St. John's Law Review

Volume 46
Number 3 *Volume 46, March 1972, Number 3*

Article 26

# Failure to Disclose Market-Making Is a 10(b) Violation (Chasins v. Smith, Barney & Co.,Inc.)

St. John's Law Review

to any applicable state statute of limitations and apply that statute. Since the alleged fraud occurred in New York, the court properly turned to the six-year period set forth in CPLR § 213(6).[24] Since CPLR § 213(6) contains a discovery rule,[25] it was necessary to apply CPLR § 203(f) as well.[26] Thus, if plaintiff had neither actual nor constructive notice of the fraud prior to the two years preceding the action, his claim under § 10(b) remained timely[27] even though some ten years had elapsed since the alleged fraud had been committed.

In finding against the plaintiff the district court had taken judicial notice of the fact that stock market quotations are published daily in various newspapers[28] and held that had the plaintiff been diligent, he could have discovered the fraud by examining these quotations on the relevant days.[29] The court of appeals disagreed and held that the defendants named were specialists in Superior Oil Stock and hence, could manipulate both prices on individual transactions and prices on multiple transactions over a period of several days. In short the plaintiff himself would have had to be a specialist in Superior Oil Stock in order to uncover the fraud. The issue of whether or not the plaintiff failed to exercise reasonable diligence in discovering the fraud is a question of fact, and, therefore, summary judgment was an inappropriate remedy.[30]

### Failure to Disclose Market-Making is a 10(b) Violation

In a recent action,[31] the Court of Appeals for the Second Circuit held that a failure to disclose market-making activity in an over-the-

[24] The New York CPLR provision for actual fraud is contained in § 213(g):

> the time within which the action must be commenced shall be computed from the time the plaintiff or the person under whom he claims discovered the fraud or could with reasonable diligence have discovered it.

N.Y. Civ. Prac. § 213(6) (McKinney 1972). For application of a state statute of limitations in a federal action, see Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

[25] The discovery rule allows a plaintiff additional time within which to bring his action if the wrong is not apparent at the time it is committed. N.Y. Civ. Prac. § 203(f) (McKinney 1972).

[26] CPLR section 203(f) applies to any and all statute of limitations which contain a discovery rule except for periods of limitation set forth in article 2 of the Uniform Commercial Code. CPLR § 203(f) provides:

> [W]here the time within which an action must be commenced is computed from the time when facts were discovered or from the time when facts could with reasonable diligence have been discovered, or from either of such times, the action must be commenced within two years after such actual or imputed discovery or within the period otherwise provided, computed from the time the cause of action accrued, whichever is longer.

N.Y. Civ. Prac. § 203(f) (McKinney 1963).

[27] 436 F.2d at 341.

[28] *See* W. Richardson, The Law of Evidence § 9 (9th ed. J. Prince 1964).

[29] 436 F.2d at 341.

[30] *Id.* at 341-42.

[31] Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167 (2d Cir. 1970).

counter market was a failure to disclose a material fact within the purview of section 10(b)[32] and Rule 10b-5[33] relating to manipulative and deceptive devices.

This action came to the Second Circuit as an appeal from a district court decision that Smith, Barney & Co. had violated rules 10b-5[34] and 15cl-4,[35] by failing to disclose to the plaintiff-appellee "that it was making a market in the securities it sold [plaintiff] in the over-the-counter market."[36] Plaintiff, at the time of the alleged violations, was a musical director of a local radio station which was sponsored by the defendant brokerage firm.[37] Four transactions occurred and plaintiff complained of all four. Apparently in each transaction, the defendant acted in a dual capacity of stockbroker and principal. Although the defendant disclosed its dual capacity in the confirmation slips which it sent to plaintiff, it never revealed its role as a market-maker in the stocks involved in the transactions.[38] The district court awarded the plaintiff $18,616.64 in damages. The amount was computed as the difference between the price at which the plaintiff purchased the secu-

---

32 *See* note 1 *supra.*

33 *See* note 2 *supra.*

34 17 C.F.R. § 240.10b-5 (1970) provides as follows:

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

35 17 C.F.R. § 240.15cl-4 (1970) provides:

Rule 15cl-4. Confirmation of Transactions.
The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker or dealer designed to effect with or for the account of a customer any transaction in, or to induce the purchase or sale by such customer of, any security . . . unless such broker or dealer, at or before the completion of each such transaction, gives or sends to such customer written notification disclosing (1) whether he is acting as a broker for such customer, as a dealer for his own account, as a broker for some other person, or as a broker for both such customer and some other person . . . .

36 17 C.F.R. § 240.17a-9(f) (1970) defines the term "market-making" as follows:

The term "market-maker" shall mean a dealer who, with respect to a particular security, holds himself out [by entering indications of interest in purchasing and selling in an inter-dealer quotations system or otherwise] as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.

See, LOESER, THE OVER-THE-COUNTER SECURITIES MARKET WHAT IT IS AND WHERE IT OPERATES 5-6 (1940).

37 According to the plaintiff, he chose the defendant for this reason, believing that he would get the best deal from them. 438 F.2d at 1169.

38 In fact, besides making-market for these stocks, the defendant also failed to disclose that it had acted as an underwriter for two of the companies in which it

rities from the defendant and the price at which he subsequently sold them before discovering the defendants were involved in market-making activities.

In attacking the decision of the district court, the defendant sought to show that its failure to disclose its market-making activity was not a violation of rule 10b-5 or 15cl-4 in that they did not fail to disclose a material fact and that the courts had never required disclosure of market-making although such a practice was widespread and notorious throughout the industry.[39] However, the Second Circuit, following the rule of *Opper v. Hancock Securities Corp.*,[40] rejected this contention and stated that

> even where a defendant is sucessful in showing that it has followed a customary course in the industry, the first litigation of such a practice is a proper occasion for its outlawry if it is in fact in violation.[41]

While it is true that in the normal circumstance, a market-maker with an inventory in a stock is the best source of the security,[42] that fact alone will not destroy the duty to disclose an otherwise material fact.[43] The issue was not whether the defendant sold at a fair price but rather whether disclosure might have influenced the plaintiff's decision to buy or not to buy. Had the plaintiff known of the defendant's role as a market-maker, this fact could very well have influenced plaintiff to act in a manner other than the way he acted. In any event, disclosure would have alerted the plaintiff to any adverse interests which the defendant

---

recommended the plaintiff invest. It also failed to disclose the amount it as principal paid for the securities. 438 F.2d at 1169-70.

39 438 F.2d at 1171.

40 250 F. Supp. 668, 676 (S.D.N.Y.), *aff'd*, 367 F.2d 157 (2d Cir. 1966).

41 438 F.2d at 1171. The court further recognized that in any event the defendant's contention was without merit since many authorities have stated that activities such as those conducted by the defendant should be disclosed to clients. *See, e.g.*, SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 1, at 385-86 (1963); CCH NASD MANUAL ¶ 2151, at 2016-17 (Sept. 1964).

42 In re Thomson & McKinnon, CCH FED. SEC. L. REP., ¶ 77,572, at 83, 203 (1967-69 SEC Rulings) (SEC brought this action to punish a brokerage firm for not acquiring the security from one who was making a market in the security, but rather going elsewhere to acquire the security for its client).

43 The test of materiality had plagued the courts for a number of years. However, recent significant decisions, such as Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), have clarified the concept of materiality to a great extent. It now appears that the test of materiality is ". . . whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968). A similar view was taken in *List* where the Second Circuit decided that a material fact is one, ". . . which in reasonable . . . contemplation might affect the value of . . . stock." 340 F.2d at 462.

might be projecting.[44] In such a case, the investor should be permitted to evaluate the total situation through appropriate disclosures.[45] The court of appeals concluded that

> in this situation, failure to inform the customer fully of its possible conflict of interest — in that it was a market-maker in the securities which it strongly recommended for purchase by him was an omission of material fact in violation of Rule 10b-5.[46]

The requisite reliance to be shown in a 10b-5 violation was self-evident here. The plaintiff clearly bought the stock upon defendant's recommendation, without any disclosure, and suffered a loss in their resale. The damages which were assessed were correct. In a 10b-5 violation, the innocent party is entitled to recover his damages resulting from the violation.[47] The court rejected the defendant's contention that the damages should only be the difference between the price the purchaser paid less the market price on the purchase date.[48] Perhaps one real problem with this case is that it was given a narrow application by the court which wished to limit the case to its set of facts.[49]

### Retraction of an Exchange Offer — No Compensable Losses

In an action for alleged misrepresentations by a corporation that it would honor an invitation to exchange stock, when in fact it never intended to do so but rather intended to sell certain assets in order to raise enough cash to redeem said stock, the court of appeals affirmed a district court order dismissing the action on the grounds that the

---

44 The defendant might have been caught in either a "short" or "long" position because of erroneous judgment as to supply and demand in a certain security. If the defendant were over-supplied, it would have been to its advantage to unload the stock. Under these circumstances, the defendant's motivations might affect the advice it gives to a client. The investor must be permitted to evaluate a broker's motivations. The only way to give the investor such notice is through appropriate disclosure. Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167, 1172 (2d Cir. 1970).

45 *Id.*

46 *Id.* The court went on to explain that it did not want to encroach on studies presently being conducted by the SEC as to the advisability and method of disclosing market making activities. They only went so far as to hold that in this case withholding information was a failure to disclose a material fact. *Id.*

47 *See*, J. I. Case Co. v. Borak, 377 U.S. 426 (1964).

48 438 F.2d at 1173:

> the evil is not the price at which Chasins bought but the fact of being induced to buy and invest for some future growth in these stocks without disclosure of Smith, Barney's interest. . . .

49 *Id.* at 1174 (Friendly, J., dissenting). The dissent was not as upset with the holding per se as it was with the retroactive effect accorded to rule 15c1-4, note 35 *supra*. The dissenters felt that in 1961, the time when the alleged violations took place, there was no requirement that one must disclose market-making activities. The dissent also felt that there was no basis to the finding that the plaintiff might not have bought the stocks had a disclosure been made. *Id.* at 1174-77.