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## *Stock Broker's Liability Under Customs, Usages, and Rules*

Robert H. Jackson\*

OVER THE PAST FIFTEEN YEARS conspicuous growth and development has taken place in the securities field. In 1950 only 3,930 brokers and dealers<sup>1</sup> were registered with the Securities and Exchange Commission; one decade later, over 5,500 were registered.<sup>2</sup> Likewise, the number of customer's men registered with the National Association of Securities Dealers, Inc. increased from 28,794 in 1950 to over 100,000 by 1962. The number of securities issues effectively registered with the Securities and Exchange Commission increased from 400 in 1935 to over 15,000 by 1962, and dollar volume increased from several hundred million to nearly 20 billion during the same period. Public participation in the securities market reflects this expansion: "A study made by the New York Stock Exchange shows that during the period 1952-59, the number of shareholders doubled, and that, in the last three years of that period, the number increased by nearly one and one-third million a year."<sup>3</sup>

Prior to 1940 the authoritative courts throughout this country adjudicated numerous cases brought against stockbrokers by customers for a myriad of reasons. Since 1940, the rapid growth of stock market speculation has caused a profusion of violations by customer's men and brokers. Strangely enough, however, the number of reported cases has not been proportion-

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[The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.]

<sup>1</sup> Brokers act as agents for customers in attempts to execute their orders, while dealers act as principals in purchasing or selling stocks to customers for themselves. For the purpose of this article, reference to brokers will include dealers unless otherwise noted.

<sup>2</sup> Securities and Exchange Commission (SEC), 27th Annual Report 1 (1962).

<sup>3</sup> *Ibid* at 1.

ate to this expansion,<sup>4</sup> especially in light of what the Securities Exchange Commission said in its 27th Annual Report: <sup>5</sup> “. . . concomitantly with the influx of a large number of new and presumably inexperienced investors into the market, there has been an influx of new and inexperienced salesmen. At the same time, the increase in the number of branch offices has tended to result in less effective supervision of the salesmen. The problem of supervision is aggravated by the employment of part-time salesmen and salesmen who operate from their private residences.”

No conclusive explanation exists as to why proportionately fewer lawsuits are initiated. Perhaps, stockbrokers are unusually willing to settle any apparently valid complaints in an attempt to avoid adverse publicity. Conversely, an investor may not know the procedures regarding possible violation; and may not even be aware that a violation was committed. On the other hand, an investor, taking his complaints to an attorney, may unhappily discover that the attorney is not familiar with this area and, therefore, is not ordinarily successful against the stockbroker. Of course, there is a possibility that the standards of the industry are so high that fewer violations do exist. Then too, recent history has reflected that during a rising (bull) market in which investors generally profit, very few complaints are made by them. Yet, a declining (bear) market, creating losses, produces a rash of accusations by customers, some valid, but many fanciful. Whatever reasons are proffered, the fact remains that investors frequently lose money because of lack of knowledge on the part of an interested party.

Much of the confusion which now surrounds security market operations leading to eventual failure and loss might be avoided if the potential market investor were more thoroughly grounded in the fundamental characteristics, technicalities, and rules involved in a purchase and sale of such securities. It is therefore pertinent that all investors, whether experienced or not, learn and be apprised of the customs, usages, and rules of the broker-

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<sup>4</sup> Clarification of this statement will be found later in the article. Customers' men (registered representatives) are either agents or employees of brokers. Violations committed by them while in the course of their employment or agency will be imputed to their brokers. Thus, in most instances the broker will be responsible.

<sup>5</sup> SEC, *op. cit. supra* n. 2.

age houses, the over-the-counter market, the various national stock exchanges, and the state and federal laws.

The numerous customs, usages, and rules of the general law of securities, unfortunately, do not always present technical exactness. Even within the jurisdictions of Massachusetts and New York, from which by far the greatest proportion of decisions have come, clarity and consistency are not known. Each individual case must consequently be viewed to determine the patterns developed in the securities field. The evolution of customs, usages, and rules is presently in a maturing stage; this permits broad general doctrines but leaves many questions unsettled. The general principles should be known by investors and attorneys alike before stepping into the treacherous securities field.

Within the framework of this article, it is proposed to consider, in summary form, the doctrines of custom, usage, and rules frequently violated by stockbrokers.

## I

The terms "custom" and "usage" are frequently used synonymously. Usage, in its narrowest sense, is a uniform course of conduct and practice, in some particular business, of which contracting parties have knowledge, either actual or imputed, and which is implied to be incorporated into the terms of a contract. On the other hand, a custom is "such a usage as by common consent and uniform practice has become the law of the place, or of the subject-matter to which it relates."<sup>6</sup> Usage consists of a repetition of acts; customs arise out of this repetition. Custom is the thing to be proved; usage is the evidence of it.<sup>7</sup> The courts will take judicial notice of a custom when properly established as the equivalent of law.<sup>8</sup>

Contracts are often affected by custom and usage. "The usage of business is never permitted to make an entire or new contract for the parties."<sup>9</sup> Either usage or custom may supply the omis-

<sup>6</sup> 1 Bouvier's Law Dictionary 742 (3rd rev. 1914).

<sup>7</sup> 55 Am. Jur. 266. "Usages and Customs."

<sup>8</sup> Eames v. H. B. Clafin Co., 239 F. 631 (2d Cir. 1917); Caslistoge Vineyard v. Luchetti, 72 Cal. App. 605, 18 P. 2d 729 (1933).

<sup>9</sup> Irwin v. Willier, 110 U. S. 499, 28 L. ed. 225, 4 S. Ct. 160 (1884); Clews v. Jamieson, 182 U. S. 461, 45 L. ed. 1183, 21 S. Ct. 845 (1901); Bennett v. Logan, 80 Cal. App. 571, 252 P. 662 (1927); Kinney v. Ginny, 136 Misc. 301, 240 N. Y. S. 713 (1930).

sions where a contract is deficient or incomplete in its terms, but the contract cannot be contradicted or varied by them,<sup>10</sup> unless ratified by the customer.

Although by definition, custom and usage are technically different, they are generally used in the courts of law as equivalent terms. One court has stated: "The words usage, custom and course of trade are used interchangeably, and it is quite apparent here that the word 'usage' was employed in the sense of 'custom.'" <sup>11</sup> Thus in many instances, decisions utilize one word when meaning the other without serious consequences. The differences only become significant in the area of evidence as previously noted.

Practically speaking, rules and regulations of stock exchanges cannot be regarded as customs. An acknowledged custom is expressed or defined by the rule.<sup>12</sup> Like every other custom, it must usually be proved whenever asserted, and must always be shown to fit the facts. But if the rule is generally followed in practice it will ordinarily be given the force and effect of custom.<sup>13</sup> An exchange rule which is disregarded in practice will not be given the effect of usage.<sup>14</sup>

## II

The history of the court's recognition of stock exchange rules and regulations as law has not been consistent. In the well-known *Bibb v. Allen* case<sup>15</sup> it was held that a stock exchange, which is organized under the statutes of New York for a lawful business purpose, had power to make such rules and regulations as "might be deemed necessary and proper to carry out the purpose of its organization." Thus, the court early recognized such rules as proper evidence without further proof when contemplated business is transacted on such an exchange. Since

<sup>10</sup> *Moore v. United States*, 196 U. S. 157, 49 L. ed. 428, 25 S. Ct. 202, (1905); *Thomas v. Guarantee Title & Trust Co.*, 81 Ohio St. 432, 91 N. E. 183 (1910). For typical brokers' practice forms and contracts see, 5 Oleck, *Modern Corporation Law*, Forms 824, 825 et passim (1960).

<sup>11</sup> *Oppenheimer Bros., Inc. v. Joyce*, 20 Ill. App. 2d 34, 154 N. E. 2d 856 (1958); *Richmond v. Union Steamboat Co.*, 87 N. Y. 240 (1881).

<sup>12</sup> *Chicrello & Bros., Inc. v. Central R.R. of N. J.*, 256 F. 297 (2d Cir. 1919).

<sup>13</sup> *Bibb v. Allen*, 149 U. S. 481, 37 L. ed. 819, 13 S. Ct. 953 (1892).

<sup>14</sup> 1 Myer, *Law of Stockbrokers* 161 (1931).

<sup>15</sup> 149 U. S. 481, 37 L. ed. 819, 13 S. Ct. 953 (1892).

then, other courts<sup>16</sup> have acknowledged that stock exchanges have the power to enact such rules and regulations concerning the government of their affairs, accepting them as evidence, without question, unless they are contrary to public policy.<sup>17</sup> In one recent case,<sup>18</sup> where the parties involved stipulated the New York Stock Exchange rules into the record, the court took judicial notice of them. Yet another decision<sup>19</sup> held that "the rules of a trading exchange cannot have the effect of statutory law"; consequently, each rule alleged as pertinent must be proven through evidence to show that the rule is a custom currently in usage on the exchange. Moreover, mere violation of a rule of a stock exchange by a member does not give rise to civil liability to customers without another rule enforcing such causes of action.<sup>20</sup>

When the brokerage house through which the customer transacts his business is a member of a stock exchange, then such broker can be liable to his customer, if a violation exists, under the applicable exchange rule. If the same member broker transacts his customer's business as directed (expressed or implied) in the over-the-counter market, he must then comply with the Securities and Exchange Commission's rules and regulations, the customs and usages currently prevailing in such market, and the National Association of Securities Dealers' rules, if he is a member of that group, and bears responsibility to his customer under those conditions. But he may additionally be liable under his stock exchange rules and regulations which specifically subject such outside transactions to its control.<sup>21</sup> Some cases<sup>22</sup> hold that when a non-member broker transacts business for his customer through a member of an exchange, then both non-member and customer are subject to the exchange's rules and regulations. This has resulted in a vast number of inequities, one of which

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<sup>16</sup> *Franks v. Bridges*, 337 Mass. 287, 149 N. E. 2d 131 (1958); *Pernie Simons & Co. v. Whitney*, 259 N. Y. S. 193 (1932).

<sup>17</sup> *Garcia Sugar Corp. v. N. Y. Cotton & Sugar Exchange*, 7 N. Y. 2d 532 (1938); *Thomson v. Thomson*, 315 Ill. 521 (1926).

<sup>18</sup> *James Wood General Trading Establishment v. Coe*, 191 F. Supp. 330 (S. D. N. Y. 1961).

<sup>19</sup> *Dupont v. Neiman*, 156 Cal. App. 313, 319 P. 2d 60 (1957).

<sup>20</sup> *Irving Weis & Co. v. Offenberger*, 220 N. Y. 2d 1001 (1961).

<sup>21</sup> *Kernahan v. Wallace*, 248 N. W. 904 (Mich. 1933).

<sup>22</sup> *Korns v. Thomas & McKinnon*, 22 F. Supp. 442 (D. Minn. 1938); *Lynch v. Maw*, 3 Utah 271, 282 P. 2d 841 (1955).

places an undue burden on the debtor-creditor relationship. It is hoped this situation will be alleviated as indicated in a recent case.<sup>23</sup>

Since the large over-the-counter market has no specific center of activity, the customs and usages in such a market can vary greatly from one city to another and from one brokerage house to another even in the same locale. Some day it is hoped this incongruity may be changed to a centralized operation with rules and established customs applicable throughout the country. In the meantime, the Securities and Exchange Commission and the National Association of Securities Dealers' acts and rules help stabilize the problem. The Securities Exchange Act of 1934<sup>24</sup> permits stock exchanges to have as many rules as the exchange considers necessary for just operations. It must have one rule wherein members, guilty of violating such rules against customers, can be sued under the rules and regulations; and, it may not have any which conflict with the federal statutes.<sup>25</sup> As regards the over-the-counter market, the Securities and Exchange Commission's statutes are generally applied where a fraud situation<sup>26</sup> or an illegal contract<sup>27</sup> arise between broker and customer. Otherwise, the customer must rely upon agency and contract laws of the various states, and the prevailing customs and usages in local markets when contract disputes arise. As to the latter, however, reference to the current rules and usages of the various national stock exchanges in determining an over-the-counter dispute can be helpful.<sup>28</sup>

Awareness of the laws and judicial decisions of the State of New York and the New York Stock Exchange rules are important for several reasons. In the first place, a great majority of

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<sup>23</sup> *Johnson v. Winslow*, 155 Misc. 170, 279 N. Y. S. 147 (1935).

Why should a customer know the rules governing a third-party, the member broker, when he does not direct his broker to seek execution of such order on that exchange? This question has not been answered.

<sup>24</sup> Securities Exchange Act of 1934, 15 U. S. C. 78a to 78jj (Exchange Act).

<sup>25</sup> *Rospigliosi v. Clogher*, 46 S. 2d 170 (Fla. 1950); *Kernahan v. Wallace*, 248 N. W. 904 (Mich. 1933).

<sup>26</sup> Exchange Act, Section 10(b) and Rule 10b-5 thereunder, 15 U. S. C. 78j, 17 C. F. R. 240.10b-5; Sec. 11, 15 U. S. C. 77k; Sec. 17, 15 U. S. C. 78q.

<sup>27</sup> Exchange Act, Section 29(a), (b), (c), 15 U. S. C. 78cc; *Rospigliosi v. Clogher*, 46 S. 2d 170 (Fla. 1950).

<sup>28</sup> Writings dealing with this area are numerous; e.g., *Andresen, Manipulation of Over-the-Counter Securities Market*, 10 Geo. Wash. L. R. No. 639 (1942); *Friend, The Over-the-Counter Securities Market* (1958).

securities transactions are effected on the New York Stock Exchange. Secondly, a transaction effected on an exchange in New York will be governed by New York law, irrespective of where the parties to the transaction may reside or where the order for the transaction may have been given, unless that particular state has enacted securities laws or has case law which makes New York law contrary to its own law and thus violates the state's public policy. Additionally, New York's judicial decisions have given careful consideration to the many questions raised in this field.<sup>29</sup>

### III

It is well-settled that when a customer transacts business on a stock exchange or market through a broker who is a member of such exchange or market, he confers authority (directly or by implication) on the broker to carry on such business in accordance with the prevailing customs, usages, and rules, even though the customer may in fact have no knowledge of them.<sup>30</sup> With certain limitations, the broker must comply with the practices of the market necessary to properly effect his customer's transaction, whether or not the customer directed him to that particular market<sup>31</sup> since the broker has, as above stated, sufficient authority to execute the order. Consequently, a customer cannot plead ignorance of such customs and rules, and the transaction binds him when he decides to confer such authority.

A customer is not bound by a usage of a particular brokerage house unless the usage is so well-known as to have become a custom recognized by the courts.<sup>32</sup> Often a brokerage house,

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<sup>29</sup> Even in states which have securities laws, their courts often refer to New York decisions. For articles in this area see Demmler, *Continuing Role of the States in Securities Regulations*, 180 *Com. & Fin. Chr. No.* 1390 (1954); Edelman, *Securities Regulations in the 48 States* (1942); Frank, *S. E. C. Respects State Jurisdiction*, 26 *Pub. Util. Fort. No.* 259 (1940); Kearns, *Coordination of Securities Acts*, 31 *Ill. L. R.* 718 (1937).

<sup>30</sup> *Bibb v. Allen*, 149 U. S. 481, 37 L. ed. 819, 13 S. Ct. 953 (1893); *Clews v. Jamieson*, 182 U. S. 461, 45 L. ed. 1183, 21 S. Ct. 845 (1901); *Sisler v. Ray*, 213 Cal. 620, 2 P. 2d 987 (1931); *Skiff v. Stoddard*, 63 Conn. 198, 28 A. 874 (1893); *Hall v. Paine*, 224 Mass. 62, 112 N. E. 153 (1916); *Shuman v. Goldsmith*, 115 Misc. 327, 188 N. Y. S. 84 (1921).

<sup>31</sup> *Van Dusen-Harrington Co. v. Jungeblut*, 75 Minn. 298, 77 N. W. 970 (1899); *Thomson v. Thomson*, 315 Ill. 521, 146 N. E. 451 (1925) *Hallet v. Aggergaard*, 21 S. D. 554, 114 N. W. 696 (1908).

<sup>32</sup> *Baker v. Drake*, 66 N. Y. 518 (1876); and see *Markham v. Jaudon*, 41 N. Y. 235 (1869). Brokerage firm custom and usage is still an important factor but there are few reported cases in this area.



as an offensive weapon in a case, will try to maintain that a particular usage or practice of theirs is a recognized custom in the field. Fortunately for the customer, this has generally been defeated in courts of law.

A customer, as party to a contract, which relies on a rule or usage of an exchange, that violates his legal rights, will not be bound to the transaction if he was ignorant of such illegality.<sup>33</sup> The underlying reason for this holding is that it cannot be implied that the customer intended to be bound by any rule or usage which was inconsistent with his legal rights and of which he was ignorant. Notwithstanding, if a customer is informed of a rule or usage, but fails to register any objection, he will be bound to such contract; however, he is not bound by amendments or new rules passed subsequent to the transaction unless he knew of and had agreed to them.<sup>34</sup> Customers and brokers can, of course, contract in contravention of the rules of markets or exchanges, especially if the customer did not know the rules which were violated.<sup>35</sup>

A custom or usage, in practice or not, which is contrary to law or to public policy is invalid and will not be enforced.<sup>36</sup> This is also true of rules and regulations of stock exchanges enacted to govern their affairs.<sup>37</sup>

#### IV

Practically all transactions with the broker are contractual in nature, whether expressed in writing or implied through oral direction and consent. Countless ramifications, subtle nuances, and continual hazards jeopardize the unsophisticated investor's financial stability when he participates in the securities market. From the foregoing, it can be observed that a stockbroker's liability is not readily ascertained since the securities field is both technical and complicated. It is difficult in an article of this

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<sup>33</sup> Dupont v. Neiman, 156 Cal. App. 313, 319 P. 2d 60 (1957); Garcia Sugar Corp. v. N. Y. Cotton & Sugar Exchange, 7 N. Y. 2d 532 (1938).

<sup>34</sup> Thomson v. Thomson, 315 Ill. 521, 146 N. E. 451 (1925).

<sup>35</sup> Doan v. Dyer, 286 F. 339 (1923); Kernahan v. Wallace, 248 N. W. 904 (Mich. 1933). The violation of a rule may not necessarily involve anyone's legal rights, but such rule may simply be policy of the exchange.

<sup>36</sup> Bibb v. Allen, 149 U. S. 481, 489 (1893); Grace v. Livingston, 195 F. Supp. 933 (D. C. Mass. 1961); Jones v. DeRonde, 142 Misc. 831, 255 N. Y. S. 505 (1932).

<sup>37</sup> Irving Weis & Co. v. Offenberger, 220 N. Y. 2d 1001 (1961); Ernst v. Miller, 293 N. Y. S. 819 (1937).

length to enumerate all the basic customs, usages, and rules commonly violated by the broker in his daily intercourse with his customers. Therefore, a limited review will be made of a few elementary usages and rules to provide insight into some pertinent problems of broker-customer relations.

The customer may buy or sell securities (referred to as orders) through any one of several methods and also have his account carried in different ways. The method employed in effecting such order is determined largely by the type of issue. Certain securities, traded on stock exchanges, are known as "listed" issues; execution of orders for these issues are consummated with member broker firms of the particular exchange involved, whether or not the order was placed with that firm. "Unlisted" issues are bought and sold directly by most brokerage firms, acting as dealers in such issues without aid of an organized market (referred to as the over-the-counter market).

Based upon the instructions given to the broker relating to the price at which they are to be executed, most customers' orders may be divided into the following categories: (1) at-the-market orders; (2) fixed price orders; (3) cancel orders; (4) stop-loss orders; and (5) discretionary orders.<sup>38</sup> Regarding these, the most common violations by brokers are non-execution or improper execution of an order. Regardless of the type of order placed by the customer (unless it is unreasonable), the broker has no right to delay execution of a transaction. A broker cannot "interfere with another's speculation by delay in carrying out orders clearly and properly given."<sup>39</sup> All orders must be promptly executed with a high degree of skill and integrity. Likewise, a broker cannot depart from an established custom in executing an order.<sup>40</sup> As the customer has the right to designate the price at which his securities may be sold, the broker may not vary that price and, in such instances, the customer may repudiate the entire transaction. It is a well-established custom

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<sup>38</sup> For a definition of these terms see Schabacher, *Stock Market Theory and Practice* (1931); Twentieth Century Fund, Inc., *The Security Market* (1938). Discretionary orders will not be discussed since their problems ordinarily do not arise under the subject matter herein. A broker can act as both dealer and broker with his customer involving separate transactions under different groups of rules and regulations even with the same customer.

<sup>39</sup> *Grace v. Livingston*, 195 F. Supp. 933 (D. C. Mass. 1961).

<sup>40</sup> *Herrlier v. Tochini*, 72 Cal. App. 218, 18 P. 2d 73 (1933); provided that the custom, under current conditions, is not unreasonable nor illegal.

that a broker, under a stop-loss order, must record and execute it upon proper instructions; failure to do so is both a breach of contractual duty and tortious.<sup>41</sup> If the broker executes the order before such price has been reached, the execution is unauthorized and the customer may repudiate it or may hold the broker for damages.<sup>42</sup>

Upon execution of an order, a broker is required to send a confirmation to his customer reporting same.<sup>43</sup> The customer must be given full notification of every transaction in writing, setting forth "a description of the securities purchased or sold, the name of the person, firm or corporation from whom such securities were purchased, or to which the same were sold, and the day, and hours between which the transaction took place."<sup>44</sup> Although now a statutory requirement, brokers have always followed a custom of giving the aforementioned data to their customers, but it should be noted that some brokerage firms utilize confused confirmation in violation of the law.

When the confirmation states "we confirm purchase from you," it does not necessarily put the customer on notice that the broker purchased the security for him. "No person who is ignorant of such custom or usage, even under a printed slip, can be held to have agreed to submit to its conditions, merely by employing the services of a broker, to whom the usage is known . . ." <sup>45</sup> A normal agency relationship does not change, except by consent of both parties.<sup>46</sup> A broker cannot be both agent and principal without knowledge of and consent by the customer.

<sup>41</sup> James Wood General Trading Establishment v. Coe, 191 F. Supp. 330 (S. D. N. Y. 1961).

<sup>42</sup> Mass v. Gordon, 101 S. 2d 836 (Fla. 1958); Baldwin v. Peters, 349 P. 2d 146 (Colo. 1960). In this area the customer is often unaware that acceptance by the broker of a stop-loss order creates a valid and binding contract, the violation of which, by the broker, creates a cause of action.

<sup>43</sup> Exchange Act, Section 10(b) and Rule 10b-5, and Rule 15c 1-4; 15 U. S. C. 78j, 17 C. F. R. 240.10b-5, 17 C. F. R. 240.15c 1-4. This rule is limited to over-the-counter brokers and dealers, but requirements for members of exchanges are substantially the same; see Exchange Act Section 11(d) (2), 15 U. S. C. 78k(d) (2). See also, Hawkins v. Merrill Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104 (W. D. Ark. 1949).

<sup>44</sup> MacDonald v. Wills & Co., 240 N. Y. 144 (1925); see also 71 A. L. R. 2d 1089; New York Penal Law, §§ 392, 957.

<sup>45</sup> Johnson v. Winslow, 155 Misc. 170, 279 N. Y. S. 147 (1935); see 71 A. L. R. 2d 1089; Hall v. Prince, 224 Mass. 66, 112 N. E. 153 (1916).

<sup>46</sup> *Ibid.* Measure of damages for customer, if transaction cannot be rescinded soon enough, is difference between price broker charged and price that would have been obtained if trade had been effected in normal market.

A broker may represent both buyer and seller in negotiating a purchase or sale so long as he is in accord with the rules and usages of his exchange or market. Such sale is binding and is not opposed to public policy.<sup>47</sup> An undisclosed principal as purchaser or seller may exist as a custom respecting unlisted securities when the transaction takes place between dealers familiar with such trades.

The broker may not make a secret profit out of a transaction which is entrusted to him. If he charges his customer a price higher than that which he paid for the stock, the broker fails to perform his contract of agency, and his customer may repudiate the entire transaction.<sup>48</sup> At one time custom permitted a broker to make and retain a secret profit from a customer's transaction but it is now *against* public policy and law.<sup>49</sup>

Accounts with brokers fall into two major categories—cash accounts and margin accounts. In a cash account, purchases are made outright for full ownership and sales are ordinarily made against immediate delivery of securities. To open a margin account, the buyer deposits, with his broker, cash or securities equal to a portion of the price of the security (margin) and his broker advances the balance. To finance this balance, the broker uses his own capital or obtains such funds by pledging the purchased securities with a bank as collateral. If the price of the stock declines, the customer must, at the broker's discretion, keep adequate margin by depositing additional cash or securities. Under certain limitations, if the margin falls below the broker's percentage, a margin call is sent to the customer; if the customer fails to provide additional margin, the broker may sell the margined securities.

It is customary for brokers, on opening a margin account, to require a customer's signature on a card under which he agrees to certain conditions. One condition generally included is that, unless additional capital or securities are placed in the account when the stock drops in price, such stock will then be sold out. The courts have held that such signature on the card,

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<sup>47</sup> Heinerdinger v. Schnitzler, 231 App. Div. 649, 248 N. Y. S. 597 (1931). At least one case disagrees; see Whelen v. Craig, 98 Pa. Supp. 103 (1929).

<sup>48</sup> Cohen v. Rothchild, 182 App. Div. 408 (N. Y. 1918); Johnson v. Winslow, 155 Misc. 170, 279 N. Y. S. 147 (1935).

<sup>49</sup> Day v. Holmes, 103 Mass. 306 (1869); People v. Royal Securities Corp., 5 Misc. 2d 907, 965 N. Y. S. 2d (1955); Exchange Act Rule 15c 1-2, 17 C. F. R. 240.15c 1-2.

resembling a contract, lacks consideration because for "this enticing parting with his rights the customer receives no correlative advantage."<sup>50</sup> A broker cannot hold a customer liable on an agreement to supply margin incidental to the purchase of securities unless there is an express agreement to furnish margin.<sup>51</sup> The broker cannot assume that such agreement was inferred as a trade custom implied from the nature of the agency. The relation between customer and broker is that of pledgor and pledgee. The broker must give reasonable notice of further margin needs.<sup>52</sup> When a broker violates a rule of an exchange, state, or federal law involving a customer's margin account, it does not give rise to a cause of action by the customer against the broker if no loss has been incurred.<sup>53</sup>

Reasonable rules and usages of the exchanges or market where the parties transact business may determine the type of collateral receivable as margin in the absence of an agreement.<sup>54</sup>

Demand for margin and notice of sale cannot be ignored even though there is a custom permitting the sale of a customer's securities without demand and notice. Such a custom, if it existed, would be inconsistent with the contract between the parties and would be unenforceable unless the customer had expressly waived it.<sup>55</sup> The broker has the right to rehypothecate his customer's securities for an amount not in excess of the customer's indebtedness against such securities. But usages permitting the broker the right to mingle them with securities of

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<sup>50</sup> *Jones v. De Ronde*, 142 Misc. 831, 255 N. Y. S. 505 (1932); see also *Markham v. Jaudon*, 41 N. Y. 235 (1869). Many problems resulting from cash and margin accounts are similar in nature and can be grouped.

<sup>51</sup> *Pernie Simons & Co. v. Whitney*, 259 N. Y. S. 193 (1932). If the margined stock were to drop in price, causing greater debt than originally agreed upon, there is no law which requires the brokerage firm to ask for additional capital. The amount requested and amount of time for delivery will vary according to the brokerage firm's discretion and relationship with the customer.

<sup>52</sup> *Ibid.*; *Byrne v. Weidenfield*, 113 App. Div. 451, 99 N. Y. S. 412 (1906).

<sup>53</sup> *Irving Weis & Co. v. Offenberger*, 220 N. Y. 2d 1001 (1961); *Nichols & Co. v. Columbus Cr. Corp.*, 204 Misc. 848 (N. Y. 1904). The courts generally hold that reasonable notice means actual notice with an opportunity to supply additional margin.

<sup>54</sup> *Ling v. Malcom*, 77 Conn. 517, 89 A. 698 (1905); *Whitney v. Nolan*, 296 Mass. 419, 6 N. E. 2d 386 (1936); 1 Meyer, *Law of Stockbrokers*, 169 (1931).

<sup>55</sup> *A. B. Kidder & Co. v. Turner*, 106 S. 2d 905 (Fla. 1958); *Markham v. Jauden*, 41 N. Y. 235 (1869). Publicly issued securities, bonds, debentures, and government securities are the common type of collateral used. Closely-held corporate stock is seldom accepted as collateral because of its lack of negotiability due generally to stock restrictions.

others in the broker's general loan<sup>56</sup> or rehypothecate them for an excessive amount will not be enforced.<sup>57</sup>

When the purchase or sale of securities is made on an exchange, the rules and regulations of such exchange will apply to the terms of delivery and payment. On the other hand, if such purchase or sale was not made on an exchange, such terms are fixed by the prevailing customs and usages of the locale. In the absence of an express agreement between the parties, delivery and payment must be made within a reasonable time.<sup>58</sup> However, the rules of an exchange located in a particular market, respecting time and place of delivery, may be so universally followed as to constitute a usage of the market even though the transaction was not effected on that exchange.<sup>59</sup>

## V

Customs, usages, and rules aid in the interpretation of the meaning of the express language in an agreement between parties. They also add provisions, not expressly stated by the parties, to the contract, and make inapplicable to an agreement rules of law otherwise applicable. Their primary purpose is generally to ascertain and to give effect to the intention of the parties. Thus customs, usages, and rules significantly interpret the entire contract between the broker and customer.

A customer who employs a broker to effect a transaction on a stock exchange or market of which the broker is a member, in general may expect to be bound by the customs and usages on that exchange or market. Such customer is not bound by a rule or custom which varies the legal relationship existing between the

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<sup>56</sup> *Sproul v. Sloan*, 241 Pa. 284 (1913). Many problems arise about these situations and more particularly as to customer's legal rights regarding brokerage insolvency. As a general rule, a customer has the right to reclaim securities held for him by a broker, provided he is able to find them in the broker's box or in his pledge. For detailed information see: *Duel v. Hollins*, 241 U. S. 523, 60 L. ed. 1143, 36 S. Ct. 615 (1916); *Leonard v. Hunt*, 36 F. 2d 13 (1 C. C. A. 1915); *Korns v. Thomson & McKinnon*, 22 F. Supp. 442 (D. Minn. 1938); *Lynch v. Maw*, 3 Utah 271, 282 P. 2d 841 (1955); *Mandaville v. Pooler*, 198 A. 235 (R. I. 1938); *Skiff v. Stoddard*, 63 Conn. 198, 26 A. 198 (1893); 1 Meyer *supra* n. 54 at 600 (1931).

<sup>57</sup> *Kittredge v. Grannis*, 244 N. Y. 168 (1927); *Wood v. Fisk*, 215 N. Y. 233 (1915).

<sup>58</sup> *Stroud v. Sautbine*, 18 F. 2d 883 (C. C. A. 8, 1927).

<sup>59</sup> Damages are the difference between market price at the time actually delivered and the time it should have been delivered. *Isham v. Post*, 141 N. Y. 100 (1894).

parties unless the customer had actual knowledge of such rule or custom, or expressly contracted with reference to it. Moreover, a customer generally cannot be bound by a rule or custom which is illegal or unreasonable.

The serious market decline this past spring, and the chaotic conditions that resulted therefrom, produced a valuable lesson. A vast number of margin calls were made by brokerage firms with subsequent complaints by customers who either could not supply additional capital or thought it was unreasonable at a time when their holdings incurred drastic losses. Many margined securities were sold, followed by complaints and, in some cases, by court actions. Probably numerous losses could have been avoided and brokers would have retained some valuable accounts if the customer had been better informed.

As the holdings demonstrate, evolution of stockbrokers' liability has not resulted in clearly discernible principles; the many exceptions and questions raised, but not settled, prevent it. Meanwhile, both customer and broker are fortunate to have controls by Federal and state laws, the various exchange rules and regulations, and case law, which should continue to advance in certainty as the growth in securities transactions expand. A customer's education in securities market procedure must be supplemented with additional knowledge; a broker's cooperation is imperative to accomplish this end.