

# N A S D

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## NASD UPHELD IN "FREE-RIDE" CASE

*"... the NASD properly found that the sale by applicant to its own . . . account of 26.6% of its allotment . . . was disproportionate in relation to the amount sold to public investors. The withholding of such shares from public investors and transferring them to the insider account was unfair and constituted a failure to make a bona fide offering to the public . . ."*

In the first test of an Association disciplinary action under its "free-riding" interpretation, the SEC dismissed an application by a member for review of the proceedings under which it was fined \$500 and costs. A key passage from the SEC decision appears above. (SEC Release No. 6586).

Basic facts in the case were these: a selling group member in a distribution of 140,000 shares of stock at \$15, was allotted 1,500 shares and sold 400 at the offering price to an "employees profit-sharing retirement plan." On the day of the offering, the market was 19 to 19½ and the following day the high bid was 20½.

The NASD complaint against the member was based on the retention of 26.6% of the allotment as being disproportionate in relation to the amount of stock sold to public purchasers, because of which the member failed to make a bona fide public offering of its allotment. Cited were the Association's several communications to members going back to 1950 in which "free-riding and withholding" criteria were supplied.

In its decision, the SEC said: "We agree with the position of the  
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## "QUOTES" CHAIRMAN



Francis J. Cunningham, of Kidder, Peabody & Co., New York, is the new Chairman of the National Quotations Committee.

## STIFFER QUALIFYING EXAM DUE BEFORE YEAR-END

The new and more difficult NASD qualification examination for registered representatives is expected to become effective before the end of the year.

Over 500 new multiple-choice questions prepared by The Psychological Corporation have been tried out since April 3rd during the experimental testing sessions conducted at 13 of the Association's examination centers. Three experimental test forms composed of 125 questions are being assembled for review by the Securities and Exchange Commission and for additional trial-testing. Scores obtained in the new questions will  
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## BOARD CHAIRMAN TESTIFIES ON MARKET STUDY

A proposal to provide \$750,000 for a Securities and Exchange Commission study of securities markets was given the support of the Association by William H. Claffin, 3rd, Chairman of the Board of Governors, at a hearing before a subcommittee of the House Interstate and Foreign Commerce Committee. Spokesmen for stock exchanges also spoke in favor of the proposal, sponsored by Congressman Mack of Illinois. As yet, the resolution has not been passed by Congress.

Following are excerpts from the statement of Chairman Claffin:

"The Association is in favor of the resolution. We note that [it] authorizes the Commission to make a study and investigation and we wish to point out that we believe a study of the rules of the various exchanges and the Association may well be beneficial in the light of the growth and increased activity in the securities markets and the fact that in the past 25 years there has not been time nor available funds and personnel for a concentrated review of these organizations and their procedures.

"As to the part of the resolution which relates to the Association, we question whether this appropriation would be justified merely to investigate the Association's Rules or the Association's enforcement procedures."

Mr. Claffin at this point reviewed the record of the Association over the last 22 years and of the close cooperation it has had with the  
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## NASD Upheld

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NASD that the basic requirement under its 'free-riding' interpretation that a bona fide public offering be made is violated, regardless of the investment history or normal investment practice of an insider account, if a sale of a 'hot issue' is made to such an account in an amount which is disproportionate in comparison with the amount being offered to the public by the member. It is clear that the 'disproportionate' test is a principal element in the requirement that a public distribution be bona fide, and in our opinion the interpretation did not subordinate such test to that of the investment character of the insider account. The underlying objective of the interpretation is to assure that members make a bona fide public offering at the offering price and do not take unfair advantage of their inside position to the detriment of investors . . . The overriding importance of the disproportionateness test could not reasonably be misunderstood by anyone experienced in the securities business and sophisticated as to such matters."

The SEC further said that the effect of withholding is not only to give insiders opportunity for a profit and deprive public investors of such opportunity, ". . . but also to restrict the supply and tend to raise the market price further and enable the insiders to realize an increased profit upon subsequent sale of the shares retained by them."

Finally, SEC said: "We consider that the practice of 'free riding' involves misconduct of a serious nature . . ."

## Stiffer Exam

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not count for registration purposes until the new examination becomes official. There will be a two-hour time limit for the new test.

Applicants who must pass the test will receive a detailed study-outline of topics covered in the

examination, and a bibliography. Preparation for the test will involve reading the test materials in the bibliography to become informed on subjects found in the study outline.

The broad areas covered in the test are:

1. Rules and policies of the NASD
2. Basic concepts and definitions of terms in the fields of corporation finance, accounting, taxation, money and banking and public finance
3. Characteristics and types of investment companies and applicable law dealing with the distribution of investment company shares
4. Investment banking, over-the-counter trading, auction markets and Federal securities law.

The complete study outline will be sent to all members at least two months before the new test becomes effective.

## MORE CENTERS

Arrangements are under way to establish 20 additional examination centers in Little Rock, Shreveport, Great Falls, Mont., Las Vegas, Albuquerque, Bismarck, Medford, Ore., Green Bay, Rapid City, El Paso, Amarillo, Birmingham, Nashville, Columbia, S. C., Boise, Charleston, W. Va., Bangor, Jackson, Casper, and Utica, N. Y.

The additional centers will enable all applicants to take the examination under controlled conditions at a center and will reduce the distances which many applicants must currently travel to take the examination.

## MEMBERSHIP

Association membership continues to increase. As of August 1, the Association had 4645 members, against 4466 firms on January 1, 1961. Branch offices also increased from 4231 to 4430 during the seven months.

## Chairman Testifies

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SEC in developments during the period. He then said:

"We are all aware of the great interest in securities which has marked recent months. Nor can we overlook the fact that this has been a cyclical development since the end of World War II.

"Rapid and constant growth has caused the Association to conduct numerous studies of its own. In the last few years, we have given consideration to and have had almost continuous discussions with the Division of Trading and Exchanges of the Commission relating to the improvement and modernization of our Rules. Prominent in these discussions have been:

- "1. Improving the admission standards required of registered representatives and the adoption of a more searching and difficult examination which will require a far greater knowledge of the securities business prior to admittance.
- "2. Changes in the Rules to provide increased monetary penalties.
- "3. Possibility of broadening areas of disqualification of individuals entering the business.
- "4. Amending and changing our methods of enforcement of the Association's policy on 'free riding and withholding,' which is designed to insure that those new issues which command a premium at the time of offering are sold to the public and not to insiders or used for commercial advantage.
- "5. Modernization of the Association's 5% Policy, which relates to the fairness of mark-ups in dealings with customers."

## **NASD WARNS ON SHORT SALES AGAINST STABILIZING BIDS**

The Association's Board of Governors has warned dealers against the practice of short-selling against stabilization bids maintained by managing underwriters in new offerings of securities.

The Board considered the problems of underwriters in protecting themselves and selling group participants against such abuses at its recent spring meeting. A special committee that has been studying the situation recommended that the Board first try a warning to members, and then take sterner action if it becomes necessary.

According to the special Stabilizing Bid Committee, headed by Edward H. Ladd 3d, some dealers have been taking advantage of over-the-counter stabilization bids through short sales in a weak market with the expectation that they not make prompt delivery and cover at lower prices after the termination of trading restrictions. This selling would reduce or eliminate the buying power of the managing underwriter and, in many instances, unjustly penalize a participant of the distribution who had sold his stock on a bona fide basis or, if an unsuccessful distribution, after all restrictions were terminated.

Regardless of the question of the legality of executing "buy-ins," the result could be that the members of the distributing group would be penalized.

Actual experiences were cited to the Committee: In connection with one offering the managing underwriter "failed to receive approximately 60,000 shares of stock two days after date of delivery and the closing of the account." In another instance, of the 600,000 shares involved in an underwriting, approximately 90,000 shares hit the stabilization bid over a period of four to five business days and delivery was not completed until a long period after due date.

There has also been some suspicion that "pools" have been

formed to depress markets on new offerings. If so, disciplinary complaints against these practices may be handled under Article III, Section 18 of the Rules of Fair Practice.

The first positive action to combat these abuses has been the use of statements by some managing underwriters—when purchasing and confirming—to the effect that "this transaction may be cancelled at our option if delivery of these shares is not received by the settlement date shown on this statement." It appears that this method of dealing with the problem has proven helpful.

Should the problem continue, however, the NASD Board will be forced to consider an interpretation under Article III, Section 1 of the Rules of Fair Practice, barring the practices as unethical, or a rule prohibiting short sales of new equity issues to a dealer stabilizing such securities.

Other members of the Stabilizing Bid Committee are J. Howard Carlson, Paul Devlin, John S. French, Robert C. Johnson, and Wickliffe Shreve.

## **QUOTRON**

Regular transmission of bid prices on over-the-counter stocks via the Quotron ticker circuit was to be extended about August 1 to all cities where Quotron is in operation.

Each bid is updated at least hourly by a firm making a primary market in the issue and is intended for use as information only. The dealer furnishing the quotation will not be identified on the ticker line, nor will the Quotron Data Center make public the source.

Some 1100 stocks will be carried on the ticker service by August 1. Symbols have been assigned to approximately 1400 OTC stocks which are listed in a booklet published by the Quotron organization.

The stocks carried over the ticker circuit are selected principally from the national and regional lists supplied to newspapers by the NASD.

## **SALESMAN SUSPENDED FOR SETTING UP FALSE ACCOUNT**

The Association's Board of Governors has suspended for 12 months a registered representative who opened an account with his employer under a false name.

The Board acted on an appeal by the salesman from a District Committee decision that would have resulted in revocation of his registration with the NASD. Reason for the modified penalty, the Board said, was that the registered representative has already served a three-month suspension by the New York Stock Exchange and has been penalized by "adverse reaction in the business and community . . ."

The Board also affirmed the District's penalty of censure and \$500 fine, plus costs, against the employing member. Close supervision and control of the branch office where the individual worked might well have made it impossible for the salesman to carry out the plan of deceit disclosed, the Board explained.

The registered representative allotted two "hot issues" to the fictitious account.

The member firm issued 10 checks to the registered representative, made out to the false name, and these were cashed by the representative. The firm was slow, if not remiss, in uncovering the true nature of the account, the District Committee said, and the Board agreed. Of the salesman's conduct, the Board said, "The deceit illustrated by the opening of a fictitious account with an employer constitutes not only unethical conduct under Association rules but a serious breach of an employee's duties to his employer."

## RECIPROCAL FREE-RIDE NETS SUSPENSION FOR SALESMAN

A registered representative, who worked out a complex scheme to enable his wife and the wife of a salesman for another firm to obtain free-rides on hot new securities issues, has been suspended for six months by the NASD Board of Governors.

A three-month suspension was ordered against the proprietor of a third firm who also participated in the reciprocal free-riding arrangement.

The Board also levied fines of \$5,000, \$3,000 and \$1,000, respectively, against the first salesman, the sole proprietor, and the second registered representative.

The free-riding scheme developed like this: The first registered representative made sales of 25 new issues, most of which were immediately quoted at premium, to the father-in-law of the sole proprietor. The father-in-law sold the shares to the sole proprietor at public offering price.

The sole proprietor, in turn, in 17 instances sold all or part of these shares to the wife of the first salesman—the original seller. The salesman's wife sold out immediately at a profit, and the sole proprietor also made a profit because he had marked up the shares to a price half-way between the public offering price and the premium price.

Also, the first salesman sold shares in three hot issues to the wife of the branch office manager of a third firm, and the first salesman's wife bought four hot issues from the third firm's branch office manager.

In its decisions, the Board added the additional penalty of suspension against the originating salesman and the sole proprietor, because of the seriousness of the offenses against just and equitable principles of trade and against the Board's interpretation on free-riding and withholding.

## CHAIRMAN



Henri L. Froy, of Abraham & Co., is chairman of the Association's Foreign Securities Committee.

## MANIPULATION SEEN IN TIE-IN SALES

The Association believes that tie-in sales in connection with new issues that go to a premium over the offering price can be considered manipulative practices under Section 18 of the Rules of Fair Practice.

Accordingly, any indication of tie-in sales will be referred to the appropriate District Committee for disciplinary action.

A question on the subject has been incorporated in the free-riding questionnaires sent to underwriting and selling group members in connection with hot new issues.

The question, in substance, asks whether any shares were sold subsequent to the offering date, at the market or at any previously agreed upon price, to any person who also received stock at the public offering price. Details of such transactions are requested.

Approximately 1200 firms are being sent free-riding questionnaires on the latest group of hot issues. This 20-issue group includes the \$25,000,000 offering of Howard Johnson Company common, involving some 500 members in the underwriting and selling groups; and \$15,000,000 of Welch Scientific Company common, which was offered by 85 underwriters.

## OVER-THE-COUNTER CLEARING HOUSE UNDER STUDY

A system for clearance and central delivery of over-the-counter securities has been proposed to the Board of Governors of the NASD and the Board has authorized a detailed study of the proposal.

A special committee, headed by Carl Stolle, president of G. A. Saxton & Co., Inc., has been appointed to investigate the possibility of setting up such facilities in New York City and eventually expanding them to become national in scope. The Board has expressed a willingness to underwrite initial costs, subject to prompt reimbursement from any clearing house corporation which may be created.

To determine the extent of interest in such a project, and at the same time provide basic information in District No. 12. The questionnaires, a questionnaire has been sent to all members of the Association in District No. 12. The questionnaire asks whether members feel there is a need for daily clearance of OTC transactions and a central delivery operation; whether members would be interested in participating in such a clearing house; whether members would be willing to contribute to a guarantee fund a minimum of \$25,000; and, whether members would make a proportionate subscription to provide operating capital.

The estimated amount of capital now being considered is \$1,000,000, but the Stolle Committee emphasizes that this and the guarantee fund are arbitrary estimates, and that favorable response to the questionnaire in no way would commit or obligate a firm.

## MORE SALESMEN

Member firms employed more representatives during the first seven months of 1961. As of August 1 there were 94,429 registered Representatives. On December 31, 1960, there were 93,824 registered.