I think further consideration must be given to a so-called fiduciary rule to be adopted under Section 15(c)(1) or under 15(c)(2). Attached is a proposed rule which follows the defining pattern of both Sections. In its present form it should be proposed only under Section 15(c)(1) although, if adopted, it should be accompanied by a Release setting forth the minimum disclosures which would be required (a) when a firm for its own account proposes to buy from or sell to a customer to whom it owes fiduciary duties and (b) when a firm, as agent for another person, proposes to buy from or sell to a customer to whom it owes fiduciary duties. The disclosures would include those which the court upheld in the Arleen Hughes case but it might be necessary also to mention others such as control of market (Norris & Hirshberg), control of the issuer (Rule X-15C1-5) participation in a distribution (Rule X-15C1-6) or in an accumulation of the particular security, etc.

If we should promulgate the rule under Section 15(c)(2), we should add to the definition specific provisions prescribed as "means reasonably designed to prevent" fraudulent practices defined in the rule. Thus we could under Section 15(c)(2) prescribe the minimum disclosures consistent with the Arleen Hughes, the Norris & Hirshberg case and existing rules.

On balance I would prefer to have the rule adopted merely as a definition of fraud under Section 15(c)(1) and interpret the rule in the light of particular facts and circumstances. That would provide greater flexibility, in my opinion.

It seems to me it is incumbent upon the Commission to adopt a rule which would embrace both the Arleen Hughes and the Norris & Hirshberg case now that the court has sustained the Commission in both.

Olga M. Steig
Assistant Director