GC:EWP

Gaylord D. Adsit, Esq.
First National Bank Building,
Long Beach, California.

Dear Sir:

Receipt is acknowledged of your letter of December 16, 1937, addressed to Miss Steig, together with a memorandum criticizing Rule MC4, which has been referred to me for reply.

At the outset I should like to state that I very much appreciate the time and trouble you have taken in formulating your criticism. It may well be that the present Rule MC4 does not achieve the object of that complete disclosure which is desirable for the protection of investors; the problem of drafting a more sweeping rule, which will at the same time be capable of practical administration, is receiving the attention and consideration of the Commission. The end which you urge is, therefore, the same which the Commission is seeking to attain and I would ask you to bear this fact in mind in reading what follows, for, as you will see, I am not able to agree with some of the details of your criticism and the statements and interpretations adduced in support thereof.

You fear that Rule MC4 may repudiate the rule established in Johnson v. Winslow, 279 N. Y. Sup. 147. In the first place, the MC Rules merely define devices or contrivances which are manipulative, deceptive, or otherwise fraudulent within the purview of Section 15(c) and Section 10(b) of the Securities Exchange Act of 1934, as amended; that statute, of course, does not take the place of or supersede existing law. In fact, Section 28(a) opens with the sentence;

> "The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity."

In the second place, it seems to me that the factual situation which brought about the decision in the Johnson Case contained elements which were not present in the personal situation which you have outlined; some of these elements were:

1. A letter from the defendant firm stated that its successor would conduct "a strictly commission business in stocks" and another letter in which confirmations of alleged purchases by the firm were enclosed stated that the securities had been "sold for your account". There was in the Johnson Case, therefore, a definitely established relationship and there was no reason for the customer to believe that such relationship had been changed.

2. The court stated that the defendants had the burden of proving that plaintiff knew that defendants had themselves bought her securities. Since the relationship existing between them was definitely established to be an agency relationship, it did not seem to the court that a confirmation which merely stated "We confirm purchase from you" gave the plaintiff the requisite knowledge. The court, however, intimated that if such wording as "We confirm purchase by ourselves from you" had been used, its view might have been different.

3. The firm in this case was also a pledgee and the court stated that it was well established that a pledgee had no authority to purchase the pledged property himself.

Furthermore, I cannot go quite as far as you do when you state that the customer should in every instance have the right of election as to the capacity in which the house with which he deals is to operate. Surely, this must be a matter of arrangement between the two parties rather than a matter of election on the part of either.

However, I agree with you most heartily as to the desirability of having the relationship as to each transaction clearly established before the transaction is effected. In order to draft a rule which would achieve this end, it would be essential that it be administrable from an evidentiary point of view. As you know, a great deal of business is transacted over the telephone or otherwise orally. Suppose in such case a house advised a customer that it was going to act as a broker and then confirmed a purchase as a dealer. If the customer sought to repudiate the transaction the "evidence" would merely consist of one man's word against another's, which I think you will agree would not be a satisfactory situation. On the other hand, it does not seem practical, in view of the manner in which much of the business is conducted, to require a written notification of the capacity the house will act in before entering into a contract for the purchase or sale of a security with or for a customer, similar to the requirement now prescribed in certain special situations by Rule MC5.

I should welcome any further suggestions which you may have and reiterate my appreciation of the stimulating communication which you have submitted.

Very truly yours,

For Allen E. Throop,
General Counsel:

Chester T. Lane,
Assistant General Counsel.

Encl: Securities Exchange Act

CC: Miss Steig
Mr. Purcell
Mr. Sherlock Davis

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