MEMORANDA FOR MEETING WITH EXECUTIVE COMMITTEE

The question is – shall the NASD try to find a way to avoid a decision of the Securities and Exchange Commission in the PSI cases, and if so, to what extent should this effort be made?

The Executive Committee of NASD decided in March 1940 to cause an investigation to be made of the various complaints to the association with regard to the practices involved in the distribution of this issue. It was not very long after the investigation started that it became apparent that there were a great many violations of the syndicate agreement. So far as I know there was never a time when the PSI cases were discussed either before the Executive Committee or the Board that the opinion was not unanimous that the Association should go forward with the investigation – should hew to the line and let the chips fall where they might. It very early developed that this animal not only had a great many spots but had practically every kind of spot. There were cases of over-allowances on securities turned in in trade. There were situations where the securities had been sold by the underwriter at a price below the public marketing price, and I believe at a price so much less than the public offering price that the distributors at the same price would face a loss while the underwriter would have a very small profit. There were situations where members of distribution groups during the distribution period traded, either as principal or as agent, PSI bonds which had passed into the hands of the public upon price and concession terms different than those under which the PSI distribution was currently being made.

The Commission took up for review on its own motion six typical cases decided by the Board of Governors and the Commission determined that the parties in those cases should remain anonymous in the public record, although the names of the parties respondent are contained in the Commission's confidential file of the cases.

After the District Business Conduct Committee had made its finding the Board, I think in New York, took up the question of the disciplinary action which should be taken. At that time it had already become apparent, as I recall it, that any action taken would in all probability be reviewed by the Securities and Exchange Commission under the power given to it. I am sure this is so because I have the distinct recollection of there being discussion as to whether under the circumstances we ought to back up and do nothing, and I am also certain that the decision of the Board was to go forward.

After the fines had been assessed and the moneys paid, I had a great many conferences with members of the Securities and Exchange Commission in an effort to save the expense that would be involved in a review of these cases. I urged upon the Commission that there really was nothing vital about arguing out in this matter the antitrust aspects of the underwriting agreement as it has been developed in the United States. I argued with the various members of the Commission with whom I talked that it would be very easy to approve the action of the Association and then call the matter of the type of underwriting agreement up for discussion, giving all underwriters the opportunity to be present and be heard to the end that the question might be determined of what type of agreement should be used hereafter if the present type should be changed. We all know, of course, that this was not done, and as a result the Association commenced the preparation of its case on review.

There are involved many questions other than the question under the Sherman Act.

These questions briefly are as follows:

(1) <u>The Effect and Meaning of Rule 1 Requiring High Standards of Commercial Honor and Just and Equitable Principles of Trade</u>

(a) Can an Association member be disciplined under this Rule for his failure to perform a contract made by him with another member?

It has always been held by the courts that an association member's failure to perform his contract violates the Association Rules requiring the observance of high standards of commercial honor and just and equitable principles of trade, for which the Association may discipline the member.

(b) Can the Association discipline its members for violating their contractual, fiduciary and moral obligations, voluntarily assumed, even though such obligations were unenforceable in the courts?

It has uniformly been held that associations could discipline their members under rules similar to Rule 1 for violating such obligations, even though the obligations themselves were unenforceable in a court for one reason or another.

We do not contend that the disciplinary action under Rule 1 could be sustained if the obligations so assumed were affirmatively unlawful, such as a contract to commit a crime. At common law a contract involving an unreasonable restraint was not affirmatively unlawful but merely unenforceable. In the PSI cases the only thing that would make the obligations assumed affirmatively unlawful is the alleged violation of the Sherman Act. We contend that the Commission has no jurisdiction to construe or enforce the Sherman Act, and in any event that the restraint was reasonable and not a violation of that Act.

(c) Can the Association member be disciplined under Rule 1 if the contract he violates relates to money, price or profits in view of sub-section (b) (7) of the Maloney Act?

Sub-section (b) (7) does contain a number of standards applicable to Commission approval of Association rules and provides that the rules shall not be designed to fix minimum profits to impose any schedule, or fix minimum rates of commission or discounts. The Commission Staff and the Department of Justice contend that to construe Rule 1, as requiring the enforcement of price and concession agreements, would make the rule violate Section (b) (7).

We contend that the standards of sub-section (b), and there are a number, apply only to the initial approval of the rules by the Commission; and further that in any event this action has nothing to do with fixing profits or fees but merely is disciplinary action for failure of members to observe their agreements voluntarily assumed.

Our contention has been that the Association has no interest in what kind of contract the underwriters make with each other, or with the distributor. We know that the price and spread in those contracts for utility offerings should meet the Commission's approval. If the contract so made receives the Commission's approval or is properly filed in accordance with the law and the Commission's rules, that is all the interest the Association has. From then on all we ask is that the parties behave honorably under the contract which they have made, both with each other and with the public, and, for that matter, the Commission. In a nutshell, we do not try to formulate, much less dictate, the contracts which our members shall make with each other or the public, but we do hope to be able to require that after having made those contracts, they shall perform them.

We further contend that the particular rule, and all the Association rules, are in accord with the standards of Section (b) (7).

(d) Is Rule 1 unenforceable because it uses general language?

The Commission Staff states that Rule 1 contains "general and innocent language" which the Commission would not have approved if it had considered the language susceptible of the interpretation adopted by the Association. The Department of Justice also urges that the language is a "vagrant concept" too uncertain to be enforced. We do not believe that there is much importance to be placed upon this objection, because we are mindful of the fact that the language in Rule 1 is contained in the identical form in the Stock Exchange Rule, in various federal securities laws, and has been construed a great many times by the courts in connection with associations. The question has nevertheless been raised.

(e) Can disciplinary action be taken against a member of the Association who trades in the issue during the distribution period and while a member of the distributing group, at prices below those fixed in the agreements?

The Commission Staff also claims that since the underwriting and selling agreement do not specifically cover the situation where a member of the distributing group trades in the particular issue during the distribution period at a lower price, there can be no violation of the rule. The evidence, however, is uncontradicted that it is inconsistent with high standards of commercial honor and just and equitable principles of trade for a member of a distributing group to trade in the issue upon different price and concession terms during the distribution period.

(2) <u>The Brief filed by the Attorney General Has Indicated a Question of Whether the Association Rule Forbidding Discounts to Non-members is Legally Enforceable In View of the Specific Provisions of Sections (i) and (n) of the Maloney Act</u>.

It is difficult to get very excited about this contention, but nevertheless it is being made.

If the proper construction of the Association rules prohibits the violation of contractual, fiduciary or moral obligations by Association members, and the obligations themselves are not affirmatively unlawful, the evidence is uncontradicted that the respondents' actions violated the Association rules.

No question whatever is raised, and it is not urged that the penalties imposed by the Association are too harsh.

In attempting to come to a conclusion on the main question as to whether NASD should try to find a way to avoid a decision in the PSI cases, I am assuming two things with regard to the underwriting agreement in the PSI matter: <u>First</u>, that the period of time during which the underwriting agreement was kept in effect was much longer than the average period; and <u>second</u>, that in the PSI case the decision to keep the underwriting agreement in effect was the decision of the Syndicate Manager, Halsey, Stewart & Co., and was a decision not acquiesced in by any of the other underwriters.

It is true that the PSI agreements gave the Manager the right to terminate the distribution at any time and also to extend the agreement for an additional period of not more than sixty days. However, the record is undisputed that the PSI agreement was only extended by the Manager upon consultation with the other underwriters (See Hough T. 868, 936-7). In fact, on January 25, 1940 the Manager of the PSI arrangements, in a letter to all underwriters stated:

> "The selling agreement, unless extended, will expire as of the close of business February 7, 1940, and it is our intention to canvass the underwriters prior to that date to determine whether or not they desire the selling agreement terminated or extended for all or any part of the entire sixty days as permitted in the selling agreement. We shall be guided by the expressions of the underwriters in accordance with their proportionate interest in the unsold bonds."

There has been a good deal said in the conferences in New York as to whether or not syndicate agreements generally up to the end of 1939 gave the Manager the sole discretion as to extending the syndicate, and it has been stated to me that even in cases where this sole discretion was given the Syndicate Manager he did not extend the agreement unless it was approved by a majority of the underwriters. I think that probably the Halsey-Stewart form was, to all practical purposes, the same as other underwriting agreements, although I do not necessarily believe it would have been possible for Halsey, Stewart & Co. to secure the approval of all 67 underwriters. Nevertheless, the record is clear that the Manager did secure the approval of the underwriters as a whole before extending the period. All of these facts were or might have been known to the governing board and the District Business Conduct Committees at the time the PSI cases were decided, and therefore I don't think they present a valid reason for reversing the decision.

It is also undoubtedly a fact that in the past month or six weeks and starting with the underwriting agreement in the Phillips Petroleum issue, the underwriters have developed a type of agreement quite different from that used in the PSI distribution. However, there has been no particular uniformity about the variations from the old form and, as I understand it, there is no one form that can be said to be the present business practice. Therefore, to the extent that it might be important in considering whether the PSI cases have become "moot", so far as the Sherman law is concerned, there is no standard to use to compare with the PSI underwriting agreement. To the extent that the new underwriting agreements as they are developed by various counsel for various underwriters differ from the PSI agreement, the case will, of course, be no valid precedent. To the extent that the new forms of underwriting agreement follow the PSI form, whatever decision is arrived at will have some weight. Now the probability is that the new forms will all differ in many aspects from the PSI form. Therefore, I do believe that whatever is decided in the PSI cases will not be decisive on this point in determining the validity or invalidity of either one of the new types of agreement. To the extent that the Securities and Exchange Commission gives its reason why the PSI agreement was either valid or invalid, it will, of course, be helpful in developing the new form.

In my opinion, however, if the NASD were to pass a resolution of the Board rescinding the former action finding the various defendants guilty and ordered the fines paid rebated, it would be doing something for which I know of no reason to be given and which in my opinion would very greatly harm the prestige of the Association.

Now I have not, in arranging these thoughts, given any special thought to the large amount of money which NASD has invested in the preparation of these cases and the misfortune which it would be not to have all of the questions which have been raised and which are in nowise connected with the anti-trust angle undecided.

At my meeting last Friday morning with Mr. Coggeshall and Mr. Clark, Mr. Coggeshall outlined some talks which he had had in New York with one of the staff of the Securities and Exchange Commission and those indicate that there was a desire on the part of the Commission to canvass the question as to whether any practical way could be found which would handle the PSI cases and leave open the anti-trust questions which are presumably burdensome both to the Commission and to us. I see no reason why a committee should not call on the Securities and Exchange Commission if it will be received to think about this matter. There is a very easy way and that is some variation of what we proposed to the Commission two years ago – which was not to undertake to decide the question as to whether the underwriting agreement in the PSI cases violated the anti-trust law but set that question for investigation and argument and determination, if you please, at a general hearing before the Commission. This would mean that you would go forward and decide all the other questions which are raised in PSI. The Commission, for instance, would decide whether the contract could not be the basis for disciplinary action by the Association because it has to do with the price at which the securities were to be sold. This in turn would mean a construction of Section 7 of the Maloney Act and a definition of the true purpose and limitations of our Section 1. Whether there is any basis other than this which will allow us to separate the anti-trust questions from the purely Association questions I do not know, but I do think that lacking valid distinction, it would be a mistake for the Association to revoke its action.

I am coming to this conclusion knowing full well that if by any chance the underwriting agreement involved in the PSI cases is adjudged to be violative of the terms of the Sherman Act and if the Commission further finds that because of such violation it becomes a contract which cannot be the basis of disciplinary action, it will be deemed by many folks to be damaging from the standpoint of the future. So far as this is concerned, my idea is that if and to the degree that the new form of contracts, whatever they be, contain features which have been held to be illegal in the PSI cases, there will undoubtedly be an attempt to use PSI as a precedent. However, there is just one major point in which we are all interested and that is – have the underwriters the legal right to fix a public offering price and a period of time during which all distributors will agree to offer the security at that price. If the language used by Justice Douglas which has been so difficult to understand really represents the idea of the Supreme Court, then any agreement for the maintenance of price becomes illegal and whether the agreement runs twenty days or a hundred days would not seem to make any difference. If, on the other hand, it is held that a reasonable agreement to maintain the public issuing price will be upheld and that the underwriting agreement in the PSI cases is found to be at fault because of the extension of the time so as to make it unreasonable, then I do not believe that PSI will be anything but a buttress in the trial of the second case if there is one.