

# NASD *News*

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## **NASD ANSWERS CRITIC OF OVER-THE-COUNTER DEALERS**

NASD has never believed that constructive ends result from public exposition of the securities business' internal differences. But it feels compelled to answer charges that have been made against the character and responsibility of the business of the vast majority of its members. Apparently several spokesmen for small stock exchanges have gone to Congress or to the press with statements and arguments that can and must be refuted. One such spokesman is Howard R. Taylor, President of the Baltimore Stock Exchange. In June, he wrote a letter to every member of Congress, circulated copies among the press; followed this up some time later with a press release; in July addressed another appeal to members of Congress. In the following, which is a reprint of a reply which NASD has sent to every Congressman, certain of the statements made by Mr. Taylor in his first letter are in *Italics* and NASD comment in Roman immediately under each passage:

\* \* \* \*

*"Do you know that any and all securities may be bought and sold in any public or private place, while by Congressional act a large percentage of the securities purchased by the public every day are barred from being traded on the supervised stock exchanges?"*

The "Congressional act" which is referred to has not "barred" any securities from being traded on stock exchanges. No issuer is *barred* from having its securities listed and traded on stock exchanges if such issuer believes that the advantages derived from listing on a stock exchange compensate it and the owners of its securities for complying with the requirements of listing. Obviously, the Congress wisely left this to the choice of the issuer.

Use of the phrase "supervised stock exchanges" in the above reference was undoubtedly intended to convey the impression that only transactions on stock exchanges are subject to supervision. This, of course, is wholly fallacious. The securities acts cover trading in over-the-counter markets as well as on the stock exchanges, and Federal and State regulation of over-the-counter markets is supplemented by regulation of the majority of the over-the-counter dealers through the medium of the NASD.

### **NASD Supervises Members**

NASD (National Association of Securities Dealers, Inc.) was established under permissive legislation (Maloney Act) passed by Congress in 1938. Among its objectives is the administration and enforcement of rules of fair practice and the promotion of high standards of commercial honor and just and equitable principles of trade for the protection of investors; and, further, to promote self-discipline among members and to investigate and adjust grievances between the public and members. Since its organization, NASD has

aggressively and successfully pursued these objectives. As proof of that here are a few facts: since its inception NASD has filed complaints against 400 members and the decisions in these cases resulted in expulsions, suspensions and fines ranging to \$2,000 and, in cases involving minor infractions, censures, dismissals or settlements between parties resulted. The SEC in several instances has followed up NASD expulsions with revocations of these dealers' registrations. NASD examines business practices of all members at least once a year. They are continuously under supervision.

*"These exchanges are the natural markets of record, have a definite commission schedule, and are so regulated that the public cannot be deceived."*

The statement that exchanges "are so regulated that the public cannot be deceived" is, to say the least, a very broad statement not necessarily related to the specific virtues mentioned; it would further appear to be inconsistent with the objective of this advocate who wants exchange regulation relaxed.

*"These small exchanges, prior to the inception of the SEC, supported the securities of small local companies and helped innumerable such companies to develop and become well established in the financial world . . ."*

Stock exchanges are auction places. They provide the physical surroundings for the buyer and the seller to meet in. They do not and cannot "support" nor can they "help" securities traded in their markets. In fact, it might more accurately be said that a security must attain maturity before it is acceptable to stock exchange listing. This is not a criticism of the stock exchange, its functions or its con-

tribution to the smooth operation of the financial machinery of the country. But it is still the fact that a security has had invariably to pass through a period of seasoning before it was susceptible to auction trading and became a recognized medium for trading on an exchange. A protracted period of time must elapse between the initial public flotation of a security and its attainment of that degree of public ownership and interest which inhibits the security with the qualities necessary for auction trading in it on stock exchanges. No informed stock exchange official today would deny that a large number of securities have been listed which, over the years, have demonstrated that they had **not** developed these qualities, perhaps never would. A large additional number, with the same inherent defects, have been placed on exchanges under unlisted trading privileges. Many securities listed on stock exchanges, and others traded on stock exchanges under unlisted trading arrangements, should never have left their natural habitat—the over-the-counter market.

### Counter Market's Investment Character

In this connection, it is appropriate, as one means of illustrating fundamental differences between over-the-counter markets and stock exchanges, to point out that securities of a high investment caliber such as United States Government issues direct and guaranteed, as well as State and Municipal issues, are very extensively dealt-in over-the-counter. In addition, high caliber investment issues of the most substantial financial institutions of the country, such as insurance companies and banks, are also dealt in almost exclusively over-the-counter. In numerous cases, the securities of these institutions have, at one time or another in the past, been listed on stock exchanges but were removed by the issuers. It is a dominant characteristic of the over-the-counter market that the issues which make up the bulk of actively-traded securities of that market are of a high investment rating.

The "support" and "help" which the financial community manifests for securities are provided prior to their arrival on stock exchanges.

If stock exchanges could *support* and *help* the securities listed on their exchanges, it naturally follows that grateful and contented issuers would not remove their securities from stock exchanges and thus the necessity for such complaints as are now made by Mr. Taylor would be obviated.

### Factors of Financial Success

Companies which "become well established in the financial world" attain such eminence as a result of success in their field of enterprise. This success comes about because of the quality and demand for the products of the corporation, sound management, etc.—which, all things being equal, are conveyed to the securities of the company. But becoming well established in the financial world presupposes success in the corporation's field of activity and in its origin has no relationship whatever to the place where the corporation's securities happen to be traded. Transactions made in that place merely reflect the changes in fortune of the issuer of securities.

*"... today such companies cannot afford to become involved in the burdensome requirements of the SEC."*

Congress left to the choice of the issuer of securities, the decision as to whether it was desirable and whether it would be beneficial if its securities were listed on a stock exchange. However numerous and tangible may be the benefits of listing securities on stock exchanges, such action entails acceptance of certain responsibilities. The issuer, in practice, weighs all the advantages against the responsibilities incurred when considering whether a security is to be listed on a stock exchange, and decides whether or not the one outweighs the other.

*"Why should the stock exchanges be penalized while the over-the-counter market is permitted to trade in all unlisted securities and also those listed on the exchanges?"*

The reason why the over-the-counter markets are employed by the public for the transaction of business in securities listed on stock exchanges is a very simple one. Buyers and sellers seek the best market in which to make transactions in listed securities. In a good many cases that happens to be the over-the-counter market. This is good economics—the operation of the fundamental law of supply and demand. The business man always tries to transact his business where the price is best. It is difficult to see how the public good could be served by passing a law or a rule, the effect of which would be to deprive the investor of his constitutional right to do business where he chooses—which means where he will obtain the best bargain.

*"We have no argument with the over-the-counter market—we merely ask that such rank discrimination be eliminated."*

The "discrimination" which is decried would, if this advocate were successful, result in discrimination against the investor for whose good and for whose protection the securities acts were enacted; it would be worse than discriminatory to deprive issuers of their right to elect whether their securities should be listed or not.

*"Your decision, when these matters come before you, will result in one of two things:*

*"1. The closing of all small exchanges—the only securities markets where records of all purchases and sales are kept for all time and are available to anyone.*

*"2. Unless appropriate action is taken permitting all regional exchanges to trade in any and all securities, whether listed or unlisted, on these exchanges which afford the ONLY market of record with proper supervision for the protection of the public, it is quite apparent that these small exchanges will be forced to discontinue operations and the entire securities business of the country will become concentrated in the large financial centers."*

1. No one in the financial community can contemplate disinterestedly the possible disintegration of small stock exchanges. They have rendered a useful service to their communities over a period of many years and it is to be hoped that they will survive and continue to be useful to these communities. However, if these exchanges can serve no useful economic purpose, then they cannot survive regardless of what may be done to save them.

### What Would Happen?

2. The "appropriate action" which would permit all exchanges to trade in any and all securities would seem to be an appeal for legislation which would enable members of stock exchanges to transact business in securities other than those "formally" listed on the exchange or traded there under unlisted trading privileges. How this could be done without a complete revision of the securities acts and the discarding of underlying principles of those acts, it is hard to see; but, even if such edict or enabling legislation were forthcoming, is there any guarantee that the lot of the regional stock exchanges would be improved? This advocate of the position of the stock exchanges has confessed (by indirection) that for many presently listed securities better markets are available off the exchanges than on the exchanges. By opening the exchanges to hundreds if not thousands of additional securities, there would be just that many securities which *could* be traded on exchanges but which still would enjoy their best markets off the exchanges. The reason this would come about is the reason for the present state of affairs. Stock exchanges are, as has been pointed out, no more than auction places. Under their roofs orders to buy and to sell securities are matched by the members of those exchanges and when the opposite order needed to complete the transaction is missing, there is no transaction. On the other hand, in the over-the-counter market buyers and sellers literally *make* markets. Those engaged in over-the-counter trading recognize no

physical confinements for their operations. If a buyer or a seller cannot be found in the immediate community, he is sought out in all likely places. If a prospect is found but there is a gap in the price, the effort is made forthwith to compose the difference. Over-the-counter dealers merchandise securities, carrying them to the ultimate consumer. It is also characteristic of the over-the-counter market that many of those who engage in it take the business man's risk in the conduct of their business. They inventory securities the same as any merchant. They are prepared to buy or to sell at a price at any time. They do not wait for a buy order and a sell order to meet by happenstance in their own offices. The existence of an order to buy or to sell is enough for the over-the-counter dealer to find the opposite of one or the other.

### Decentralization Not Concentration

The statement that the demise of small stock exchanges will mean that "the entire securities business of the country will become concentrated in the large financial centers" is a projection that cannot be reasonably argued. The small stock exchanges are located in the more important centers of financial activity in various parts of the country. These communities are truly "centers" of their particular regions and the more business that flows into these centers the more concentrated becomes the securities activities of those regions served by the small stock exchanges. In contrast, the over-the-counter markets are decentralized and diffused to such an extent that even the smallest community can be said to supply a purely local market for securities native to the area. The larger the number of people engaged in over-the-counter securities business, the more widespread and local is the volume of business done. Obviously, then, the regrettable disappearance of small stock exchanges (and we view such a prospect with considerable concern, although confident that it is unlikely to develop) would most likely result in an even wider diffusion of securities activities than prevails at present.

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