

**Our Securities Markets—Some S.E.C.
Problems and Techniques**

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OUR SECURITIES MARKETS—SOME S.E.C. PROBLEMS AND TECHNIQUES

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THE integrity and strength of our securities markets are essential to our national economy. They are symbols of our freedom and a measure of our capabilities. As we move toward greater participation in international economic exchange, they will be a major factor in the influence of our policies, and our markets will be subjected to competitive tests of increasing severity. It is clearly appropriate to give serious and frequent thought to their effectiveness and practical workings. The purpose of this paper is to discuss some of the regulatory and enforcement aspects, not so much the technical procedures as the overall problems that cannot be resolved by formalistic measures.

The Federal securities laws were enacted and, in 1934, the Securities and Exchange Commission was established to revive virtually dead markets by imposing standards of integrity, thus restoring public confidence and encouraging public participation. The Commission has used three approaches to achieve this end: enforcement activities directed against wrongs, the regulation of specific practices, and the requirement of disclosing significant information so as to enable investors to protect themselves and to discourage sharp practices that would be embarrassing or worse were they disclosed.

A paternalistic, or licensing, approach, in which the Commission would be required to pass on the merits of securities, transactions, or prices, or the professional qualifications of broker-dealer firms, was specifically avoided.

During recent years market activity has been the greatest in our history. Trading has been at unprecedented highs. More public investment money has been directed into capital expansion and improvement than ever before. New companies and new industries have risen in striking demonstration of vitality. It is estimated that fifteen million Americans now participate, as direct investors, in our capital markets. Many others participate through mutual funds and, as a result of the trend toward liberalization in "legal investments," through bank deposits and insurance policies. Apart from the statistics, this represents a psychological development of great significance. In an increasingly complicated and industrialized society it answers the

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desire of many people to feel that they have some ultimate proprietary stake in the nation's economy—a desire to be something more than an element of production. In this sense, such widespread participation in the ownership of securities offsets a feeling of exclusion that has, in the past, been catered to so effectively by the proponents of social ownership.

The heavy flow of public money into the market bespeaks the undoubted success of the Commission's activities over the years. Of course, general economic swings, speculative phases, inflationary pressures, and particularly the efforts of some exchanges and leaders of the financial community are also largely responsible. And yet, despite all of these indications of well-being, the Commission in these same recent years has faced mounting problems in the traditional areas of fraudulent selling, manipulation, touting, embezzlements, and conflicts of interest. The market itself has shown that, despite the activity of the Commission, it is still subject to substantial fluctuations on high trading volume, indicating sudden and basic reappraisals by investors.

Both the Commission and the financial community might well wonder: What will be the ultimate effect if this broad public venture into the market place turns out to be a generally bitter experience?

Some characteristics of the securities markets should be noted at the start. Our markets are distinctively open. Mere disclosure admits any scheme, brokers and dealers are not federally licensed but simply registered, and the public is invited in without restriction. They are characteristically American, free and available to all and, as noted, used by a very broad segment of the people. Most of the problems come from these qualities, but so do the strength and energy, the competition, and the fresh outlook.

Healthy markets fluctuate in response to free trading pressures. Market prices also move in trends with evolutionary changes in the basic factors bearing upon them, while random fluctuations caused by specific incidents jar individual prices or the market generally. The characteristic of constant motion, of course, greatly excites the speculative interest in the market and gives rise to the evil practice of exploiting and exaggerating the movements by running them up and chasing them down. This problem is approached primarily through the Commission's short selling rule, the floor trading rules of the principal exchanges, and the specialist system of conducting the market. Secondarily, the full disclosure policies of the Commission as enhanced by responsible exchanges and securities houses smooth out the trading by eliminating the blindness which always causes panic. However, recent price movements have shown that even with

the inhibitions against "bear raiding" and widespread use of full disclosure, the market is still subject to seemingly convulsive movements. This is largely because there are many other factors bearing upon the market than mere business statistics and trading mechanics. The human factor, which if free will never let a price remain unchallenged for very long; the outlook for particular industries and the national economy; and government policies on currency, taxes, trade, wages, prices, budget, and the securities markets themselves all are of great importance, as is the state of foreign affairs. There simply is not much "full disclosure" in the political, governmental, and diplomatic areas; "bear raiding" is an accepted technique. And, even seemingly small shifts in a factor can be greatly magnified if the analyst chooses to apply to it the straight line projections which are so tempting to anyone seeking to prove a point.

There seems to be more and more market concentration in New York, or, to put it another way, the New York market has drawn to it the participation of the entire country. This, of course, has practical advantages. Large volume makes a continuous auction market. Even more important, the sheer compression generates a trading psychology that attracts ever new interest, not only here but abroad. Concentration gives the market a power to carry individual transactions along with it, rather than merely being the function of those transactions.

This quality gives rise to an ethical responsibility not to pervert that power which far transcends basic statutory duties. Responding to that responsibility is a complex of the conflicting interests and duties of brokers, underwriters, specialists, investment advisers, reporters, commentators, trustees, custodians, exchanges, auditors, lawyers, and many others who play their essential and often delicate roles.

Ideally, a securities market is analytical, its activity is based on reliable information supplied and interpreted by stable securities houses. It is both questioning and enterprising—conservative, yet ready to embark upon venture. The full effectiveness of the Commission's disclosure and regulatory requirements is largely predicated upon such an ideal market.

In depression years the market is unduly timid, demoralized, sluggish, incapable of even supplying the needs of existing business. It was to counteract just this situation that the Commission was formed.

The market in recent years has been increasingly subjected to psychological forces, preponderantly those of optimism—a desire to speculate on the future—with occasional cold winds of pessimism

generating recourse to the "market out" in many an underwriting, as the Street hastens to reassure its skittish customers. Market dynamics have taken on an exaggerated importance. Many investors, if they could be called such, act upon expected market movements rather than an analysis of the merits of the particular security. It has even seemed that the more implausible a security appeared in the prospectus as it finally cleared the Commission and the more outrageous its offering price, the greater the public demand. Stimulated panic—that age-old merchandising technique of "Buy! Buy! It will be oversold tomorrow"—has been particularly in evidence. As the registration process loses its practical effectiveness, we are faced with the proposal of increased regulation designed to take up the slack, to protect such investors from themselves—if such a thing is possible. Is it a complete throwback to question whether this particular last full measure of protection is actually desirable?

In this type of market even the most subtle fraud or manipulation can cause enormous injury. Enforcement activity becomes increasingly important, because to achieve the desired effect by regulation the necessary burden on the whole industry would be out of line and might return it to the doldrums where the Commission first picked it up. But enforcement problems themselves become much more acute as the investor's native shrewdness and common sense are abandoned in favor of blind speculation.

With these thoughts in mind, let us consider certain endemic Commission problems and some of the particular areas of major concern.

Manipulation, or the artificial movement of market prices by one deceptive technique or another, is always a tender subject. What is proper is often distinguishable from what is improper not by the act itself but solely by the intent. Easier to detect than to prove, manipulation is a particular problem when it is with the trend of an active and highly responsive market.

Prior to the establishment of the Commission, manipulation was usually conducted by pools formed by traders who would bid up the price of a stock. When public interest had become aroused, the pool manager would carefully feed out the stock owned by the pool so as not to quench the interest before a maximum amount had been moved. Coordination by management was clearly of vital importance to prevent some participants from "back-dooring" the others by laying off while their confederates were still buying. Pools were open and notorious and were elaborate affairs, moving a stock up or down over extended periods of time. Such avowedly manipula-

tive pools are unknown today, principally as a consequence of the Exchange Act of 1934.

There are, of course, pooled market transactions by mutual funds acting on behalf of their securities holders. But the stated purpose of these funds is investment, and they pursue that purpose under the control and scrutiny of the Commission pursuant to the Investment Company Act of 1940.

Prohibition of specific manipulative techniques, such as wash sales and matched orders, are excellent regulatory aids to enforcement because they eliminate the need to show intent. Increasing use is being made of the Commission's regulatory prohibition of purchases at a time when a distribution is contemplated. But it is difficult to establish just when a distribution is actually contemplated. Even the Commission staff has differences of opinion on this matter. Substantial purchases by persons having an interest in distributions, or persons associated with them, are not infrequent. And there may well be a real motive of clearing away a market overhang, or lining up some cheap stock based upon inside information in purported "arbitrage" transactions, or crudely driving up the price of the stock. Perhaps the best way to police this area is through the disclosure procedures of registration. Would it not be reasonable to require that all transactions by underwriters, insiders, principals, and their associates during, let us say, the year preceding a distribution be set forth unless it be specifically determined that they were of minimal effect?

On some exchanges there is the practice known as "scalping," by which traders on the floor gather around a trading post, collectively bidding up a stock until public money is enticed in, and then feed the stock out. There is no formality to the arrangement, and therefore its effectiveness is limited to hit-and-run operations. By the same token it is difficult to establish by investigation. But persons up to such wrongdoing are easy to spot, and exchanges have rules against floor traders taking a stock on an "up-tick," or even holding it there and clearing the book at that price (a "zero up-tick") so that a "market buy order" from off the floor would inevitably take it up. Such rules also forbid unduly congregating at a particular post as a further measure against scalping. From the nature of things these rules can only be effectively enforced on the floor of the exchange. It seems clearly preferable that this particular police work be done by the floor committees of the exchanges, rather than by Commission personnel.

Another alternative is complete abolition of floor trading.

Floor trading is useful to an exchange, in the sense that sheer volume and continuity of trading are good. This is particularly so because the trading is by professionals who tend to move in on a sudden sell-off to pick up bargains, and thereby prevent a serious dip. One is now prohibited by rule from "shorting on a down-tick," so the play on the floor during a sell-off is pretty much restricted to the "bulls," and in this sense the traders do, in fact, back up the specialist.

Also, is it not reasonable to suggest that whittling away the privileges that go with membership will lessen the on-the-floor responsibility of members? And yet, in view of its possible abuse, the overall desirability of floor trading has been challenged by high Commission spokesmen. The activity being desirable but so susceptible to abuse, it is difficult to understand why a few have been permitted on some exchanges to jeopardize it completely by their "jam sessions."

Hot issues were one of the more spectacular phenomena of recent trading and perhaps an indication of some characteristics of the market. It seems incredible that an issue of stock be offered at 5 at 2 o'clock in the afternoon, "out the window" by 2:15, traded immediately at 7- $\frac{1}{2}$ to 8 and, by the end of the day, at between 10 and 12; and yet this was not unusual just recently. The Commission has released a study indicating possible manipulative techniques that might artificially cause the market to take such unnatural jumps. These techniques are, by and large, abusive exaggerations of recognized practices, which in themselves are necessary and accepted in the merchandising of securities.

Such an issue as described was undoubtedly oversold. A demand was stimulated that was far in excess of the reasonable supply. Of course, some overselling is necessary to get any issue out smoothly. Underwriters generally go short enough of the stock so that they can be sure the issue will not stick and the immediate aftermarket will not sag. But with so much emphasis on the non-binding characteristic of an "indication of interest," how does one know in the pre-effective period when an issue has been oversold by the dealers, and from the Commission's point of view how does one prove that someone intended that an issue be excessively oversold?

Another possible manipulative technique used to make this issue "hot" is that a substantial part of the stock in distribution was deliberately placed in safe hands so that it would not come into the after-market, thus limiting the available trading supply artificial-

ly and magnifying the effect of the overly stimulated demand. This particular abuse stands in interesting contrast to that proscribed by the "free-riding" rules and regulations, in which the practice of buying a new issue just to sell and snatch a point or two in the after-market is decried as still another form of manipulation. Such "free-riders" are deemed to be part of the distributive process and statutory underwriters who exact tribute as the stock passes out into distribution. If they are associated with the securities industry, their participating at all could be evidence of a violation of the "fair and equitable principles of trade" of the National Association of Securities Dealers.

In discussing manipulative techniques, especially in the recent context of so-called "hot" issues, the most important aspect of all is frequently overlooked, the purpose of the run-up. In order to constitute a manipulation, some wrongful end must be achieved by artificially lifting the price and giving a fictitious appearance of value to the security. In other words, a purpose must be shown that is inconsistent with any legitimate use of the techniques.

It might seem curious that a "hot issue" in and of itself invites challenge. The instinctive concern of the Commission should be with the "cold" issues, the issues that go sour after distribution, not those that go up. In explanation of the Commission's attitude, it should be remembered that in the case of most new public offerings the significant distribution takes place after the original offering—usually six months after—when warrants, options, cheap stock, front-end stock, insider stock and so forth, registered at the same time as the original offering, come onto the market under a post-effective amendment sticker. If the market price went up spectacularly just before and down without explanation afterwards, a pattern of a classical manipulation appears, one calling for prompt attention. It also would seem to represent a truly abusive "free-ride" by these statutory underwriters in what is actually a continuing distribution.

At the same time, let the authorities remember that in other offerings, artificial market stimulation by aggressive buying, touting, and locking in large stockholders artificially, can take up a stock just before the original offering to the public. This is just as much a manipulation as the so-called "hot-issue," even though the lock-ins may be in the underwriting agreements on file with the Commission, while the run-ups are simply matters of observation. And, let them also remember, though with due reserve, that some issues are "hot" because the underwriters located sound and attractive investment

opportunities for their customers and a strongly psychological market ran off with them.

Touting and publicity, the aggressive promotion of stocks by word of mouth, using sly, deceptive innuendo or plain lies, is as old as trading and has been consistently condemned. And yet, "tout and out" is as new as this morning's market. As in the case of centers of political activity, talk of all sorts moves around the financial community with amazing speed. The hunger for information, which sometimes is as indiscriminate as it is acute, derives from and in turn creates a direct effect on trading. In fact, to the cynical in-and-out trader, the accuracy of a report is not nearly as important as the existence and currency of the report. If he waited to prove it out, the market would have left him far behind. From an enforcement point of view, tracking a rumor is a futile exercise leading inevitably to some unidentified man who was overheard talking in a bar on New Street.

Free and current information is the best way to meet the rumor and touting problem. Stock exchanges or over-the-counter houses making markets should, and the responsible ones do, promptly call upon authoritative sources to comment on rumors and get the straight facts in direct quotes out on the broad tape. And, a thought for the Commission itself: nothing gives greater currency or impact to rumors than an artificially imposed news blackout while the world awaits the duly processed version of the facts.

Nevertheless, rumors will persist and touts will be there to spread them as long as men have tongues and ears and an anxiety for information. Let us reconcile ourselves to this: it is impossible to give effective protection to someone who buys on rumor—he is pretty much on his own and should understand this. The only cure is an occasional authoritative reminder, which is usually enough for basically responsible people, and the hard school of being taken, which is the only form of communication understood by the tape-watching gamblers who make up the hard core of this particular victim group.

The great bulk of financial information is much more than word-of-mouth exchanges. Its dissemination, as in the case of any other information, has become a complex and effective science. Information should be broadcast so that investors can make up their minds, but a large part of the public itself has become conditioned to look to and accept an "image" as a substitute for facts and application of the individual reasoning process. It would be easy to criticize the "image" if it were only used aggressively, but apparently it is

a necessary defensive coating to any legitimate person or business wandering out on the public domain. Perhaps all this will cure itself in time. The purveyors of the "image" seem to be taking on something of an image themselves, and poetic justice might truly prevail.

Meanwhile, the approach should be an anathema to any authority concerned with "truth in securities," or with truth in anything else for that matter.

In this general area, and particularly in connection with Commission enforcement work, a rather extraordinary proposition is asserted with some frequency, and surprisingly it is sometimes accepted. The wrongdoer claims that to proceed against him, would bring out into the open the true state of affairs that he created and, therefore, collapse an image of well-being and respectability. The immediate effect of this would be to depress trading prices of affected securities; and it is argued that, therefore, the Commission is hurting the public investors, who are the very ones the Commission should be trying to protect. That the wrongdoer should try to use his own victims as a shield is generally enough to incite even the most phlegmatic to decisive action. But, let us follow the thing through, because sometimes the proposition is voiced by well-meaning and honorable people. It is not the province of the Commission to conceal wrongdoing or gross incompetence in order to perpetuate an artificial impression or image. The inevitable collapse will, of course, cause loss, but why should present security holders be permitted to pass that loss on to others until ultimately the truth is out? Then, too, it is a very shortsighted policy to accede to blackmail of any sort. If wrongs are not righted, enforcement problems become contagious epidemics and get out of control. Anything that depends upon false impressions to give it some immediate strength will not last, and when the realizations become general the disillusionment and reaction have a far more sweeping effect than mere temporary oscillations in an otherwise secure market.

Fraudulent selling is the basic wrong against which Congress first legislated. Yet it achieved its most virulent manifestations quite recently in the great boiler-room epidemic. Virtually hundreds of convicts and additional should-be convicts were pushing out securities over long-distance telephones in the Wall Street area. The immediate take ran over one hundred million dollars a year. Many thousands of small investors lost all their savings in these cruel swindles. The resurgence of the boiler-room was conceived by shrewd promoters and lawyers who generated the securities, papered the market with

investment advice, manipulated the trading prices, organized the boiler-rooms, and pushed out their shoddy merchandise at ten or twenty times cost. It was the climax of two decades of lax enforcement and indifference by the courts ("It's only money"), when punishment was decried as tribal ritualism, ineffectual vengeance, and hypocrisy, and to be replaced by regulation and other modern techniques.

The legal problems of proving the existence of a securities fraud and connecting the top promoters to it are enormous. Nothing lends itself to a fraudulent scheme like securities. Mere pieces of paper, for little extra cost they can be adorned with impressive scroll work and symbols of prosperity. Value depends on complexities of property rights and operating results, of which each element, even including cash in the bank, is subject to varying interpretations. But, most important, these documents represent that highly volatile intangible, the possibility of speculative gain. Any really good fraudulent scheme accords the victim a feeling of participation, gambling on the future, lured on by the insinuation that he has special inside information. It appeals to the more basic acquisitive instincts, the desire to get something for nothing, which tragically is a particular weakness of those who work hard and save for everything they do get.

The techniques employed by the skilled loader, or master dynamiter, would frequently clean out the victim of all his savings and then put him in debt. Crude misrepresentation is, interestingly, the least effective. Some operations worked on the classical bait-and-switch approach using sound securities, perhaps sold at a discount, as the lure or "come-on." Then when the victim was ready he would be switched-out into the "junk." It can be seen that this is necessarily a sporadic technique not suitable to a large, highly organized "bust-out."

Without a doubt the most dangerous and efficient, the most remorseless in its consequences, is the "load-and-reload." Generally, a listed stock is used. In a typical scheme the promoters would gain control over the company and then issue themselves a large block of stock using the old 133 merger. The new shares would be washed around brokerage houses so the true ownership could not be traced. Trading on the exchange would remain quiet, while the boiler-rooms opened up introductory accounts over the long-distance telephones with thousands of persons who could see no risk in buying a hundred shares or so. Corrupt investment advisory services would begin to tout the stock, and public relations men would

disseminate favorable publicity. Trading on the exchange would increase in tempo and the prices would begin to move. As they did so, the boiler-rooms would report back to their stimulated customers and suggest new purchases, but in modest amounts. The market activity and publicity would be increased, and as the prices moved and the loaders' "inside information" seemed completely confirmed the victims would become fully aroused. Up and up would go the prices, and the victims had become helpless at best but more likely imploring the loaders for more and more of this fabulous stock. Certificates would be slow in delivery, incidentally, so they could not be fed back onto the market. As the "big bundle" was finally worked off, the market would begin to slide and the loaders would advise their victims to "average down." Sometimes the market would be worked up and down a bit just to euchre out that last possible dollar. The anguish of persons who have been badly taken by the load-and-reload simply cannot be described.

How does such a case appear to the Commission investigators? They start with a purchaser, let us say in Kansas, who bought over the long-distance telephone from a salesman who claimed to be in New York. He, in turn, obtained his information about the company from a sales manager in a firm that took down the stock from a broker located outside the country. The stock is of a foreign-domiciled corporation. The investment advisory services and market rigging activities were financed by a complexity of foreign-origin numbered banking accounts.

These difficulties seem formidable indeed, but they were overcome. The Commission, in good heart, launched an all-out attack, described as "savage" by financial commentators. In order to achieve some immediate results flash quizzes were instituted into the manipulated markets. Administrative procedures were started against the firms for the bookkeeping violations inherent in their schemes and, as the market quizzes collapsed the manipulated values of the boiler-room merchandise, temporary restraining orders were obtained closing down houses for failure to have adequate capital. These were temporary expedients only, but they did put a halt to the very large and well-organized operations. The hard-core loaders scattered with their sucker lists and set up smaller hit-and-run operations. Criminal investigations were simultaneously initiated as the only effective or appropriate way to deal with this type of activity. It was unfortunate that much of the investigation could not have been done by the Grand Juries themselves so that more timely criminal prosecution would have been possible. As it was, there was what appeared

to be a hiatus of several years while formal criminal investigation reports were referred through channels to the United States Attorneys. Over 300 persons have been indicted by Federal Grand Juries as an aftermath to the boiler-room epidemic. Most by now, some six years later, have been tried and convicted, including not only the salesmen but also sales managers, promoters, lawyers, and intermediaries. All too frequently, these procedures have not, at least as yet, reached all the way up the pyramid to the ultimate principals; but a hard, steady push should get there and vindicate at last our commercial integrity.

Because of the innate possibilities, we will never see an end to fraudulent schemes in our securities markets. They appeared with the first crude participations in joint ventures. We will, however, keep them to a minimum if we never forget that the only effective, as well as the only proper, remedy is criminal enforcement.

Corrupt promoters are a particular responsibility of the Commission. Disclosure requirements of the Federal securities laws make it possible for an investor to protect his interests by means of the information that must be supplied to him. They also have an additional use, which will play an increasing role in Commission activities. They give a basis for Federal enforcement action in the event of serious wrongs inflicted by insiders upon a corporation, on the grounds that such wrongs were incompletely reported or not reported at all. In other words, by proceeding upon a violation of reporting requirements the Commission has recently, in effect, entered into the prosecution of internal wrongs against a corporation.

Aside from the ample legal basis for this, there is very compelling practical justification. The average large, publicly held corporation is usually formed in one state, it has its administrative headquarters in another, and its plants, properties, and activities are spread everywhere in this as well as foreign countries. Its executive officers, directors, and stockholders reside in many separate jurisdictions. Transactions involving these corporations, particularly when devious and intentionally complex, cut across the lines of so many domestic and foreign sovereignties that wrongs inflicted upon them can seldom be localized in any state or, increasingly, in any country. The techniques are subtle and not susceptible to efficient treatment by local enforcement agencies. There is no Federal offense *per se* in an embezzlement from a large corporation, and, if sufficiently complicated, such crimes have gone on without remedy almost indefinitely. Obviously, Federal authority offers tremendous advantages in the questioning of witnesses, the obtaining of documents,

and the elimination of jurisdictional controversy, as well as in other problems more peculiar to local enforcement situations.

Perhaps embezzlements of major proportions from publicly held corporations should be in and of themselves Federal offenses as essentially interstate problems. But, meanwhile, reliance must be had on failures to report or incomplete reports. This limits, to a great extent, effectiveness to listed companies or companies that fall within the definition of "investment companies" in the 1940 Act, and to a lesser extent to companies that made more recent distributions and were required to subscribe to reporting undertakings. As a result, quite a special market has been generated in publicly held corporations not under any Commission reporting obligations, usually those that have not registered shares in the past ten years—or, most simply, a spinoff from another publicly-held corporation. Of particular interest to a shopper in this market would be one of the companies of which the shares are admitted to unlisted trading privileges—all of the market advantages of a listing and no reporting or disclosure responsibilities. Exemption of these was a special category of lubricant apparently necessary to slide through the Securities Exchange Act in 1934.

In no other area of the Commission's work today is enforcement activity so necessary. It should be the very special province of this Federal agency to protect the market place and all it represents from the predatory raiders and strippers, instinctive players of the jurisdictional game, buttressed by their own shrewdness and the most skillful and prestigious lawyers, accountants, financial technicians, public relations men, and the sort of powerful connections that seem to flow from and enhance this type of operation.

Of course, effective remedial measures require considerable discernment. The most venal and dangerous offenders do not wear identifying insignia, and sometimes their press is quite good. Their association with charities, cultural activities, and cosmopolitan society is likely to be pronounced. The special enforcement work or necessary processing presupposes special instinct and great insight in accurately identifying the quarry. The hounds so often pursue and run down the awkward innocent or petty offender while once again the fox heads for the chicken coop.

Conflicts of interest in almost every aspect of our national life are coming up for scrutiny. Naturally, there are many conflicts in the securities industry, as there are in any fairly complex human activity. For the most part difficulties are kept in check by decent

self-restraint, at least until some greedy and short-sighted person finds that he can make a few points by exploiting his dual role.

The conflicts of a market specialist holding the trading book of a particular security and charged with making the market in it, who is also engaged in making a distribution, trading for customers, or giving advice to investment bankers, have been the subject of a recent special report to the Commission. Aside from the sheer crudity and the fact that there are specific provisions directed against abuse in this area, a remarkable thing is that this activity was permitted to persist by the exchange involved and seriously jeopardize the whole institution of market specialists.

Sensitivity in respect of specialists is really akin to the older, more basic problem of conflicts in the functions of broker and dealer which are combined in almost every important securities house. Operationally these functions combine very well, and awkwardness is removed if the firm points out to its customer whether or not it is acting exclusively on behalf of the customer or whether it is actually on the other side of the transaction. Such disclosure is required at any rate on the confirmation reflecting the transaction. Sometimes a firm might impose on a brokerage relationship with its customers to set up an underwriting or some other dealer activity. Those who do threaten the combination with the same surgical fate that befell the commercial-investment banking combination thirty years ago.

Conflicts between persons having access to inside information about a corporation, arising out of a position of trust which they occupy with that corporation, and public stockholders or investors, have been of concern to the Commission for some time. Let us take the situation of a brokerage firm that has a close associate on the board of directors of a corporation and is servicing the accounts of customers and partners who trade in the securities of the corporation. This conflict problem will arise where anybody, particularly directors, attorneys, auditors, or executive officers, has access to particular inside information. To be sure, in listed companies directors are personally subject to the short-swing restrictions. But the problem of conflict remains between the obligations of a broker who is a director to the stockholders of a corporation and the investing public at large and the responsibilities of that same person to the clients of his brokerage office. A very circumspect broker who is also a director may actually be at a disadvantage in the use of information that, although not publicly reported, is generally

known, to the great detriment of his customers who look to him for guidance in investment matters.

Generally, this conflict of interest first arises when the firm, acting as a dealer, underwrites an issue of the corporation's securities. A representative of the firm goes on the board of directors of the issuer to protect the interests of the customers who invested in those securities, to make sure that the public money is wisely and profitably employed. Also, the investment banker has undoubtedly had wide industrial and executive experience and can render much better financial and business advice if he is part of the management. As time goes by a market is established and the firm may be active in trading for its own account (as a dealer) or in executing transactions for customers (as a broker). Many people become investors who do not have accounts with the firm in question, and of course they are at a trading disadvantage with the firm and its customers.

This difficulty is not limited to broker-dealers. Let us take the case of a bank that has a substantial block of shares in trust for members of the family and charitable designees of a former officer of the issuer. The bank is given representation on the board of directors, and the bank official serving on the board learns in that capacity of a situation that, if generally known, would halve the market trading price of the stock. He reports this to the bank. Should it sell the shares, or should it await a public announcement of the new situation? Avoidance of this dilemma is the reason why some mutual funds will not permit persons associated with them to serve as directors of the issuers of their portfolio securities. Many an investment-banking house is now adopting this practice even though it has underwritten a distribution of securities of the issuer.

A brokerage firm sponsoring a mutual fund finds that if the fund goes into a particular security its purchases will take up the price of that security. It locates an investment opportunity that appears attractive. Should it put its customers into the security first, or the mutual fund, or what? The same applies to investment advisers who find that a recommendation to a large or financially powerful list of subscribers can have a substantial effect upon a trading price. Investment advisers usually protect against any unfair advantage by releasing the information over a weekend, so that all of their customers have equal access to the market on the opening of trading Monday morning. It goes without saying that reputable investment advisers and mutual fund operators do not take a free ride on the backs of their customers through personal investments in the

selected securities, and yet isn't it a fact that this practice is not unknown?

Some say that this whole area should be covered by a "code of ethics." If specific prohibition is necessary to identify this sort of thing as wrong, then indeed there is cause for serious concern for the moral climate of the industry. And, further, once such a code is in preparation and all of the usual and prudent safety factors are incorporated to assure that every conceivable wrongful thing is effectively prevented, who can tell where the general prohibitions will stop?

Mutual funds have grown in the past decade at a rate which is literally phenomenal. Our national prosperity and patterns of wealth distribution have placed unprecedented savings in the hands of persons who badly need fiduciary assistance in investments. A combination of inflationary pressures, aggressive selling, and rising markets has driven a growing share of the more modest savers from savings banks and bonds to the funds. Mutual funds, being pools of investment capital, give rise to problems of market activity. Mutual funds, being merchandised to a great part on a door-to-door basis to unsophisticated persons by part-time salesmen working on a commission basis, face problems of fraudulent selling techniques. Mutual funds, being a complex of trust relationships in often conflicting areas, are also subject to abuse on his score.

These characteristics of great need, fiduciary relationships, and conflicts are the reason that the Commission, in this area of investment companies, has been given jurisdiction over the internal workings of those companies, in addition to the usual requirements that issuers of securities to the public make disclosure of such workings.

A mutual fund by its large and coordinated purchasing power can move the price of a security substantially, particularly if it deliberately uses certain market techniques to do so. By continued support buying it can hold that price in a certain range. This, in a sense, would be in the promotional interests of the fund, because mutual funds are permitted in the computation of their net worth to show their entire investments at the current market value. Pronounced advances in per share net worth are the big inducement for additional investors to come into particular mutual fund, and their investments in turn are converted by the fund into additional market purchases of securities selected by it. The "snowballing" possibilities are apparent.

On the other hand, from the point of view of value received for investment—aside from the effect on market quotations—a fund

would, and the proper do, try to acquire its stock with minimum movement of the market. It thus becomes of interest, just how and when, technically, the purchase orders were placed, and what was the activity of the fund, or an affiliated brokerage firm or investment adviser, just prior to balance sheet date.

The funds have become so large, that perhaps much of the trading activity on the exchanges is dominated by their transactions. It has been argued whether or not this major participation by mutual funds will have a stabilizing effect, or whether it might tend to accelerate a downward push. The answer basically lies in what kind of activity the funds have been engaged in. If a fund has been running up stocks, it is bound to bring an unhealthy, unstable quality into the market which would make any down swing or shake-out much more severe. There is experience in the past that the funds have had a stabilizing effect, which might of course be due to different characteristics of funds a number of years ago. An old dilemma appears: Market power in intelligent hands is necessary to stem the tide of a down swing, but what is to prevent such power from capriciously moving a market price up? It is said with intent to comfort that the Commission is in a position to lock investors into mutual funds by preventing them from turning their shares in for liquidation, and it can thus stabilize the market. It would certainly raise serious questions and cries of anguish if this were done in a strong downward market movement so as to hold in mutual fund investors while everyone else was liquidating.

The prodigious growth of mutual funds and the mounting effect of fund transactions on the market is a problem requiring consideration. The Commission has had studies of these matters made by a prominent business school, but the results have not been released. It appears that further studies are under way, and perhaps public hearings are in the offing.

For the most part, mutual funds are formed and promoted by firms interested in one or more of the following aspects: selling its securities, giving it investment advice, conducting its portfolio brokerage transactions, or administering it—or more specifically, in the sales load, management fee, or brokerage commissions. There is a consequential danger that the fund might become a mere vehicle to achieve these ends. Management becomes negligible and the fund is run exclusively to suit the interests of those who are paid to serve it.

When one has the power to invest large sums, there is always a temptation to use that power to give leverage to a private trans-

action. As an example, there is the temptation to make a personal investment and then bring in fund money to give the particular stock a ride. There is the temptation to allocate the commission business in such a way that a private end rather than fund interest is served, as a reward say for a chance to subscribe to a particularly attractive new offering. Using an investment company position to gain a voice in management can open up possibilities of a myriad of side deals. But, whatever the twist or the angle, practices of this sort are a strong indication that the management tolerating them should not be entrusted with the fiduciary role which is the principal thing that a fund sells to its investors.

Merchandising techniques of funds vary widely. Since it is a competitive business, the decent and reputable may be hard put to match the high pressure drives of the unscrupulous, and the better element should be protected by Commission action. Deceptive statistics, based upon stocks which have been run up, are the most dangerous but least-mentioned abuse. There is much talk about "reciprocity," the giving of commission business to a broker as an extra reward for selling the fund as a dealer. Of course, if the portfolio is being churned deliberately so as to give a sweetener to the sales load, this practice would be intolerable. But if not, and if the broker gets good market executions and if the practice is openly and fairly administered, what is the harm? On what other basis, aside from compensation for investment advice, should commission business be handed out?

Contractual plans have been criticized as a method of merchandising, particularly if they employ a front-end load. They do go against the grain as devices which tend to lock smaller investors into long-range commitments to buy securities. However, some lock-in in thrift programming seems appropriate, in fact the participants seem to want it. It is characteristic of insurance and other savings programs. The big question is: Does the particular fund qualify as a true thrift program? Was security or speculation the big selling point? The inherent abuse is apparent in taking a fund with statistical demonstration of spectacular past performance and binding the unsophisticated to a long-range obligation of regular investment.

Despite the great recent growth of funds, the future holds promise of even greater growth. This is because the funds bridge the gap between the practical requirements of small investors and the practical realities of the market place. The importance of this role is matched by its delicacy, and for this reason, the national policy is that this be a carefully regulated and supervised industry. The ultimate responsibility is clearly the Commission's.

The national exchanges have been aggressive in bringing in new listings and in encouraging the participation of the public. The point is made in advertising and public relations work that the public investors receive certain extra protection when dealing with members of a particular exchange and in securities listed on it. This, of course, places special responsibilities on an exchange which engaged in the promotion, and in response the principal exchange has taken the notable steps of making up losses to customers occasioned by the insolvency of a member firm, placing restrictions on member firms in respect of dealing in the issues of unseasoned companies, and limiting the amount of fees and cheap stock received by member firms acting as underwriters. In short, the major concern of that exchange has extended to what member firms have been doing off the floor and with unlisted securities. This protective activity in turn stimulates additional public reliance on the good name of the exchange and so expands still further the implicit responsibilities of the exchange.

It has also been the growing practice of exchanges to require listed companies to solicit proxies and therefore supply qualified proxy soliciting material in connection with all meetings of stockholders. Exchanges on their own are increasingly requiring listed companies to submit large acquisitions, dispositions, or transactions involving a possible self-interest to stockholders and thus, among other things, exposing them to full disclosure under the proxy rules and giving far greater leverage to those rules. The propriety of internal corporate procedures, the sufficiency and adequacy of financial information, and even, in effect, the soundness of operations have been questioned by exchanges. Any unusual transaction by a listed company might well invite sharp inquiry.

Thus we see that national exchanges are in a position to and do take up some of the slack between the noncommittal position of the Commission and the practical needs of so many members of the public for more affirmative and specific assistance in their dealings with brokers and in securities. This of course gives rise to great reliance in a most sensitive area on the men controlling the exchanges. Some of these men control indirectly through business volume and some of the others do so directly through organizational politicking. Here the attention of the Commission is most urgently required, not in taking over or nationalizing the exchanges, but in watching that this power is properly used and not exploited.

Interestingly enough, there remain on one of our principal exchanges a substantial number of issues that are admitted to un-

listed trading privileges. These have never been registered, and the issuing companies file no reports. They make ideal vehicles for fraud because they have all of the advantages of an exchange listing—the prestige, public attention, trading reports, trading prints on the tape—without being subject to any of the reporting requirements. Our other principal exchange has eliminated all such companies from its list, but the persistence of such issues cannot be explained except to give some economic assistance to a weaker exchange. One suspects that the long-run effect of this form of assistance is to make the weak weaker and the strong stronger.

Because of the Commission requirements and the superimposed exchange requirements, some companies have declined to list their securities. The Commission has sought to remove the difference in treatment between listed and the more important unlisted stocks, at least as far as their own reporting and proxy soliciting requirements go. There is every reason to believe that its efforts in this respect will be continued. It should be borne in mind that some companies state with great sincerity that for the purposes of their particular securities over-the-counter traders make a stronger and closer market than would an exchange specialist. This is a controversy of some years' standing, but it is a fact that in some of the larger over-the-counter trading houses trading is conducted in a volume and with a continuity which exceeds that of most of our national exchanges.

The National Association of Securities Dealers supplies to firms that trade in the over-the-counter market an organization with some resemblance to exchange membership. However, there are significant differences that substantially weaken the hands of the N.A.S.D. It has virtually no say in the qualifications of its members. It cannot even establish a minimum capitalization for membership; although, recently the National Daily Quotation Service, which publishes the "sheets," set a minimum capitalization for a broker-dealer before he can obtain a subscription and solicit business by listing quotes. Perhaps the next logical step in assuring financial responsibility would be the requirement that this minimum capitalization be maintained in order to insert quotes in the sheets and that the insertion of quotes constitutes a representation to that effect.

The N.A.S.D., with its substantial responsibilities for the conduct of its member firms, faces a very sensitive problem in any efforts to upgrade its membership and, therefore, exclude in a practical sense from the major trading markets what might be regarded as fly-by-night firms. The problem it faces is the suspicion

that attaches to all industry conducted self-regulation, that it is engaging in restrictive practices for the purpose of lessening competition and keeping the industry an exclusive club.

The business of being brokers and dealers in securities is more open to the newcomer and the outsider in this country than in any other country. The restrictions of the Commission on registration are so limited that it is little more than a listing of names. One new broker-dealer is said to have declared just \$3 in assets. There is nothing to prevent a man presently in confinement for robbery or embezzlement, or any other major crime for that matter just so long as it did not involve securities, from registering himself as a broker-dealer with the Commission. This is in furtherance of a national policy to keep the securities markets open and available for participation by all, whether in the area of issuing securities, investing in securities, or acting as brokers and dealers in securities.

The operational problems under such a policy are serious, but the policy is a strong one and has survived all of its unpleasant consequences of recent years. There are things that can be done, however, to counteract the dangers implicit in it. Suspect persons registering as broker-dealers under fairly recent programs of the Commission have been subjected to careful investigation and questioning under oath and on the record about previous activities and associations, hidden partners, sources of capital, and the location of bank accounts. They can be and are warned on the record to avoid certain practices. They can be put on "active-watch" lists for frequent inspection as to their books and records, finances, salesmen, and the type and source of securities that they sell. In short, this policy of openness can be maintained, but only if the dangers inherent in it are minimized by alert and aggressive enforcement activity to make up for the safeguards which come with regulatory restriction and exclusion.

Aside from the limited control over its membership, the N.A.S.D. is at a great disadvantage in that it has virtually no control over the securities in which its members trade and deal. Over 7,000 of such issues are listed daily in the National Quotation Sheets alone. There have been quoted bids for the capital stock of a company with no assets, no business and no employees which would give that company a total equity value of many millions; and, in fact, there have been quoted bids for a company that did not even exist. Dealers making a market in such securities assert that they have neither the time nor the facilities to assemble basic information. They have looked, as a practical matter, to the firm which introduced

the security into the professional market for some warranty that there was real value in the merchandise, the rest of it is pretty much a matter of market dynamics.

It certainly is not feasible to have full information on every corporation issuing a security which is the subject of a transaction. But, as to the securities traded in a professional market and nationally reported, the N.A.S.D. should be in a stronger position to obtain information in the interests of some practical assistance to public investors, particularly when there is a strong or psychological market running. The N.A.S.D. is aware of this problem and is said to have formed active committees frankly passing on the merits of securities, particularly new issues. In this way, using informal techniques, great practical good can be done in heading off bad issues before they can be traded up and then worked off on "the unsuspecting public," particularly in those market periods when "the public will eat anything." But, the N.A.S.D. is indeed on the high wire: subject to heavy criticism if practical help is not given when needed and to heavy criticism if its procedures unduly restrict the trade and inure to the benefit of the "ins."

It can be seen that great and good judgment is called for in all of these areas, but if the market place, through the national exchanges and the N.A.S.D., cannot supply it, then it would appear that our free market is not adequate to meet its inherent responsibilities.

Foreign aspects of securities trading have always been important, as they are in the related areas of investment, commercial, and merchant banking. No other commodities are so easily transportable as "paper" and securities. The exchange of these items is an absolute prerequisite for any international economic activity not limited to primitive barter or governmental sponsorship. And yet, every one of the elusive perils surrounding a purely domestic transaction is compounded by variables in currencies, laws, political climates, customs, and such when it becomes international. It is not difficult to understand why markets in these commodities should be traditionally cosmopolitan. At the same time, they are so subject to abuse and so closely bound up with the welfare of individual nations that controls, arbitrary practices, and suspicion have, just as traditionally, marked them.

International transactions in securities represent at once a difficult problem and a substantial challenge to the Commission. It is not unusual for a bank in London representing a resident of Sweden to sell the stock of a Canadian corporation on an exchange in New York to a bank in Switzerland representing a resident of South

Africa. There is obviously no regulatory or enforcement authority that can cope with this entire transaction.

Frequently a foreign instrumentality is used to avoid the application of such domestic regulations as those limiting the amount of credit in securities transactions. And it is not unusual for an American citizen to cable his foreign bank to place securities orders for him on a stock exchange that might be within a hundred yards of where he sits, just to achieve that end. But it is the area of evasion --the avoidance of detection rather than the avoidance of the provisions of the law--which is of most concern. The foreign instrumentality can be used, for example, to enter manipulative orders, to avoid disclosure of insider selling or buying, to avoid having to register a sale of control stock, and to avoid the disclosure of conflict-of-interest transactions by investment advisers, mutual fund managers, and other fiduciaries, let alone to avoid paying income taxes. Such transactions cause great embarrassment to the Commission and frustrate its work to the limited extent that it even knows about them.

Proposals are made from time to time requiring disclosure of ultimate beneficial interests to cut through the code names and numbered accounts. These raise many problems under foreign laws protecting anonymity in financial transactions, and practical enforcement for the most part would be impossible under present circumstances. Therefore, it is hoped that continuing enforcement pressure will be a sufficiently effective alternative. It is noted that various foreign countries and cities that became the locale of illicit activity soon found that, although a certain amount of immediate and flashy prosperity was generated, a reaction set in. The legitimate local businessmen lost standing in the eyes of the world by the operations of international floaters, who move on when they have discredited one place and aroused the local financial community.

We should see to it that it is not good business for any foreign jurisdiction to domicile illicit operations directed at this country. To that end the combined work of several of our principal enforcement agencies, our private business interests, and our diplomatic representatives should make it unnecessary for the imposition of stringent regulations that would be to the detriment of all. Let us also acknowledge that some foreign authorities put some of our domestic authorities to shame in the practical effectiveness of their measures to protect our own investors.

Another aspect of foreign transactions is far more promising and challenging. With the development of the Common Market in

Europe, perhaps the most significant aftermath of World War II, there has been a vivid demonstration of the great benefits from the free flow of goods and services between nations. With continuing economic integration has come substantial political and diplomatic unification in Western Europe. It would seem that with it will also come integration of the financial markets of member nations. This might in time generate in Western Europe the largest and most versatile pool of capital funds in a world sorely needing capital investment. The ultimate implications are clear and cannot be ignored. The last of the great European commercial nations that are not members are already finding themselves drawn into this market place, and should they go in, our own position outside might become tenuous.

Western Europe has within it highly skilled, sophisticated, and resourceful capital markets. Traditionally, they have been exclusive. Outsiders have been regarded with suspicion; small investors have not been encouraged. This has saved them from much of the scandal so frequently plaguing our own markets. It makes for a certain efficiency and flexibility because regulatory burdens are lessened. But this very exclusiveness would characteristically be associated with the established interests. It would tend to impede the new in order to protect the old. Equitable participation is severely limited, and so, of course, is the volume of investment money. It may be that the principal commercial nations are tending in the direction of our own more open markets. One of them, in denationalizing a major industrial concern, took great and very significant pains to provide for the broadest possible public distribution of the equity.

It seems reasonable to assume that the Common Market nations will bring their capital markets together through some form of common regulatory and enforcement structure which will assure effective procedures for the protection of public investors of the different nations. As such procedures are perfected these markets will be in a strong position to attract the investment capital of the entire free world, including this country. Of ultimate importance will be the ability of markets to meet the tremendous capital requirements of backward as well as advanced countries, to find the means of practical protection for foreign investment, to avoid the ancient problems of foreign ownership. Despite the tremendous obstacles now facing such prospects, the urgency of the demand, the availability of the supply, and the promise of strong and enterprising markets, make inevitable a future meeting. Standing aside will cause us to lose our position not only in trade and capital investment, but in the entire scope of international influence as well.

We presently face the more immediate problem of foreign securities now traded in the United States: the extent to which, for example, the Commission should impose our own standards for auditing and disclosure on foreign corporations. If effective progress cannot be made with closely related countries, the possibilities of our ever being able to deal with the rest of the world would seem remote indeed. It may well be that the Common Market nations will be able to establish reasonable and effective principles for international policing and, at the same time, effective local treatment of international transactions, which will have the effect of encouraging legitimate international transactions. It is hoped that the Commission on its own will move with assertion and imagination into this area and, looking back to its own history, will note that a Federal authority was necessary because local state authorities proved unable to cope with large-scale interstate transactions. The question will soon be posed whether any local national authority is fully capable of handling the transactions that will mark an era of burgeoning international activity.

Some conclusion is always looked for even though the purpose of a discussion might have been problems rather than answers.

In discharging its responsibilities, the Commission must employ its weapons of disclosure, regulation, and enforcement selectively, using each where most effective and most appropriate. Although principles have evolved over the years, the use of these approaches singly or in combination should be constantly reconsidered. The resources of the Commission are not unlimited, and neither is the ability of the legitimate market to remain effective and yet absorb the impact of indefinite regulation and formalization of information procedures. The temptation may be there for the more orderly planners on the Commission staff to propose regulatory patterns in areas that could be handled by enforcement work in an effort to do away with the necessity of enforcement or to make up for lackadaisical enforcement. But the goal should be a vigorous patient, not a historic operation.

Regulation should be straightforward, directed at a particular wrong or to achieve a particular effect, and as simple as possible. Complexity of regulation can actually make enforcement difficult, because minute provisions covered by regulation exclude activity with formalistic differences from that which is specifically proscribed. Most of the truly substantial thieves in the securities and corporate areas demonstrated time and again that they knew how to make the regulations and disclosure requirements work for them. Regulations

not effectively enforced debilitate the best elements of the market place to the advantage of those who have no scruples about twisting or evading them.

Regulations should not be merely a substitute for what could be accomplished by alert, aggressive and imaginative enforcement against the unscrupulous minority. Those interested in the freest possible market should favor the fullest use of enforcement work as an alternative to an ever-increasing regulatory burden.

Market movements should not be suppressed for the simple reason that one might not like what they indicate. Faults in the market mechanism must be dealt with—but selectively. And, in assaying a violent move, careful consideration should be given not only to the tendency of some who exaggerate such movements for the purpose of exploitation, but as well to the economic and political causes which underlie them.

A market place has an identity, an atmosphere created by and in turn stimulating trade. Those who participate in the market place have a great stake in that intangible quality. Indeed, no matter how strong the particular house is, its strength is based primarily on its location in the market. It is, of course, natural that some will find that they can exploit this intangible quality. In so doing they undermine it. Therefore, when it is found that an element given to sharp practice is taking advantage of the market, a legitimate element must drive it out. Sometimes the legitimate element lacks the virility or the cohesiveness to do so and abdicates the initiative to the others, and then it cries in indignation when scandal after scandal destroys the good name of the market and results in oppressive regulation.

To a certain extent what is called the public image, the good name, can be sustained and carried on by professional public relations people, but eventually the base metal will come through. Despite the complexity of Federal laws and regulations, the market is essentially free. It is the ultimate responsibility of that market itself to make sure that it is truly worthy of public confidence and a great national trust.

