representatives, the head of the Los Angeles trading department and 2 assistants, and the west coast research analyst.

These allocations to insiders of the issuer, Shearson's personnel and Dunbar's customers were made at a time when Dunbar and the other insiders had every indication that the stock would be a "hot issue" and would rise substantially after the original distribution was completed. Dunbar testified as follows:

> The vending industry at that time was attracting a great deal of attention. There were many articles in the paper stating about the tremendous growth and the tremendous possibilities, and the future for this company.
>
> * * * * * * *
>
> I wish I could get across the tremendous demand that there was, not only for this stock but for all stocks at that time. We were literally besieged with offerings, all kinds of propositions being made to me and other brokers. Many people called me and told me if I could get them this stock, they would transfer their account from another house to me, and so forth.

Even before the distribution of the original public offering was completed, Shearson's Los Angeles office assumed the major role in creating and maintaining a trading market in USAMCO shares and in merchandising the stock to California investors. On November 14, 1960, the day the company's regulation A filing was cleared, Shearson began making a dealer market in the stock[104] although the initial regulation A offering was not yet fully subscribed and paid for by the purchasers. Dunbar's name was not added to the list of shareholders until November 21, 1960, at a time when the 10,000 shares for which he paid $1 per share were selling for over $5 per share. For most of the period between November 14, 1960, and late September, 1961, when Shearson stopped trading in the stock, its Los Angeles office made the principal—and much of the time the only—market in the stock, and the firm realized a net profit of approximately $140,000 from its trading in the stock.

(3) *Selling activities*

While the public appetite for new speculative issues during the bull market of late 1960 and early 1961 may have stimulated the eagerness of Shearson customers to purchase USAMCO shares at prices from $3 to nearly $20 per share, the firm's salesmen and partners aggressively recommended the stock, both while the price was rising and during the decline which set in after April of 1961. The extent of the merchandising campaign in USAMCO which was conducted by the firm is demonstrated by the fact that Shearson customers purchased over $3 million worth of USAMCO shares in less than 1 year. As of March 31, 1961, over one-third of USAMCO's 311,500 then-outstanding shares were registered in Shearson's street name, while of all other brokers holding shares in firm names the highest total was 4,235 shares and the next highest total was 1,800 shares.

Public purchases of USAMCO resulted in large part from the representations made by Shearson salesmen. In late 1960 and in early 1961, the only public information about USAMCO were some newspaper stories based on the company's press releases and information reported by Shearson salesmen since no reports were made to the pub-

[104] For a detailed discussion of over-the-counter quotations and of dealer functioning in the over-the-counter market, see ch. VII.

lic during that period.[105] Shearson's customers were given no suggestion of the problems which beset the new company. Salesmen told customers that company earnings were expected to amount to as much as $1 per share during the first year of operation; in fact, the company at no time showed net earnings, and it suffered a loss in excess of $600,000 through August 31, 1961, its first year of operation. Salesmen told customers that the company had acquired vending and financing companies which would contribute to the company's earnings when such acquisitions had not been, and indeed never were, consummated. Using projected earnings based upon the contemplated acquisitions which did not materialize, some Shearson salesmen predicted that the stock would rise to over $100 per share. When the stock had receded from its high of $20 per share, salesmen told customers that a public offering was contemplated in the fall of 1961 and then the price would once again reach 20.

In addition to price predictions and earnings projections which salesmen used to induce some customers to buy USAMCO and others to hold it, a number of salesmen told their customers that Shearson partners and employees had purchased the stock, that a partner of the firm was on the board of directors and had access to "all the inside information on the company," and that Shearson would never permit the price of USAMCO to decline below specified levels because of the interest of the firm's partners and employees in the company. Although Shearson salesmen did not hesitate to inform customers of purchases by themselves and others in the firm, it is apparent that customers were not informed when such salesmen sold their USAMCO shares.

Many of the more flagrant misrepresentations to customers were made in June (after the price of USAMCO shares had receded to approximately $14 from its high of nearly $20 per share. They can be traced in part to a meeting held at Shearson's Los Angeles branch office by Teweles, the branch manager and by then a partner of the firm. At the meeting Teweles outlined to his salesmen the status and prospects of USAMCO, basing his statements, according to his testimony, on information received from the company's president. He told his salesmen that the company would have minimum net earnings of $675,000 before taxes, having reached this figure by including in his computations more than $370,000 in estimated future earnings of three companies which the company wished to acquire but had not acquired and ultimately never did acquire. He reported that the company had broken even in April, which it had not, and he noted profits in May without explaining the nonrecurring nature of the sale of machines in inventory that accounted for the profits. He also told his salesmen that the company's financing of vending machines was a profitable operation and that its stock should be a fully registered issue by November 1961. After the meeting, Shearson salesmen passed on the substance of his statements to investors and potential investors. Teweles testified in the study's public hearings that he intended the information only for USAMCO shareholders who might ask for information about the company, and not as a basis for solicit-

[105] Customers even had to rely on Shearson for information on the market price of the stock because local newspapers did not carry price quotations in USAMCO.

ing new customers, but he did not so inform his salesmen, and at least one salesman who attended did use the facts as stated at the meeting in soliciting customers to purchase USAMCO shares. Whatever may have been Teweles' purpose in holding the meeting, at this time Teweles was himself engaged in substantial transactions involving USAMCO stock, as is discussed in subsection (4) below.

The selling effort employed by Shearson salesmen primarily involved oral solicitations in which the foregoing representations were used. In at least one case, however, selling literature was used. On July 24, 1961, a letter which was neither prepared nor reviewed by the firm's research department was mailed to customers from the firm's San Diego branch office, describing USAMCO as a "must buy now situation." Here again, a statement was made that USAMCO had made an acquisition which, in fact, never occurred. In addition, reproductions of newspaper stories based on news releases prepared by USAMCO's public relations counsel were used by Shearson salesmen to interest clients in purchasing USAMCO stock.

The erroneous and misleading information concerning USAMCO was transmitted to customers by Shearson salesmen orally and in writing at a time when the firm itself had reason to be aware of the major financial problems the company faced. The firm's own senior west coast partner was on the company's board of directors, which, as has been seen, became aware at least as early as April 1961, of the critical need for financing. The home office of Shearson was also aware of USAMCO's capital needs at the same time, when shares were selling near their high. By letter dated April 20, 1961, H. Stanley Krusen, a member of the firm's executive committee, was told by one of his assistants:

> For the 5 months ended February 28, 1961, USAMCO alone had gross revenues of $52,000 on which it suffered a loss of $130,000 * * *. Also, USAMCO is in a tight-cash position at the present time. As of April 4, 1961 the cash position was $140,000 and there were apparently equipment commitments within the next 30 days in excess of this amount.

None of the warning signs were reflected in the optimistic predictions of Shearson salesmen recommending USAMCO stock. While customers in California were being urged to invest in USAMCO shares, the research department in New York steadfastly remained silent on the company, not giving any approval or recommendation, nor preparing any research report or bulletin for the use of salesmen or customers. Although there is a research man in the Los Angeles office, he made no analysis of USAMCO.

At the study's public hearings Murray Safanie, Shearson's senior partner, testified that the firm's reputation rests on the superior quality of the firm's research staff, and it is evident that the firm's public customers considered this reputation important in their decisions to purchase USAMCO shares. A number of Shearson customers stated that they purchased the company's stock because it was strongly indorsed by a brokerage firm of Shearson's stature. The investors who relied upon the firm's reputation may have mistakenly assumed that the "firm" indorsed the stock, but in any event they had no way of knowing whether their salesmen's recommendations were based on expert research and analysis or on something much less. At the hearings it was conceded that in the light of the research department's failure to comment on a company whose securities were being sold by the firm's salesmen, it might be inferred that the firm did not disapprove of the solicitations by such salesmen.

Not until September 1961, did the firm actually impose effective restraints on its salesmen's recommendations of USAMCO. Disturbed by reports from a new executive vice president, Shearson sent a member of its investment banking department to Los Angeles, to review the company's cash situation. His report was sufficiently disturbing to stimulate a trip to the coast by a partner in the investment banking department and, shortly thereafter, by the senior partner, Safanie, and Krusen, the head of the investment banking department. The disclosure through these inquiries of "serious cash deterioration," "reason to question the real value of some of the machines USAMCO had in inventory," and undisclosed liabilities and demands of creditors, led in late September to an "advisory" to the organization indicating that pending completion of an audit, "there be no further solicitation of business in the company stock, and that in any event no employee be permitted to buy or sell any securities he might own himself."

(4) *Self-interest in USAMCO transactions*

Shearson salesmen who were vigorously recommending that their customers buy or hold USAMCO shares were also busily engaged in trading the company's stock for their own personal accounts. The activity of the firm's partners and employees in USAMCO stock raises serious questions of conflict of interest.

The number of Shearson partners and employees who received allocations of USAMCO stock at its original offering price of $1 per share has already been noted. In May 1961, Dunbar sold, at $16 per share, 3,300 of the 10,000 shares which he had purchased at the offering price of $1 per share, thus realizing a profit of over $40,000. Dunbar testified that originally he thought this stock might sell around $5 per share during 1961. In February 1961, he wrote to his branch managers:

> As I have said to many of you in the past month I am becoming increasingly concerned over the vast amount of unlisted small issues we are getting into our clients' hands. * * * I would at least see where stocks have doubled that you don't keep adding to your positions but get out of the ones where you have a very thin market.

Again in a communication dated April 27, 1961, addressed to Pacific coast managers he stated:

> Now I firmly believe that OTC stocks have gone far out-of-line with good listed stocks. There has never been a time when high caliber registered representatives could not do a better job for their customers by passing up short-term immediate profits toward a long-range view of taking care of his accounts.

Nevertheless, salesmen under his supervision actively solicited customer purchases at prices three to four times his $5 figure, and he took no effective action to restrain them.

Teweles, the manager of the Los Angeles office, had purchased 4,500 shares at the $1 offering price in November 1960. In the spring of 1961, he and five salesmen arranged for the purchase of some of USAMCO's original convertible debentures. The underlying shares were then selling at $14 to $18 per share, and although the debentures would not become convertible until September, they were convertible at a rate of $1 per share. Teweles and the salesmen arranged for the purchase of an aggregate of $350,000 in face amount of convertible debentures at the equivalent of $10 per share for the underlying shares, expecting to be able to get bank financing for the purchase. When it was determined that the debentures could not be pledged as collateral because they were held in escrow, Teweles financed his purchase of debentures by selling his original 4,500 shares on June 22 and 23, at prices ranging from $14.50 and $16 per share for a profit of over $63,000. One of the salesmen obtained his financing by borrowing from three Shearson customers. After these transactions Teweles and these salesmen had an obvious incentive to see that the price of USAMCO shares did not fall below 10, at least until such time as they were able to convert their debentures.

Another Shearson employee heavily involved in sales on his own account was James Brum, who was responsible for conducting the trading market in USAMCO for the firm. Brum purchased 4,500 shares for his own account at the $1 offering price. He sold his in a price range of $5 to $16 per share for a profit exceeding $37,000. Brum sold his shares through another brokerage firm and then bought them back for Shearson's trading account.

Shearson salesmen who purchased USAMCO stock at $1 per share were engaged in selling their own shares simultaneously with their recommending purchases to their customers. One registered representative was extremely active in soliciting his clients to purchase over 2,000 USAMCO shares during the period June 14 to June 19, 1961, when he was engaged in selling his own holdings at a profit of over $34,000. He did not disclose to his customers that he was disposing of his own shares, although in earlier solicitations, he had emphasized his own purchases to demonstrate his confidence in his recommendation. One of this salesman's customers stated that he was urged to buy the stock in a long-distance telephone call from the salesman. Between June 13 and June 28, Shearson customers purchased over 9,000 USAMCO shares through Shearson salesmen, while the firm purchased only 300 shares from public customers. Investors have reported that during that period, while Shearson employees were selling their USAMCO stock at between $14 and $16, the firm's salesmen refused to accept customers' sell orders.

(5) *Shearson policies*

The course of conduct followed by the Shearson salesmen and partners in selling USAMCO stock was generally inconsistent with the firm's written declarations of policy, although some of the specific activities did not technically violate firm policies at the time they occurred. In connection with the Study's public hearings, Shearson described the two fundamental concepts of its sales approach:

1. The customer's interest is paramount.
2. The best possible research is the only basis on which to build a successful securities business.

In training material prepared by the firm for its salesmen-trainees, the following captions appeared in lecturers' course outlines:

Be motivated by client's best interest.
Render complete and professional service.
Maintain high ethical and business standards.

Never promise more than you can perform.
Give all pertinent facts.
Label opinion as opinion.
Don't slant comments; give both sides of a story.
Don't make unsound promises or guarantees.

In addition to Shearson's general emphasis on research and the interest of the customer, the firm was specifically concerned about the speculative fever in the 1961 bull market. Dunbar's own ineffective communications to his salesmen have already been noted. In a memorandum to branch managers dated April 1961, the firm's home office also cautioned against excessive speculation in unseasoned securities as a followup to similar views expressed by the New York Stock Exchange. In July 1961, the firm sent out a communication to branch managers commenting on the impracticability of developing sound investment advice on any unseasoned securities sold over-the-counter, and a September 1961, memorandum to branch managers commented on the intelligent and instructive use of research. Subsequent to the selling campaign in USAMCO, the firm issued a memorandum to branch managers dated December 1961, in which salesmen were reminded of the "firm's policy against permitting corporate officers having access to the sales force with a view of recommending shares of their own company without clearance by research."

It is possible to reconcile the practices followed in the sale of USAMCO stock with the firm's announced policies only by assuming either that the firm chose to ignore infractions of its own rules, or that it was seriously deficient in supervising the activities of its salesmen and partners. Salesmen were urged to follow the recommendations of the firm's research department, but they were free to solicit customers to purchase all types of securities—whether favorably reported by the firm's securities analysts or not. Some issues were felt to be too speculative or unseasoned to be suitable for formal underwriting by Shearson, but the firm permitted the same securities to be initially distributed to Shearson customers in the original allocation of shares, and to be recommended by salesmen after initial distribution had been completed. (The firm has now revised its policy and prohibits after-market solicitation for such securities.) While firm policy required that customers' orders be given priority over orders of partners and employees, its customers holding USAMCO could not get their sell orders executed in June of 1961 though Shearson salesmen were then selling their own shares.

Under the firm's procedures, techniques were available which might have detected infractions of its rules and prevented much of what occurred in connection with USAMCO. All activity in partner and employee accounts is supposed to be reviewed daily. Shearson's central office, through its modern electronic data processing equipment, had available to it on a daily basis complete records for each security showing all transactions in the sequence of their executions, and a list of all transactions by employees in their own accounts. More vigilant attention to the tools of supervision at hand in its central office might have enabled the firm to assure that their customers' interests remained "paramount."

Shearson has placed heavy reliance for supervision of its sales forces on branch managers and regional partners. Each manager is expected to review all orders executed in his branch on a daily basis, to investigate any unusual activity or circumstance and, in the case of any concentration of business in securities not recommended by the firm, to satisfy himself as to the priority of the orders for the clients involved. Each manager receives from the home office within 2 days a statement for his salesmen that shows every transaction executed for customers of his office on the day in question, a complete list of employees' transactions in their own accounts, and on each security, a transcript of all transactions in their sequence. Managers are expected to review, at least on a sampling basis, all monthly statements prepared for customers.

Local managers and resident partners are in the best position to police sales activities and spot selling trends, but the danger inherent in home-office abdication of responsibility is forcefully demonstrated in the *USAMCO* case. Here neither the regional partner nor the branch manager and resident partner could be counted upon to restrain their salesmen since they were engaged in the identical practices. Both Dunbar and Teweles purchased substantial amounts of USAMCO stocks at the $1 offering price and sold the shares for substantial profits while salesmen were recommending purchases of the stock. Teweles, at his sales meeting in June, stimulated rather than retarded enthusiasm among his salesmen with respect to their selling efforts. Furthermore, under the Shearson system, both the office manager and the regional partner were free to service clients at the same time as being charged with responsibility for supervising activities of a large sales force.

In September 1962, Shearson distributed a "Statement of Policy for Registered Representatives" which appears to be aimed at preventing a recurrence of the USAMCO episode. Described as reflecting "only a modest amount of change in policy," the statement actually contains a number of new policies relating to selling practices. When a recommendation of a security does not orginate with the partners or the research department, this fact must be made clear to the customer, and when a salesman makes a recommendation contrary to the firm's opinion, this too must be made known. A salesman must have the approval of a branch manager before embarking upon a general program of soliciting orders in securities not recommended by the firm. Such a program can be conducted only for listed securities or high-grade unlisted securities, and in any event is said to be at the salesman's own peril and financial risk in the event of customer complaints. Salesmen are urged that in making any recommendations they should use meticulous care to avoid use of positive language which suggests assurances or guarantees, and must mention any known adverse factors. "Care should be taken in using words descriptive of risk such as 'speculative', as these are often interpreted as promises of profits." No salesman may issue personally prepared market letters or research reports without research department approval. Salesmen may not recommend purchase of securities in regulation A offerings. Stockownership and directorships held by salesmen or partners should be disclosed, but not "as an implied endorsement or as indicative of our having special knowledge," and not as an inducement to a customer to make a purchase. Finally, a salesman about to sell a security which he recommended to customers must solicit their sale orders before selling his own shares, unless the reason for his sale is a personal emergency not related to the merits of the security.

6. SUPERVISION AND CONTROLS OVER SELLING PRACTICES

Previous pages have explored problems of various kinds in the area of selling in firms with and without internal controls. This section considers generally the controls applicable to the industry as a whole and particular segments within it. The activities of securities salesmen are, in fact, subject to a pattern of controls that overlaps but is of widely varying effectiveness in different segments of the industry and, as already seen, less than complete effectiveness even in the strongest segments.

First, each salesman is covered by the supervisory activities and policies of his own employer, who, if only because of his legal duty to adequately supervise his sales force, has an interest in insuring that the salesman does not stray beyond the bounds of propriety. Second, he is subject to the rules and sanctions of the several external regulatory bodies, both governmental and industry: the Commission, the State securities administrators, the NASD, and the exchanges (if his employer is associated with one or more of them), all of which also impose rules and sanctions on the employer firm.

The first part of this section contains a description of the techniques for supervision which have been developed by the industry, the particular selling practices and potential abuses which are intended to be "supervised" by specific controls, and the allocation of responsibility for supervision within the firms. It should be noted that only the supervisory tcehniques relating to selling practices are considered. In the second half of this section, the outside controls over selling practices imposed by the Commission and the self-regulatory agencies are discussed.

a. Internal supervision

Broker-dealers are charged with the responsibility for supervising the activities of their employees. Failure to perform this function adequately can result in disciplinary action with sanctions up to and including revocation of the firm's registration. The requirement to supervise is embodied in the rules of the NASD [106] and the NYSE [107] and in the Federal Securities Acts,[108] and is consistent with the existing pattern of regulation in its emphasis on the ultimate responsibility of members and registrants for the conduct of their agents and employees.[109] In its opinion in the *Reynolds* case,[110] the leading case on supervision, the Commission clearly set forth the responsibility for adequate supervision which must be borne by broker-dealers:

> Customers dealing with a securities firm expect, and are entitled to receive, proper treatment and to be protected against fraud and other misconduct, and may properly rely on the firm to provide this protection.[111]

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[106] Sec. 27, art. 3, "Rules of Fair Practice."
[107] Rule 405.
[108] *Reynolds & Co.*, Securities Exchange Act release No. 6273 (May 25, 1960).
[109] Sec. 27 of the NASD Rules of Fair Practice requires that members certify to the good character of registered representatives. Under the Exchange Act, only broker-dealers are registered and there is no provision for direct proceedings against agents or employees.
[110] Note 108, above.
[111] Id. at 14.

The Commission went on to find:

> * * * where the failure of a securities firm and its responsible personnel to maintain and diligently enforce a proper system of supervision and internal control results in the perpetuation of fraud upon customers or in other misconduct in willful violation of the Securities Act or the Exchange Act, for purposes of applying the sanctions provided under the securities laws such failure constitutes participation in such misconduct, and willful violations are committed not only by the person who performed the misconduct but also by those who did not properly perform their duty to prevent it.[112]

Although all broker-dealers are under a duty to provide adequate supervision, fulfillment of the requirement generally creates the greatest problems for the larger retail brokerage firms. This segment of the industry must maintain supervision systems to control the activities of great numbers of salesmen often scattered over a widening geographical area. On the other hand, the sole proprietor or small partnership with no sales force has no problem at all, while the firm with a small number of salesmen located in one office generally can successfully fulfill its supervisory function with a modest control system. The larger a firm becomes in numbers of salesmen, sales offices, customer accounts, and brokerage transactions, the greater the danger that it will lose control. The relationship of rapid growth to the magnitude of the supervision problem has been recognized by both industry spokesmen and the Commission.[113]

(1) *Supervisory organization, controls and devices*

As one would expect, the complexity of the structure of supervision systems varies with the overall size of the firm, measured in terms of the number of branch offices, salesmen, supervisory personnel, and the variety of the firm's business. In small firms with no branch offices, supervisory responsibility for sales personnel is usually concentrated in a single person, who may or may not be a partner or officer.[114] Even where a small firm has more than one office, supervision may still be left to one partner of the firm located in the home office.

(*a*) *Branch managers.*—In all larger firms with numerous branch offices, it is necessary to create levels of authority within the supervision structure. Common to such firms is the key figure of the branch manager, upon whom great responsibility is imposed for supervising the activities of all salesmen in his office.

One firm with a worldwide network of branch offices, in an internal bulletin on the supervision of registered representatives and customer

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[112] Id. at 14 and 15.

[113] The strain on the supervision mechanism which has resulted from rapid growth was set forth in the *Reynolds* case as follows:

"The circumstances of this case illustrate vividly the necessity for this rule and call for further consideration of its implications, particularly under present conditions of active markets, increased interest in securities by inexperienced customers, and the rapid growth and broadened operations of certain large securities firms of which registrant is one. The existence of numerous and scattered branch offices complicates the problem of supervision and makes essential the installation of an adequate system of control. The growth of securities firms also tends to increase the number of inexperienced personnel who require especially careful supervision, particularly where many firms are growing at the same time and thereby creating a shortage of experienced people. Supervisory personnel cannot rely solely upon complaints from customers to bring misconduct of employees to their attention, particularly where customers may be inexperienced and may fail to realize that they have been mistreated, or where rising markets tend to obscure the effect of such mistreatment. All of these conditions increase the importance of maintaining and enforcing adequate standards of supervision. The duty of supervision cannot be avoided by pointing to the difficulties involved where facilities are expanding or by placing the blame upon inexperienced personnel or by citing the pressures inherent in competition for new business. These factors only increase the necessity for vigorous effort."

[114] Data from questionnaires STS–1 and STS–2 indicates that of the smaller firms, 35 percent relied upon one principal for supervision, while 47 percent employed supervisors who were not principals.

transactions, describes the responsibility it places on branch managers in the following way:

> The primary, immediate responsibility for the uncompromising, direct enforcement of firm policy rests with the domestic and foreign branch managers * * *. This means that—
>
> (*a*) The managers of these branches * * * will be fully accountable for the legitimacy and propriety of the business done by their units, for the actions of their registered representatives, and for the work of any back office personnel under their control.
>
> (*b*) They must be constantly aware of the nature of the transactions handled in their branches * * * through reviews of daily business and other means of supervision.
>
> (*c*) They must put an immediate stop to any unlawful or improper activity which they notice or which is brought to their attention.
>
> (*d*) They must report their disciplinary actions or recommendations in each case * * *.

An officer of another large firm with over 500,000 customer accounts calls branch managers the firm's "first line of defense." The same firm outlines the following "basic duties" of the branch manager:

> To approve the opening of each new account, exercising due diligence as required both by the regulations of the exchanges and by the policies of the company.
>
> To make careful periodic analyses of all open accounts * * * to assure himself that the customers' best interest are being served in accordance with their investment objectives.
>
> To make personal calls on customers and to make himself freely available to customers * * *.

Supervision, however, is only one of the functions with which branch managers are charged. In most firms they are expected to strive constantly to increase the volume of business generated by their branches. They may also be responsible for hiring and firing employees, customer relations, local public relations activities, representation of the branch before local representatives of the Commission, and such other duties and responsibilities as may be assigned from time to time. The number of salesmen for whom branch managers are responsible varies greatly among the firms. One broker-dealer considers 12 salesmen per branch manager or assistant branch manager to be a desirable ratio. An executive for an even larger broker-dealer firm, which has at least 1 branch office at which 60 to 70 salesmen are employed, said that a competent manager could review the transactions of 60 to 70 salesmen at the end of each day. Data compiled by the Special Study indicate that the number of salesmen per branch office for large firms averages approximately 17, and in many large firms the branch manager has such supervising assistants as an operations manager, an assistant manager, a cashier and an order clerk. Not all branches have the full complement of lesser supervisory personnel, however, and in any event ultimate responsibility for maintaining the necessary controls falls upon the branch manager.

The principal control technique used by a branch manager is his daily review of transactions. Out of a sample of 25 large firms, all but 1 require that branch managers review all transactions every day and 2 firms reported that branch managers review all transactions on a monthly basis as well. Large or unusual orders may be called to the manager's attention prior to execution, by the cashier, order clerk or margin clerk, and the manager's specific approval may be necessary for transactions which are unusual or contrary to general firm policies.

He may require that all orders taken by inexperienced salesmen be submitted for his approval before execution, and in some firms, branch managers must approve all new customer accounts before orders can be executed. Branch managers in some firms also regularly monitor salesmen's correspondence. A study of large firms indicates that supervisors read or initial all outgoing mail in 80 percent of the firms, approximately 20 percent of them requiring that all outgoing mail be sent over the signature of a supervisor, while only 12 percent require a review of incoming mail.

One large firm has a long list of specific supervisory activities which its office managers are expected to perform. Among other practices, the manager should have a system for meeting new customers and learning their investment objectives; detect changes in buying practices of old and new customers; arrange to be informed of unusual changes in any account; review accounts to see that the frequency an type of securities purchased are consistent with firm policies; insure that solicitation of accounts is consistent with firm policy and ethical business practices; determine that salesmen are following firm policy in making representation to customers about securities, are advising customers on proper investment objectives and are not using boiler-room practices to sell securities; review all correspondence before it is mailed; review the more active accounts with extra care; regularly review orders entered in the accounts and statements of employees under his supervision, and make sure that they do not overextend themselves, and that there is no evidence of free riding, check kiting, or other improper practices; know the whereabouts during the office day of all employees subject to his supervision; and review all orders entered by salesmen.

Recognition of the critical position of the branch manager in the scheme of supervision generally has not, in spite of the many administrative functions he performs, extended to relieving him of his own customers or of the commissions he earns from such accounts. According to data compiled by the Special Study, 88 percent of large firms have "selling" managers in all branches while only 4 percent of the firms have no selling managers with their organizations. One firm, which is in the process of changing from a system of "producing" supervisors, did not want to eliminate the managers' incentive to generate business in the branches, and therefore is paying branch managers a fixed salary plus a percentage of the net profits of the office. This policy is consistent with a view expressed by one of its executives that the objective of supervision is "to balance the desire to make money against proper control."

(*b*) *Centralized controls.*—Reliance on the branch manager as the keystone of supervision does not preclude supervision from central or regional points, and the large firms superimpose various systems of home office control on branch supervisors. The structure of the hierarchy of control varies from firm to firm.

One firm has a "branch administration division" with a partner in charge whose primary responsibility is to keep his "finger on the pulse of the branch office system." In this division are six regional managers who, from the home office in New York, supervise the branch offices within their assigned regions. Other departments with supervisory functions relating to selling activities include an "operations liaison group," a special team which "crosses all lines to correct trouble"; a "trading control section" which reviews all transactions throughout the firm on a daily basis; a law department, with an attorney assigned to each of the regional managers; and an audit department which conducts internal audits of branch offices both on a regular basis and when special problems arise in particular branches.

In another large firm overall supervision is directed by a "security committee" consisting of six general partners and six senior executives. The firm also relies on its internal counsel and his staff; an internal auditing system, under the direction of a controller; regional office managers; a national sales manager and a New York sales manager: an operations department; and a margin department. Other firms have similar hierarchies under different names, though, in some cases, with a single senior executive with primary responsibility for overall supervision. One large broker-dealer maintains a "new accounts department." Another firm with "main offices" and "subbranch offices" has a sales manager in each main office responsible for supervision of the subbranches. In still another large firm "division syndicate departments" review all over-the-counter trades, while "senior margin clerks" review all listed transactions; a different firm has a "compliance department" which performs the same function on a monthly basis. Each of the various departments and individuals can separately detect improper practices or abuses and presumably initiate corrective action.

This multiphrased central supervision is facilitated by, or possible only because of, electronic data processing equipment (EDP). Of the study sample of large firms, 23 out of 25 have such equipment.[115] The importance of this equipment in supervising the daily activities of a network of branch offices is reflected in the testimony of the managing partner of Shearson, Hammill & Co.:

> Question. I take it you are pretty dependent upon electronic machinery in processing for control of your total offices?
> Answer. It is almost indispensable for any kind of day-to-day control, sir.
> * * * * * * *
> Question. And all of your branch offices are tied into the same system?
> Answer. That is right. The bookkeeping for the entire firm is centralized in New York City.

For Kidder, Peabody & Co., a firm with over 35 branch offices, almost 300 salesmen and 1,500 transactions a day, EDP makes possible the following supervisory activities:

> A daily purchase and sale trade journal * * * covering every transaction effected by our organization on a particular day is available in our New York office on the following day and in our Boston regional office, our Boston branch offices and our Philadelphia, Chicago, Los Angeles, and San Francisco regional offices on the next following day.
> This trade journal is examined in New York on the day it becomes available there by our controller, our internal counsel, one of his assistants, our national sales manager (for other than New York transactions), and New York sales manager (for New York transactions).
> The trade journal is examined on the day following the day it becomes available in New York by appropriate regional office partners and senior supervisory personnel and branch office managers.

[115] These data are from questionnaire STS–1. One of the two firms which did not use such equipment had 19 branch offices, and indicated that transactions were reviewed by the office managers and the "home office." This firm has subsequently been merged with another firm and is no longer a registered broker-dealer. The other firm has only 6 branch offices and a total of 50 salesmen, and indicated that all sales-office transactions are reviewed daily by branch and divisional managers.

Transactions in the trade journal are grouped basically according to regional and branch offices. Within such basic grouping, transactions are grouped according to customers. The following information is given with respect to each transaction: identity of the customer, settlement date, number of shares or amounts of bonds, identity of security, unit price, gross price, net pricé, and identity of salesman.

Appropriate samplings, deemed adequate for the exercise of proper control, of customers' confirmation statements are examined on a daily basis by our controller, the manager of our operations department, the manager of our margin department, our national sales manager, our New York sales manager, appropriate regional office partners, and senior supervisory personnel and branch office managers. Appropriate samplings of customers' monthly statements of account are similarly examined on a monthly basis. All of such monthly statements are examined by one or another of the persons specified above.

In addition, appropriate samplings of purchase and sale order forms are examined on a daily basis by the manager of our trading department (a general partner) and his assistant (also a general partner), the manager of our margin department, our national sales manager, our New York sales manager, appropriate regional office partners and seniors supervisory personnel and branch office managers.

In addition, our controller, the manager of our trading department, and the manager of our margin department regularly apply such other tests as are deemed necessary to insure adequate control.

At Bache & Co., the second largest retail brokerage firm, with a total of 97 sales offices and approximately 1,500 salesmen, the EDP equipment is programed to provide a daily "run" listing all transactions by security, by branch office, and by customer. The run gives information on each transaction as to the amount of shares and the price, whether it was a buy or sell and margin or cash, and the identity of the individual salesman. The machine records the firm's 5,000 to 9,000 transactions per day, which are reviewed to spot particular activities such as employee trading, local over-the-counter transactions in branch offices, large block transactions which might indicate sale of unregistered securities, and sudden increases in activity in low-priced or speculative over-the-counter securities. The runs are also useful in providing the home office with information on concentrations of activity in a particular security in a number of branches, which would not be seen by any single branch manager. In addition to daily runs, the EDP equipment provides monthly runs that are programed to detect "churning."[116] Charles Halsey, the partner in charge of central controls, who refers to the EDP equipment as "the monster," testified to Bache's reliance on EDP for supervision:

It could not be done any other way. I mean the sheets are that high [gesturing] listing the trades of the previous day. It could not be done other than coming out of the mouth of the monster * * *.

Clearly, any firm with a number of branch offices which does a large volume of retail business would be severely handicapped in fulfilling its supervisory responsibilities without EDP equipment to provide information on the type described above. But even with the extensive use of machine tabulations and their distribution to various departments and individuals, selling practice abuses can go undetected, particularly in times of extremely active public participation in the securities markets. Possession of the means of detection must, of course, be accompanied by careful analysis. Ultimately the information produced by the machines must be reviewed by human beings,

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[116] Similar use of EDP equipment is made by Merrill Lynch and by Shearson, Hammill according to testimony given by these firms at the study's public hearings.

who must have the skill and experience necessary to plan and analyze the runs, and must devote sufficient time and effort to make optimum use of the data.

Many large firms use an internal "surprise" audit as a technique to control branch office operations. This is usually conducted by a team of auditors who visit a branch office to examine its operations in order to evaluate office procedures and determine compliance with firm policies. Responses to questionnaire STS–1 indicate that approximately 64 percent of the large firms conduct such internal audits of each branch office at least once a year. Twelve percent conduct such audits less than once a year, and 24 percent had no surprise audit system in effect. Audits may be undertaken regularly one or two times per year, or they may be scheduled when problems arise in a particular sales office. Reasons for irregular or special audits include unusual personnel turnover, overspending, unusual number of errors, absorption of a new location, or doubt concerning any activity in an account.

Most audits do not primarily examine for bad selling practices, since the procedure is essentially a verification and review of accounts and accounting journal entries. However, in at least one firm the audit procedure encompasses examinations which relate to selling practices and to the branch office's supervision of selling practices. The firm, in its instructions to auditors, directs that a representative sample of customer account statements for the previous month be reviewed for "free riding," "switching" mutual funds, "churning," unusual activity in speculative or little-known securities, concentrations of activity in one security, and patterns of "hot issues" unwarranted by the activity in the account. The auditor is also instructed to check a random sampling of discretionary accounts for approvals by the branch manager, to ascertain the availability and currency of the branch's copy of the Canadian restricted list;[117] to determine whether branch managers review executed orders at the close of business each day, whether they review customers' statements, whether the order clerks have been instructed to call to the manager's attention any large or unusual orders, and whether the office does business with factors or private financial companies; and to verify that all correspondence sent out by branch personnel on firm stationery is approved by the branch manager. The audit reports of this firm indicate that lack of compliance with the firm's supervision requirements by branch managers is commonly found.

(2) *Objects of supervision*

No system of supervision can be expected to be totally effective as to all the improper practices which can be employed in the sale of securities. However, certain characteristic abuses occur with sufficient frequency to require that firms as a minimum gear their supervision to the detection of such conduct. Among the more common of these practices are overtrading of a customer's account, misrepresentation, and recommendations of unsuitable securities. The New York Stock Exchange advises its members that a supervision system should detect the following additional specific problems: any relationship between cus-

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[117] This is a list of Canadian companies whose securities the Commission has reason to believe currently are being, or recently have been, distributed in the United States in violation of the registration requirements of the Securities Act. See the SEC. 27 Ann. Rept. 175 et seq. (Jan. 10, 1962).

tomer trading and a salesman's which would indicate that the customer's orders were not given priority over those of the salesman; any trading in particular securities, by a member of his family, prior to or shortly after the release of a report by the firm which makes recommendations about those securities to the firm's customers; excessive concentrations of activity in particular securities; late payments by customers; prepayments to customers; the passing on to customers of unjustified claims and rumors concerning a particular security; and excessive markups on over-the-counter transactions.[118]

(*a*) *Detection of overtrading ("churning")*.—As noted in the section dealing with the saleman's compensation, the dependence on commissions is an incentive to increase the activity in customers' accounts. The danger is most acute when the salesman has earned the trust and confidence of his customer, who relies on him for investment advice. When the size and frequency of securities transactions are excessive in view of the financial resources and character of the particular account, the account is said to have been overtraded or churned. Overtrading is an abuse usually associated with accounts where, under a power of attorney, discretion to purchase and sell securities is vested in the firm or the salesman, but it can also occur where an investor places reliance on the recommendations of his salesman.[119] While the self-regulatory agencies and the Commission require special protective procedures for discretionary accounts,[120] such procedures are not specifically required where no formal discretion is granted. This is not to suggest that the Commission or the industry in any way sanction churning, a practice recognized to be illegal even in the absence of any grant of formal discretion. One large firm, in cautioning its salesmen strictly to adhere to the NASD rule governing churning of discretionary accounts states:

> It is our policy not to limit the application of this rule to discretionary accounts, but to extend it to accounts with respect to which customers generally give great weight to registered representatives' recommendations. It is also our policy that all such transactions be based on sound investment reasons.

Procedures to detect churning of accounts are included at almost every level of supervision in most large firms. One firm with 65 offices and almost 600 salesmen reports taking a number of measures to prevent churning, including: a weekly review of accounts by regional sales managers; instructions to margin clerks to report unusual or excessive activity; an electronic data processing run of all open accounts with commission charges of $200 or more, which is distributed to branch managers, regional sales managers and the firm's legal department; and warnings to salesmen and customers to avoid engaging in excessive transactions. Another large firm with similar procedures, programs its electronic data processing equipment to produce a monthly run of all accounts with commission charges of over $500, although it may be noted that, depending upon the size of the account, excessive trading can take place in 1 month without producing commissions of $500. A third firm, with 17 branch offices, reports that it maintains a department which devotes its full time to analyzing customer ac-

[118] NYSE Department of Member Firms, "Supervision and Management of Registered Representatives and Customer Accounts," pp. 22–27 (1962).

[119] *Norris & Hirshberg*, 21 S.E.C. 865, 890 (1946), *aff'd sub nom. Norris & Hirshberg v. S.E.C.*, 177 F. 2d 228 (D.C. Cfr. 1949); *E. H. Rollins, Inc.*, 18 S.E.C. 347, 380 (1945).

[120] NYSE, rules 408 and 435; NASD Rules of Fair Practice, art. III, sec. 15(a); Securities Exchange Act, rule 15c(1)–7.

counts for churning; where any such action is indicated, the firm immediately broadens the scope of its investigation to include all accounts of the particular salesmen involved. The auditing departments of some firms review all customers' statements periodically and report questionable accounts to the appropriate supervisors.

Although the procedures noted above appear to be common to the large firms, the study found evidence of undetected churning activities in firms employing all or some of these procedures.[121] This indicates that the review of accounts may in some cases be inadequate.

In smaller firms prevention and detection of churning or any other bad selling practice is more easily accomplished. A firm with 9 branch offices, 26 salesmen, and 15 partners reports that periodic checks of customers' purchase and sale ledgers are made to detect possible churning, and "any particular account that shows excessive activity is scrutinized." Another smaller firm, with 5 branch offices and 13 general securities salesmen, reports a policy under which "any orders placed for sale of securities recently purchased are questioned by an officer; and if there is the slightest indication of churning, the order is not executed." Firms with no branch offices and a small number of salesmen can closely circumscribe the selling activities of their salesmen to conform to the ethical standards of the principals. One such firm, with three partners and three salesmen, reported that churning was not allowed—but when one salesman gave an "indication of such inclination," his employment was terminated.

(*b*) *Misrepresentations.*—It is more difficult to prevent or uncover occasional or isolated misleading representations by salesmen to customers than to control churning of accounts. Churning is clearly evidenced by the relative activity in a customer's account, but a misrepresentation, particularly an oral one, is hard to catch up with. To prevent sales by oral misrepresentation, one firm relies on daily "blotter" analysis by supervisors to find unusual activity in a particular security by an individual salesman, who would then be required to explain the basis on which the securities were being recommended. Complaints from customers provide another source of information on the verbal selling efforts of salesmen. A large firm, which finds it impossible to monitor telephone or personal conversations between salesmen and customers, reported that any customer complaint alleging misrepresentation by salesmen is investigated promptly and if found to be correct results in dismissal of the salesman. Other firms do accomplish some supervision of telephone conversations in a branch office, although no firm reported monitoring of telephone calls. Most firms, however, seem to rely principally on the effectiveness of their training programs and continuing meetings with salesmen.

(*c*) "*Suitability.*"—Effective supervision to assure that salesmen recommend to their customers only such securities as, on the basis of the customer's other security holdings, financial situation and needs, are "suitable,"[122] calls for a delicate system of control, particularly at the branch office level. A local supervisor is in the best position to examine transactions closely and to be familiar with the essential facts about the customers with whom their salesmen do business.

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[121] See discussion in sec. 5, above.

[122] NASD Rules of Fair Practice, art. III, sec. 2. Churning or excessive trading is one aspect of "suitability." It is supervised through the specific control procedures discussed in sec. 6.a(2)(a), above.

A general absence of fixed procedures to uncover abuses with respect to suitability is evident from the responses to questionnaires STS–1 and STS–2. One firm stated that local managers require salesmen to justify purchase orders of low quality stocks. Another firm cited as a control its training program, in which trainees are instructed that "firm policy requires that recommendations to purchase or sell securities must be made in the light of clients' individual financial situations and investment objectives." Still another mentioned as its "special measure" for the prevention of abuses in this area, the "policy kits" for its salesmen setting forth management's guide for the proper observance of all rules and regulations. One large firm with 28 branch offices and 135 full-time salesmen indicated that it considers "suitability" to be a matter to be determined by the customer himself. Only one large firm reported that, in situations where an order for a speculative security was solicited by a salesman, it would speak with or write to the customer about the particular purchase. Smaller firms appear to have equally inadequate controls relating to suitability, but formal supervisory techniques are not as important in small firms where, as one firm stated, "because of the relative small size of our firm, management is able to maintain a close and constant relationship to the customer."

(*d*) *Other improper salesmen's activities.*—Among other unethical and illegal activities of salesmen proscribed by reputable brokers are such activities as manipulation, distribution of unregistered securities, "free riding" [123] and extensions of credit in violation of existing regulations.[124] In most firms supervisors at the local and home office level are required to be constantly alert for signs of these types of activity.

In large firms, manipulation can be detected by daily "blotter" checks at local and divisional levels. Manipulation of an over-the-counter stock can also be detected in the trading department and in the wire and order departments. Floor partners of member firms on exchanges, too, are in a position to notice activity in the stock which would indicate manipulation. "Free riding" (or withholding by firms or their salesmen of allocations of new issues for sale at a quick profit), particularly prevalent during a bull market when new issues are traded at immediate premiums, is controlled in large firms through electronic data processing runs which identify all accounts through which shares are sold for a given period after the commencement of the distribution of the security. Manipulation and "free riding" are easily detectable in small firms where the principals can be quickly aware of unusual activity and the allotments of new issues.

Control of the sale of unregistered securities is primarily accomplished in large firms through instructions to order clerks to alert the branch manager and home office to unusually large transactions. Most firms report that any such activity is immediately investigated and called to the attention of firm counsel and others with responsibility to prevent violations of this nature. Improper extensions of credit to customers fall mainly within the jurisdiction of the firms' margin departments. Branch managers in their daily examination of accounts are also expected to detect violations of this kind.

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[123] NASD Guide, interpretation with respect to "free riding and withholding," G–23. See also ch. IV.B.3, below.

[124] See ch. X, below.

(3) *Firm policies*

For a number of brokerage firms of all sizes, "firm policies" aid in the task of supervision. Firm policies are special rules and prohibitions relating to selling activities, which are internally applied by individual brokerage firms. For example, in order to prevent improper handling of discretionary accounts, most firms have specific rules limiting the use of such accounts. A study of a sample of broker-dealers indicates that every large firm has some restrictions on salesmen handling discretionary accounts, and over 18 percent of large firms, 40 percent of medium-sized firms and almost 60 percent of small firms accept no discretionary accounts under any circumstances.[125]

Although some firms permit the salesman complete freedom as to the type of security he may recommend to customers, a number of broker-dealers limit the type the firm will handle. Limitations range from outright prohibition against handling transactions in specified types of securities, such as those on the Commission's Canadian restricted list or cited in Commission releases as being illegally distributed—types proscribed by almost all firms—to admonitions that a salesman recommending a particular category of security does so at his own risk. Less frequent, but not uncommon, are restrictions on sales of low-priced over-the-counter securities, on execution of orders of securities recently issued pursuant to regulation A, and on securities issued pursuant to an intrastate exemption. Such restrictions may be absolute prohibitions or may condition orders on the permission of a supervisor.

One large firm severely circumscribes solicitation of orders for all over-the-counter securities. None of its salesmen can recommend an unlisted security unless it is currently recommended by the firm, it was recently underwritten by the firm, or qualified persons in the firm have analyzed the security and reached favorable conclusions. Other firm policies include: A requirement that over-the-counter securities sold as principal be on the firm's approved list; a prohibition against recommendations of "highly speculative securities"; a prohibition against executing an order for any low-priced unlisted stocks with which the firm is unfamiliar; a requirement that salesmen restrict recommendations to securities on a list approved by the firm; and a requirement that salesmen's recommendations be restricted to "investment quality securities only." Although many of the restrictions imposed on salesmen by firms relate only to recommended or solicited transactions, a relatively small percentage of the firms require their salesmen to report whether an order is "solicited" or "unsolicited."

Some firms with lists of "approved" or "recommended" securities prefer that their salesmen concentrate their selling efforts on such issues, but generally do not restrict salesmen to those lists. Typical comments from firms reporting no restrictions include the following:

> This is not to imply that we do not have a recommended or selected list, and at all times encourage its use.
>
> * * * * * * *
>
> The firm does not maintain any so-called approved list of securities to be used by salesmen in making a recommendation to a customer. The salesmen are trained to be able to competently answer questions, using the facilities of our research department to obtain all facts before expressing an opinion to a customer.

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[125] Data from questionnaires STS–1 and STS–2.

Besides restricting the type of securities which may be sold by salesmen and the handling of a particular type of account, some firm policies relate to the information required before opening a new account. Of the three major regulatory bodies only the NYSE regulates the opening of accounts,[126] and the thrust of its regulation has traditionally been directed at safeguarding the members from unscrupulous customers. Even in its most recent publication relating to supervision and customers' accounts, the exchange indicates its primary concern for the firm rather than the customer in its recommendations for processing new accounts. For example, in emphasizing the importance of obtaining the customer's occupation, employer, and type of business the pamphlet states:

> This information is essential to make sure that the exchange rules concerning employees of other securities firms and financial organizations are not being violated.[127]

Although the pamphlet states that "the representative usually should determine the client's investment objectives and his financial situation before transacting business," the recommended new account form [128] makes no provision for recording this kind of information.

Some firms, however, do record the investment objectives of the new customer. In a recent paper presented to the Investment Bankers Association, Donald Regan of Merrill Lynch stated the following:

> In order to avoid a charge of unsuitability of a recommendation, you must first know the customer's investment objective. This should be ascertained right at the time the account is opened. Some firms will note the objective on the new account form. Mine does not. We follow the practice of noting it on the customer's holding record. Naturally, the registered representative should change the objective on his records whenever the customer changes his plan.[129]

During the past year, possibly as a reaction to the Special Study and the market break—both of which sharply silhouetted the excesses and abuses that were prevalent during the recent bull market—representatives of a significant segment of the brokerage community have exhibited a growing awareness of the importance of adequate supervision. In his paper at the recent IBA meeting in New York,[130] Regan, in urging his fellow members to adopt vigorous and effective supervision systems, told them to:

> Either supervise or go out of business. You should supervise primarily because of your firm's reputation. * * * In active markets there is a temptation to let down the bars because of the press of business. Active markets also lead to the recommendations of lower quality stocks, particularly in the blow-off stages of a bull market. These are the times when you must be most careful, and not let your people get caught in the frenzy of speculation that leaves so much grief in its wake. In slow markets you must guard against the temptation of some salespeople to trade for the sake of trading. You are aware of this problem, and even though it might hurt sales, you must keep your perspective in order to guard your firm's reputation.

Recognition of the importance of adequate supervision was also recently demonstrated by the NYSE in its pamphlet on supervision. In its concluding section the pamphlet states, in part:

> Any firm, lacking the systems of supervision and control of representatives and accounts discussed in this guide, is in considerable danger of losing custom-

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[126] Rule 405 (1) and (3).
[127] NYSE "Supervision and Management of Registered Representatives and Customers Accounts, p. 13 (1962). But see also sec. 6.b(3)(a) below.
[128] Id. at p. 17.
[129] IBA, "The Management Function in the Investment Banking Industry" (1962).
[130] Id., at p. 30.

ers, suffering large monetary losses, and being severely disciplined by one of the regulatory bodies.

It is, therefore, incumbent upon each firm periodically to examine its systems of supervision and management in order to bring its service and advice to the highest level.[131]

b. External controls

The internal supervisory controls which have been discussed are designed to assure those firms which use them that their salesmen are acting in accordance with firm policies and with the legal and ethical responsibilities that attach to the sale of securities. To see that the firms themselves, as well as their salesmen, observe these responsibilities, a complex structure of external controls exists. The rules and sanctions which constitute these controls are administered by governmental and industry regulatory authorities including the Commission, the NASD, the NYSE, and other exchanges and State regulatory bodies. Because only the first three organizations have nationwide scope in their jurisdictions, this section is primarily concerned with a review of their rules relating to selling practices and the manner in which these rules are administered. Brief reference is also made to the contributions in this area of the other national securities exchanges and the various State regulatory bodies.

(1) *Federal controls over selling practices*

(*a*) *Federal statutes and rules and their application.*—Federal controls over improper selling practices rest primarily on the fraud sections of the Securities Act and the Exchange Act, and the sections empowering the Commission to prescribe rules and regulations reasonably designed to prevent fraudulent, deceptive or manipulative practices.[132] Under section 17(a) of the Securities Act, it is illegal for any person in connection with the sale of or offer to sell securities—

> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Similar language is used to cover purchases as well as sales in rule 10b–5, under section 10(b) of the Exchange Act. Although this rule covers all persons, broker-dealers specifically are also prohibited from engaging in any "manipulative, deceptive, or other fraudulent device or contrivance" by section 15(c)(1) of the Exchange Act.

Under the broad category of "fraud" the Commission has disciplined brokers-dealers when customers' accounts have been churned; when salesmen have in the sale of securities used misrepresentations and gross exaggerations or have omitted to state material facts; when, in connection with other high-pressure selling techniques, unsuitable securities have been sold to public investors; when customers have been charged excessive commissions or markups for securities; and when brokerage firms have failed to supervise their salesmen adequately.[133]

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[131] NYSE, "Supervision and Management of Registered Representatives and Customer Accounts," at p. 35.

[132] See, e.g., sec. 15(c)(2) of the Exchange Act.

[133] See pt. A, above, and cases cited therein.

In addition to the general fraud provisions, certain specific types of selling activities are prohibited by the Federal securities laws and Commission rules. The Securities Act [134] contains a provision prohibiting "touting" of securities, as it is commonly known, while under the Exchange Act there are included provisions and rules relating to manipulation of the prices of securities listed on national exchanges,[135] the use of extra compensation in connection with a distribution over a national securities exchange,[136] and the churning of discretionary accounts.[137] The Exchange Act and rules relating to over-the-counter markets also prohibit specific types of misrepresentation, such as the representation that broker-dealer registration indicates Commission approval of the financial standings, business or conduct of the broker-dealer,[138] and require disclosure of specific material facts in confirmations.[139]

A registered broker-dealer whose activities violate the statutes and rules enforced by the Commission is subject to several types of sanctions. Through administrative proceedings the Commission may, after appropriate notice and hearings, revoke a broker-dealer registration,[140] with opportunity for appeal of an adverse ruling. This has the effect for the broker-dealer, its proprietors, and any salesman who is found to be a cause of the revocation, of eliminating them from the securities business unless specific approval for reentry is later obtained. Pending final determination of a revocation proceeding, and again after notice and opportunity for hearing, the Commission may temporarily suspend a broker-dealer's registration in the public interest or for the protection of investors.[141] Alternatively, the Commission may bring civil proceedings in the Federal courts to enjoin the broker-dealer and others from carrying on particular unlawful activities in connection with the purchase and sale of a particular security,[142] and the issuance of a temporary or permanent injunction may serve as the basic for revocation by the Commission if that is in the public interest.[143] In situations involving flagrant violations, individuals as well as firms may be subject to criminal prosecuition in the Federal courts, which may result in fines and imprisonment. Such cases are referred to the Department of Justice by the Commission, which assists in the investigation and preparation of the case. Finally, violations of Federal statutes or Commission rules may of course subject a broker-dealer to civil liability and the payment of damages in private litigation,[144] though the Commission is not directly involved in such actions.

Prior to the enactment of the first of the Federal securities acts in 1933, fraud in the sale of securities could only be reached on the Federal level through criminal prosecution under the mail fraud statute [145] or by a cumbersome administrative procedure by which the Postmaster General would attempt to prevent the seller of securities from receiv-

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[134] Sec. 17(b).
[135] Sec. 9(a).
[136] Rule 10(b)(2).
[137] Rule 15c1-7.
[138] Rule 15c1-3.
[139] Sec. 11(d)(2) and rule 15c1-4; see also rules 15c1-5, 15c1-6, 15c1-8, and 10b-9.
[140] Exchange Act, sec. 15(b).
[141] Ibid.
[142] Exchange Act, sec. 21(e).
[143] Exchange Act, 15(b).
[144] Sec. 12(2) of the Securities Act and sec. 9(a) of the Exchange Act. In addition to these express provisions, courts have inferred a civil liability for fraudulent selling practices in connection with the purchase or sale of securities from rule 10b-5 under the Exchange Act. For a discussion of civil liability under the securities acts see 3 Loss, Securities Regulation 1683-1852 (1961).
[145] 18 U.S.C., sec. 1341.

ing mail from his victims.[146] While the Commission, as indicated, is now not so limited, since most securities fraud schemes involve mailings of confirmations, checks, or selling literature, a count alleging violation of the mail fraud statute is commonly included in indictments charging violations of the securities acts.[147]

Those disciplinary proceedings which are instituted by the Commission and relate to selling practices have been primarily directed at situations where the firm as a whole has been engaged in a course of conduct designed to sell securities by illegal means. Typical is a recent case [148] involving a firm using boiler-room tactics, in which the Commission noted that the firm's—

> policy was to maintain a large sales force consisting of men with no previous experience in the securities business which concentrated on telephone solicitation of unknown persons.

In revoking this firm's registration as a broker-dealer, the Commission found that the firm and its salesmen sold securities "without consideration of the quality of the securities involved or the needs of the investors," churned customers' accounts, and made false and misleading representations in connection with the sale of various securities. It concluded that the firm's principal—

> deliberately created an organization of salesmen lacking in experience and ethical standards and trained them to secure unsophisticated and acquiescent customers.
>
> In such a situation the potentiality for fraud was so great that even the strictest and closest of supervision could hardly suffice to prevent misconduct.

Situations involving substantially less flagrant violations of Federal laws and Commission rules are often left to be handled as disciplinary matters by the self-regulatory bodies. However, Commission discipline is not directed exclusively at boiler rooms. Where large and well-known firms have been found to engage in improper conduct, the Commission has instituted public proceedings and has disciplined the offending firm.[149]

(*b*) *Methods of detection.*—While information on violations of Federal statutes or Commission rules comes to the Commission from a number of sources, the most important source may well be complaints from public investors, a substantial number of which are sent directly to the Commission. Most complaints are referred to the appropriate regional offices of the Commission for information, consideration, and necessary action.

Individual customer complaints relating to selling practices often concern the activities of one salesman in one branch office of a firm. Under present law the Commission can conduct a proceeding to revoke a broker-dealer's registration but cannot institute any administrative proceeding directly against an individual salesman.[150] The Commission is reluctant to begin a time-consuming suspension or revocation proceeding against a firm for the isolated misconduct of one salesman. However, where the complaint alleges conduct which ap-

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[146] 39 U.S.C. sec. 259.

[147] Loss, 3 Securities Regulation 1421–1430 (1961).

[148] *J. Logan & Co.*, Securities Exchange Act release No. 6848 (July 9, 1962).

[149] See, e.g., *Reynolds & Co.*, Securities Exchange Act release No. 6273 (May 25, 1960); *Bruns, Nordeman & Company*, Securities Exchange Act release No. 6540 (Apr. 26, 1961).

[150] The Commission can indirectly reach a salesman for unlawful conduct by finding him to be a willful violator in a broker-dealer revocation proceeding. Under the Exchange Act, any registered broker-dealer who "controls" a person with this disability, among others, is itself subject to the revocation of its registration with the Commission as well as its membership in the NASD, unless express approval for the person's employment is obtained, secs. 15(b)(2) and 15A(b)(4).

pears to constitute serious selling practice violations and defects in firm supervision, and particularly where a number of complaints related to one firm or branch, the matter will be investigated and may lead to revocation proceedings. Where a complaint involving an NYSE member firm is not of sufficient gravity to warrant Commission disciplinary action it may be turned over to the exchange for appropriate action, as was done in connection with Bache's Seattle office.[151]

The second major source of information on violations of laws concerning selling practices is the Commission's program of broker-dealer inspections, the only systematic Commission procedure to determine broker-dealer compliance with the Federal securities laws. The Commission has continuously and substantially increased the number of inspections, from 686 inspections made in fiscal 1953 to 1,515 in fiscal 1962. While the latter number would suggest that all broker-dealers would be inspected about every third year, the Commission emphasizes inspections of new registrants, inspecting them when possible on a 6-month basis. Since the NYSE has an inspection program which in many respects covers the same ground as Commission inspections, the Commission, although empowered to inspect NYSE member firms, confines its inspections for the most part to other firms, in order to use its limited manpower most effectively.

Commission broker-dealer inspections are conducted on a surprise basis similar to the audits conducted by agencies responsible for bank regulation. From the point of view of detecting illegal selling practices, however, such inspections have their limitations. Since the inspections involve, among other things, a determination of the broker-dealer's financial condition, a review of his pricing practices, and an evaluation of the safeguards employed in his handling of customers' funds and securities, inspectors mostly confine their activities to an examination of books and records and do not routinely uncover evidence of misrepresentation or high pressure in the sale of securities, as they do not generally listen to the sales presentation or question any customers. Inspectors are not even able to determine whether customers have purchased securities on the recommendation of the salesman, since broker-dealers are not required to note whether a particular transaction has been solicited by the salesman. In addition, the firm is not required to keep customers' complaints in one readily available file which might prove valuable in aiding detection of selling practice violations.

However, misconduct such as churning and excessive markups which can be seen on a firm's books is sometimes found, and when an inspector comes upon a firm which specializes in selling one or two unseasoned securities or employs a host of salesmen with boiler-room backgrounds,[152] he alerts Commission staff members responsible for conducting investigations to the fact that a possible boiler room is in operation. The Commission is in the process of revising its inspection procedures to put greater emphasis on selling practice violations. Under the new instructions, the inspector will—

> be required to observe the general nature of a firm's business and to note particularly any items coming to his attention which would indicate high-

[151] See discussion in sec. 5.b, above.

[152] Commission rule 17a–3(a)(12)(A) now requires registered broker-dealers to keep background records of salemen available for inspection.

pressure or boiler-room selling activities, such as a large number of telephones, concentration of transactions in one or two securities, and rapid turnover in employees.

Information concerning improper selling practices sometimes comes to the Commission from members of the brokerage community or from the NASD. The latter organization maintains an individual employment record of each registered representative or salesman, to which the Commission staff has access. When a single firm appears to have a concentration of salesmen with long backgrounds of associations with known boiler rooms, the NASD alerts the Commission staff to the existence of another possible boiler room.

Detection of selling practice violations must be followed by enforcement action. The primary responsibility for this phase of the Commission's activities is assigned to the Commission's nine regional offices throughout the country. These are responsible for conducting investigations, for the preparation and trial of most actions to enjoin violations, and for the conduct of some types of broker-dealer proceedings. They work under the supervision of the operating divisions and staff offices in Washington, which in turn are responsible to the Commission. No court or administrative proceedings, public or private, are commenced and no case is referred to the Department of Justice except with the authorization of the Commission itself.

(c) *Commission enforcement.*—The Commission chooses from among administrative, civil, and criminal enforcement proceedings when illegal selling practices have been detected, depending on the gravity of the offense. The more common enforcement proceedings relating to selling practices are administrative and civil court cases, and here the Commission has its choice of starting its own administrative action, either to revoke a broker-dealer's registration [153] or suspend or expel it from the NASD or an exchange,[154] or of commencing injunctive proceedings in the Federal courts. An indication of the extent of Commission administrative enforcement activities relating to selling practices is gained from figures for the Commission's fiscal year ended June 30, 1962, during which it instituted 84 separate proceedings to revoke registration, with or without raising as an additional issue, the question of suspension or expulsion from the NASD or an exchange, revoked registrations of a total of 47 broker-dealers, and dismissed three cases in which the firm withdrew its registration. Most but not all of these revocation proceedings involved fraudulent selling practices. In addition the registration of five broker-dealers against whom revocation proceedings had been begun were suspended after hearings indicated that they were engaged in serious misconduct in the sale of securities.

In fiscal year 1962 the Commission also instituted 89 injunctive and related enforcement proceedings to prevent fraudulent and other illegal practices, a substantial number of which involved firms engaged in illegal selling practices. A Federal court injunction [155] has the advantage as an enforcement tool of permitting the Commission to

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[153] Revocation proceedings are authorized under sec. 15(b) of the Exchange Act.

[154] Under sec. 19(a)(3) and 15A(1)(2) of the Exchange Act, the Commission has the power to expel members from a national securities exchange and from the NASD or to suspend them for periods up to 1 year.

[155] The Commission is authorized to seek injunctions in the Federal district courts under sec. 21(e) of the Exchange Act. The swiftest type of injunctive action is the temporary restraining order which may be obtained on an ex parte showing.

take immediate action when necessary in the public interest to prevent actual or threatened violations of the securities laws. Generally, injunctions are sought to prevent the continuance of specific conduct, and the Federal courts usually limit their injunction orders to the particular type of activity which is the subject of the action. Thus, the remedy is narrower in scope than the Commission's suspension procedures, but generally speedier. Therefore, in most cases involving injunctions against broker-dealers engaged in a course of conduct of high-pressure sales of unseasoned, high-risk securities to unknown investors, the injunctive action is followed by revocation proceedings and perhaps criminal prosecution.

The most drastic sanction which can be visited on persons who engage in illegal selling activities is a criminal prosecution. Most often such actions involve grossly fraudulent schemes and devices which result in substantial financial losses to public investors. The operations of Tellier & Co., referred to in section 4.b above, where an estimated $20 million was obtained from customers through boiler-room selling tactics, represents the type of large-scale fraud which precipitates criminal prosecution.[156]

Although most criminal prosecutions involving improper selling practices are brought under the general antifraud sections of the Securities Act and Exchange Act, violations of other sections of these acts are sometimes prosecuted. In 1960, the first conviction for violation of the antitouting provisions of the Securities Act [157] was obtained, in a case in which the defendant had recommended purchases of a speculative security without disclosing that he had received compensation from the issuer and underwriters and that his "buy" recommendations to his clients were for the purpose of facilitating a distribution of the stock.[158]

Criminal prosecution for violations of the Federal securities laws are brought by the appropriate U.S. attorney after evidence gathered by the Commission's staff is transmitted to the Department of Justice.[159] During fiscal 1962, the Commission referred more cases to the Justice Department than in any previous year. Sixty cases were referred for prosecution,[160] as a result of which 42 indictments were obtained against 205 defendants. There were also 67 convictions in 20 completed cases, a majority of which involved the offer and sale of securities by fraudulent selling practices. Since securities fraud prosecutions are far more complicated than most criminal cases, usually staff members of the Commission are called upon to assist the U.S. attorney in preparing the case for trial. At the conclusion of a recent case involving boiler-room selling, which turned out to be the longest criminal trial in the history of the Federal courts, the trial judge commended the U.S. attorney's office for its trial of the case and also the two Commission employees who assisted in the investigation and preparation of the case for trial, and went on to say:

> It took years of unremitting labor in the face of all kinds of investigative difficulties to develop the facts that were presented to the jury, and if the case took 11 months to present the evidence one can only imagine how long it took to dig up the evidence.

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[156] For a more recent case, see *U.S.* v. *Farrell* (S.D. Calif., 1962), appeal pending.
[157] Sec. 17(b).
[158] *U.S.* v. *Todd* (D.C. Mass., 1960).
[159] Securities Act, sec. 20(h); Securities Exchange Act. sec. 21(e).
[160] In addition, four criminal contempt actions were referred for prosecution.

I therefore want the Securities and Exchange Commission to know that its efforts have been recognized, and that the Securities and Exchange Commission and its facilities and personnel should be implemented and strengthened so that they could carry on with even greater effectiveness the task of protecting the securities markets and the investing public from frauds and swindles and other sophisticated types of chicanery.[161]

Boiler-room practices are clearly not extinct, and while the Commission has made great strides in rapid detection and elimination of boiler rooms, in most cases the unscrupulous operator has succeeded in dissipating the capital of several victims before the Commission can act. Thus, there is a continuing need to evaluate existing selling standards as well as qualification standards for entry into the business [162] in an effort to reduce the numbers of public customers and of dollars that are drawn into the hands of this type of firm.[163] On the other hand, it is much more difficult for the Commission to detect and deal with boiler-room practices and other improper selling activities occurring on a more modest scale, at the level of the individual salesman, or when they do not constitute the principal activities of a firm. Rules and procedures to aid in the detection of serious abuses are required in order to remedy these inadequacies. For the most part, the Commission has traditionally looked to the principal self-regulatory agencies—the NASD and the NYSE—to control selling practices throughout much of the brokerage community. The manner in which these organizations discharge this responsibility is reviewed in the following sections.

(2) *NASD controls over selling practices*

The NASD, which is the self-regulatory body with the largest membership,[164] is required under section 15A of the Exchange Act to have rules—

designed to prevent fraudulent and manipulative acts and practices * * * and, in general, to protect investors and the public interest, * * * [165]

The Exchange Act also requires that the association provide for discipline of its members, for violations of its rules—

by expulsion, suspension, fine, censure, or any other fitting penalty, * * *.[166]

Pursuant to these statutory requirements, the NASD has adopted rules of fair practice to regulate the conduct of members and their salesmen, and has prescribed procedures and penalties for violations of those rules.

(*a*) *NASD rules and their application.*—The study's review of industry selling practices suggests that the problems which arise most frequently fall into one or more of four categories: sales by means of misleading representations, exaggerations or omissions of material facts; churning of customers' accounts; solicited sales of securities which are unsuitable for the purchasers; and failure of firms adequately to supervise their salesmen. The NASD rules of fair practice, in their general and specific provisions, apply to all these situations.

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161 Remarks of Judge William B. Herlands, *S.E.C.* v. *Garfield* (D.C.S.D.N.Y. Feb. 4, 1963).
162 See ch. II, above.
163 See Securities Exchange Act release No. 6885 (Aug. 16, 1962) re proposal to adopt rule 15c2–6 for dealing with boiler-room problem.
164 The powers and functions of the NASD are discussed in detail in ch. XII. See also ch. II for discussion of the NASD's role with respect to qualifications of individuals and firms in the industry.
165 Sec. 15A(b)(7).
166 Sec. 15A(b)(8).

As a general ethical standard for all conduct of its members, the rules of fair practice prescribe that—

> A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.[167]

While all of the objectionable practices could be said to violate this standard, specific provisions apply to each of the four categories. Sales by misrepresentations are banned in language patterned after the anti-fraud provisions of the Federal securities laws:

> No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance.[168]

Excessive trading in discretionary accounts is covered by a rule which, with respect to such accounts, prohibits—

> any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such accounts.[169]

This rule expressly relates only to accounts where the "member or his agent or employee is vested with any discretionary power." Salesman's recommendations which lead to excessive trading as well as to purchases of securities inappropriate to the investor's circumstances fall within the association's "suitability" rule, which provides:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[170]

The member's responsibility to supervise the activities of his salesmen is enunciated as follows:

> A member who employs any registered representative shall supervise all his transactions and all correspondence relating thereto. All transactions made by a registered representative with or for a customer shall be approved by a partner, a duly accredited executive, or a branch office manager of such member. Approval shall be evidenced by written endorsement made upon a copy of the original memorandum or other record of such transaction, and each memorandum or other record, so endorsed, shall be made a part of the permanent records of such member.[171]

The association thus has in effect a framework of rules which are intended to control the most prevalent objectionable selling practices.[172]

In 1961, the association decided 34 cases involving charges of fraud under its rule, and of these only 5 presented instances of false and misleading statements relating to the merits of the security or the nature of the market for the security.[173] One of the five concerned a salesman who made false statements to a single customer in order to cause him to sell his medium-grade securities for low-priced speculative issues. In another case a dealer was charged with fraud for failing to disclose that no independent market existed for the security

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[167] Art. III, sec. 1.
[168] Art. III, sec. 18.
[169] Art. III, sec. 15(a).
[170] Art. III, sec. 2.
[171] Art. III, sec. 27(a).
[172] It should be noted that the association, like the Commission, must exercise its powers through proceedings against the member firm, though it can join particular salesmen as parties for its proceedings and, unlike the Commission, can impose penalties directly on salesmen.
[173] The balance of the cases related to doing business while insolvent, the use of false confirmations, and the establishment of fictitious accounts by insiders to obtain allocations of "hot issues" (see ch. IV.B).

he was recommending. The third case concerned the sale of $37,000 in stock issued by the broker-dealer firm itself without supplying investors with the necessary material facts concerning the firm's operations, income and expenses and disposition of funds. The fourth case involved a boiler room in which salesmen made false representations as to the existence of a free trading market in the stock. In addition, the firm was found by the district committee to have used false confirmations—"wooden orders" [174]—to induce purchases by customers. In the fifth case the fraud finding was based on the respondent's use of misleading market price quotations on order blank forms sent to customers.

The relatively infrequent use by the association of charges of fraud undoubtedly reflects the association's reluctance to question investor witnesses, stemming in part from its lack of express power to subpena witnesses and in part from its unwillingness to question members' customers. Its staff concedes that when boiler-room activities including fraudulent representations come to its attention, it is common practice to see whether a case can be developed on a charge of violating the Commission's net capital rule or other rules whose violations can be established by mere examination of books and records. While its desire to rid the industry of boiler-room-type firms is commendable, it should be noted that the use of a net capital or other technical charge, rather than a fraud charge alleging misconduct on the part of individual salesmen, allows unscrupulous salesmen to escape the disciplinary power of the association and go on to find work in another firm or start their own firms.

The restricted manner in which the association exercises its powers to curb excessive trading is suggested by a recent decision of its board of governors in a case involving a salesman of an NYSE member firm who had turned over the accounts of 3 lady customers 1.42, 1.03, and 1.53 times, respectively, in a period of 10½ months. The district business conduct committee which heard the case determined that the salesman had actual discretionary power over the customer's accounts, despite the absence of formal documents. It also found that his—

> magnifying of risks through use of margin techniques, which were obviously beyond the comprehension of these clients, the speculative nature of the stocks selected from the approved lists, and the accelerated rate of purchases and sales during the * * * period analyzed could hardly be considered as being in the best interests of these clients * * *.

Upon these findings it imposed fines on the salesman and the firm and suspended the salesman's registration for 6 months for violations of its specific rule on churning discretionary accounts and of its general rule of just and equitable principles of trade. The board of governors reversed the findings and dismissed the complaint, apparently on the principal ground that the churning section was not violated where the salesman "was not vested with full discretionary power under a written agreement as is normally contemplated when the term 'discretionary account' is used." Although conceding that "the degree of activity in these accounts might raise a question," the board opinion did not expressly consider whether such conduct might constitute a violation of its rule on suitability. As a statement of the NASD's administrative position on excessive trading, the decision

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[174] For a brief description of this practice, see sec. 4.b, above.

suggests that the board will apply sanctions only in the most flagrant and obvious cases.

Undoubtedly the NASD rule on suitability [175] has the most far-reaching potential for dealing with improper selling practices, and for the most part the NASD has interpreted the rule in ways which strengthen its impact. Despite its apparent failure to consider the rule in the case just discussed, the NASD has held it to apply to recommendations which lead to excessive trading by a customer.[176] It also has been held to reach unsuitable recommendations made to previously unknown,[177] as well as to known,[178] customers. Although the rule speaks in terms of recommendations being suitable "upon the basis of the facts, if any, disclosed" by the customer, the application of the rule to telephone solicitations of unknown persons to buy low-priced speculative issues in a boiler-room operation has been upheld over the argument that the rule could not apply where no information concerning the customer had been furnished to the broker.[179] In another proceeding under the suitability rule arising from a public complaint, the association disciplined a salesman, the firm for which he worked, and the firm's president for recommending to an elderly widow, dependent upon income from her securities, that she dispose of mutual fund shares and make purchases of shares of an oil company and a tobacco company selling at $0.50 and $2.25 per share. The local district business conduct committee noted the testimony of the salesman that he obtained no financial information about new customers and that it was the firm's policy to recommend such securities to customers without any such inquiry, and stated that the firm and the salesman had two responsiblities:

> To have knowledge of (1) *what* they are recommending, and (2) *to whom* they are recommending it. [Emphasis in original.]

It held that the purpose of the suitability rule would be defeated if it were construed as permitting recommendations of low-priced speculative securities to unknown customers.

The board of governors' recent decision in disciplinary proceedings against Shearson, Hammill & Co. and a number of its partners and salesman for their conduct regarding USAMCO stock [180] raises a question of whether the board is retreating in its interpretation of the rule. In its decision, the board commented on—

> the problem * * * in the distribution of securities on an impersonal basis in an extensive campaign by telephone or otherwise, without any knowledge whatsoever of the customer, his occupation, income, means or needs; in fact, frequently, with no contact between the seller and buyer before and after the sale other than telephone.

Despite the suggestion in this and prior cases of a responsibility on the part of salesmen to ascertain facts about the financial situation and needs of a customer, the board dismissed charges against one

[175] The NASD currently is considering an amendment to art. III, sec. 2, of its "Rules of Fair Practice." Under the contemplated amendment, the salesman would have an affirmative duty to determine essential facts about a customer before recommending a purchase of a particular security.

[176] *First Securities Corporation,* Securities Exchange Act release No. 6497 (Mar. 20, 1961).

[177] *Boren & Co.,* Securities Exchange Act release No. 6367 (Sept. 19, 1960); *Greenberg & Leopold,* Securities Exchange Act release No. 6326 (July 21, 1960).

[178] *First Securities Corporation,* note 177 above; *Philips & Co.,* 37 S.E.C. 66 (1956).

[179] *Greenberg & Leopold,* see note 177 above.

[180] See sec. 5.d, above.

salesman for violating the suitability rule, although he had been found by the district committee to have recommended USAMCO to a customer with "no knowledge of her financial situation and needs" and to have made recommendations of the stock "to anyone without consideration of its suitability." The only salesman against whom the charge was upheld was one who knew of the limited financial means of one customer and knew that a second was purchasing for an account for the benefit of a minor. Under this narrow interpretation of the NASD's own suitability rule, salesmen might be encouraged to learn as little as possible about the customers to whom they recommend securities.

In the *Shearson, Hammill* case, the board of governors of the association found that the firm, its partner in charge of west coast operations and the manager in charge of its Los Angeles branch office had violated the NASD rule on supervision by failing to supervise the one salesman who was found to have violated the suitability rule. Charges of violating the rule on supervision also arise in conjunction with charges of many other types of rule infractions in cases of firms involved in boiler-room selling practices.[181] More commonly, however, charges that a firm violated the supervision rule arise under the specific provision of the rule requiring all transactions executed by a registered representative for a customer to be approved by a partner, an officer, or a branch manager. The approval may be evidenced by initialing the order ticket or "blotter," and need not take place before the transaction is actually effected or confirmed. Despite the ease with which members can comply with the requirement, a majority of the supervision cases were based upon failure to provide evidence of supervision of this type. Supervision cases also arise where the firm itself finds that a registered representative is engaged in improper conduct and so reports to the NASD. In such cases the employing firm is charged with violating the rule on supervision in order to obtain NASD jurisdiction to discipline the salesman, and the supervision charge against the firm is generally dismissed. Another common group of charges of failure to supervise involve registered representatives who send out correspondence and other written material which violate a provision of the Commission's statement of policy on selling literature for mutual funds, where charges of failure to supervise are often coupled with allegations of violation of the statement of policy.

Other association rules, modeled on the Federal statute and rules,[182] govern particular aspects of selling practices, such as the rules requiring every member to disclose to his customers whether he is acting as a broker or dealer at or before the completion of each transaction,[183] whether he is in a control relationship with the issuer of the security which he is trading,[184] or whether he has an interest in a primary or secondary distribution of securities which he is selling.[185] Still other specific rules govern touting [186] and untrue representations during the

[181] *First Securities Corporation,* Securities Exchange Act release No. 6497 (Mar. 20, 1962).
[182] Securities Exchange Act, sec. 11(d)(2) and rules 15c1-4, 15c1-5 and 15c1-6 thereunder.
[183] Art. III, sec. 12.
[184] Art. III, sec. 13.
[185] Art. III, sec. 14.
[186] Art. III, sec. 11.

course of a distribution that a sale is "at the market" when no market exists.[187] Disciplinary proceedings charging members with failure to disclose whether they acted as principal or agent are fairly common, often in conjunction with charges of recordkeeping irregularities, net capital deficiences, violations of the prompt payment requirement of regulation T of the Federal Reserve Board, and fraud. Cases involving the other rules are rare, however.

(*b*) *Methods of detection.*—The principal tool of the NASD in enforcing its rules is its regular program for inspecting member firms and their branch offices. Valuable though this program has been in detecting rule violations in many areas, it leaves something to be desired in the area of selling practices. To some extent its deficiencies result from inadequate inspection techniques, but partly they stem from the fact that many objectionable practices are not easy to find through an examination of books and records.

Examination techniques for uncovering violations of the rule on suitability, for example, are not well developed. The examination form which must be completed by the NASD inspector does not deal specificially with the rule, and such inquiry as is made rests primarily with the discretion of the inspector. While some district secretaries indicate that efforts are made to check customer accounts for excessive trading or other evidence of unsuitable recommendations, they admitted that it is difficult to detect violations without speaking to customers, which NASD policy forbids unless there is specific authorization by the local district committee. Similarly, there is no systematic examination procedure for reviewing the supervision policies and practices of firms, and as has been noted most charges of failure to supervise involve noncompliance with mechanical rules of initialing transactions or checking correspondence.

Since branch offices are responsible for such a large proportion of the improper selling practices, the very superficial attention given to branch offices by the NASD inspection program becomes significant. Figures on branch inspections show that the association has about a 10-year branch office inspection cycle at best, as illustrated by a comparison of the number of branch offices with the number of branch office examination for each year during the period 1957–61:

Yearend	Number of branch offices	Number of branch office examinations	Percentage of branch offices examined
1957	2,780	130	4.7
1958	3,242	533	17.0
1959	3,836	365	9.5
1960	4,231	515	12.2
1961	4,519	470	10.4

One difficulty encountered in branch office inspections is the inadequacy of branch office records in many instances, which impedes analysis of sales activities in the branch.

In contrast with the Commission, public complaints play an insignificant part in the NASD's detection of rule violations. Since asso-

[187] Art. III, sec. 16.

ciation rules and policies restrict broker-dealer use of the fact of their membership in their advertising and the association affords limited publicity to its own enforcement role and the results of its disciplinary cases, there has been little public awareness of the association's work, at least until recent months. The result has been a rather small volume of public complaints, and a varying attitude toward them on the part of the association. The national office and some district secretaries view them as important enforcement tools, while others view them with suspicion as a sort of necessary evil. In recent months increased public awareness of the NASD has stimulated public complaints particularly as to selling practices, and its largest district committee established a separate docket of such complaints and assigned a full-time examiner to handle them, but their growing volume appears to exceed what the limited staff of the association can follow up for enforcement purposes.

The association's rules of fair practice give "any person feeling aggrieved by an act, practice or omission of any member" who may violate the rules the right to file a formal complaint which will initiate a disciplinary proceeding.[188] This right seems limited in its usefulness, however. In the period from 1959 to 1961, only 28 proceedings based on nonmember complaints were instituted, and of these complaints 16 were dismissed and 3 withdrawn by the complainant. To some extent the limited use of the procedure may stem from the fact that when a public complaint appears to have merit, the district committee will itself file a complaint.

(*c*) *Enforcement*.—The extent to which improper selling practices have figured in the NASD's enforcement program can be seen by an analysis made by the study of the disciplinary proceedings of the association during the years 1959 through 1961.[189] During that period, 809 separate decisions were rendered involving a total of 1,729 alleged violations of NASD rules, of which 1,506 were found to be violations. Of the violations found, 115 were violations of the rule on supervision, 95 were violations of the fraud rule (most of which were unrelated to high-pressure selling), 77 involved failure to make required disclosures, 35 were violations of the suitability rule, and 4 were churning violations. These figures may be compared with 211 findings of free riding, 191 findings of violations of regulation T, 176 cases of improper maintenance of books and records, and 97 cases of net capital violations. As has already been noted, charges of violations of net capital or of keeping improper books and records are frequently brought when the NASD believes that improper selling practices are being carried on but cases on that ground would be more difficult to develop and prove.

(3) *NYSE controls over selling practices*

Control by the NYSE over the selling practices of its members and their personnel is superimposed upon, not in place of, the controls imposed by the NASD and the Commission, since with few exceptions NYSE member firms dealing in securities are also members of the much larger NASD and are registered with the Commission.[190] Membership on the exchange has traditionally been limited to persons with

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[188] Art. IV, sec. 2.

[189] See ch. II, tables II-2 and II-3.

[190] The powers and functions of the NYSE are discussed in detail in ch. XII, below. See also ch. II, above, with respect to qualifications of exchange members and their personnel.

substantial financial means and relatively well established reputations in the brokerage community,[191] and the problems created by fly-by-night operators and boiler rooms have not directly concerned the exchange. However, as has been shown, exchange member firms and their employees are sometimes responsible for selling practices which violate the regulations of the exchange as well as those of the Commission and the NASD. The exchange provides specific procedures to detect and deal with violations of its rules, and a range of penalties from censure to expulsion for firms and individuals found to have violated its standards.

(*a*) *Exchange rules relating to selling practices.*—The statutory authority for the self-regulatory function of the NYSE and the other national securities exchanges is found in section 6(b) of the Exchange Act, which requires that the rules of the exchange—

> include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

The general standard of "just and equitable principles of trade" permeates the constitution and rules of the NYSE. The constitution recites it as one of the objects of the exchange,[192] and members and allied members may be suspended or expelled for violation of this standard of conduct.[193] In addition the constitution provides sanctions for any member or allied member who is adjudged by the board of governors to be guilty of "fraud or of fraudulent acts,"[194] violations of the constitution or rules of the exchange,[195] or willful violation of the Exchange Act.[196] Section 6(b) has been held by the Federal courts to place an affirmative duty on the exchange to discipline their members for misconduct.[197]

To supplement the general standards of conduct set forth in its constitution, the board of governors of the exchange has adopted rules governing conduct of members and employees in their selling practices. These rules include an overall requirement that firms and individuals "adhere to the principles of good business practice in the conduct of his or its business affairs"[198] and specific rules covering the opening and handling of discretionary accounts,[199] and barring the churning of such accounts.[200] The rules also require firms to "supervise diligently all accounts handled by registered representatives."[201] Although the exchange has no "suitability" rule as such which compares to the NASD rule, it does have a "know your customer" rule[202] requiring that partners or officers of member organizations:

> Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization * * *.

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191 See ch. II.B.2.c, above.
192 NYSE constitution, art. I, sec. 2.
193 Id., art. XIV, sec. 6.
194 Id., art. XIV, sec. 1.
195 Id., art. XIV, sec. 6.
196 Id., art. XIV, sec. 7. This provision is required by sec. 6(b) of the Exchange Act.
197 *Baird* v. *Franklin*, 141 F. 2d 238 (2d cir. 1944).
198 Rule 401.
199 Rule 408.
200 Rule 435(2).
201 Rule 405(2).
202 Rule 405(1).

In the study's public hearings, President Funston of the exchange expressed the opinion that the "know your customer" rule was primarily designed to protect member firms against irresponsible customers, and the past application of the rule in exchange disciplinary proceedings confirms the view that it has generally been restricted to such use. However, the inspection program instituted by the exchange in 1962, discussed below in subsection (b), indicates that the rule will apparently also be interpreted to impose an obligation on exchange members to prevent their salesmen from recommending unsuitable securities to their customers.

In addition to the above rules concerning the more usual selling practice abuses emphasized in this chapter, the exchange has adopted individual rules governing particular improper conduct. These include a prohibition against participation in a manipulation,[203] the circulation in any manner of "rumors of a sensational character," [204] participation in a "bucket shop," [205] "touting," [206] and rules relating to advertising and sales literature which are discussed in part C of this chapter.

The exchange rules apply not only to the member and all general partners and stockholders of member organizations but also to all individual salesmen. In addition to the requirement that the employment of a salesman by a member must be approved by the exchange,[207] a prospective salesman must sign an agreement to obey all rules of the exchange, and exchange approval may be withdrawn at any time if in its opinion the salesman is guilty of violating "just and equitable principles of trade." [208] Thus the exchange, unlike the Commission and the NASD, may exercise direct discipline over a salesman without necessarily involving his firm.

(*b*) *Methods of detection.*—The exchange has three principal methods for detecting violations of its rules on selling practices: (1) Its examination program consisting of a periodic analysis of responses to financial questionnaires and examiners' visits to the offices of members and member organizations, (2) the investigation of public complaints, and (3) its stock-watching program.

The stock-watching program [209] is primarily designed to uncover manipulative practices and influences on the exchange market and to alert the staff to unusual market situations rather than to detect examples of improper selling. Although extraordinary activity in a particular issue might warn the exchange of the possibility of high-pressure selling, it does not appear that the program is particularly aimed at detecting such violations nor does it purport to be a comprehensive detection system. Furthermore, securities traded only over the counter are not included in the stock-watching program.

During 1961, the exchange processed approximately 1,200 complaints from members of the public. Although many of these requested information or raised questions on executions or bookkeeping problems, a number concerned selling practices. The experience of

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[203] Rule 435(4).
[204] Rule 435(5).
[205] Rule 403.
[206] Rule 350.
[207] See ch. II.C, above. In addition, when a salesman's employment is terminated, the member firm must inform the exchange of the reasons for termination. NYSE "Guide," par. No. 2345.13.
[208] Id., par. No. 2345.17.
[209] For a fuller discussion of the stock-watching program, see ch. XII.B below.

the Commission indicates that the investor who believes that he has been victimized by high-pressure selling, subjected to misrepresentations, unauthorized transactions, or excessive trading, or induced to purchase securities that were unsuitable for his portfolio, is often the first source of information concerning improper selling practices.[210]

A thorough examination of public complaints handled by the exchange in 1961 revealed that its normal procedure upon receipt of a complaint letter was to send a copy to the firm involved for comment on the allegations. At the same time the exchange advised complainants that it would "investigate" the matter. After receiving the firm's reply the exchange would edit it and send it to the complainant asking for his further comments on the matter. If the firm's responses disagreed with the facts stated in the letters from the customer, the exchange would ultimately advise the customer of its arbitration facilities. Additional letters were then passed back and forth among the customer, the exchange and the firm, but independent investigations of the complaint were rarely undertaken by the exchange.[211]

The treatment of public complaint letters concerning the sale of USAMCO shares by Shearson, Hammill & Co., discussed previously in section 5.d of this chapter, illustrates the exchange's failure to utilize public complaints to detect potential violations of its rules on selling practices. The exchange received two public complaints regarding the sale of USAMCO shares by Shearson, Hammill & Co. in July and November 1961, prior to the beginning of the NASD's investigation on December 1, 1961. The first complaint asserted, among other things, that a branch manager had represented that USAMCO stock would eventually sell for $100 per share, with an extremely small chance of loss. The second complaint charged a registered representative with "a high pressure, hard sell" in a telephone solicitation in August 1961, which included suggestions that—

> big men of S., H. & Co. were directly or indirectly with this deal and that they could not afford to let anything go wrong with it. * * * He proceeded, I now realize, to hard sell me with such a glowing picture of how big deals were lined up and ready to explode and push this stock up and up to at least 30 or 32 in a comparatively short time. * * *

In both of these cases the exchange followed its normal procedure, and went no further than referring the letter to the firm, getting an answer and telling the customer that its arbitration facilities were available. The exchange's reaction brought this comment from one of the complainants:

> * * * As I said before, all this writing back and forth seems a waste of time and effort. You have as far as I know no investigative staff to get at the details and facts. It is their word against mine. They contribute to the upkeep of your organization, and I do not, except indirectly * * *

The exchange's third potential means of detecting selling practice violations is its examination program, which, like the Commission and NASD inspection programs, is primarily geared to the detection

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[210] See sec. 5.a, above, relating to public complaints.

[211] Subsequent to discussion of exchange handling of public complaints in the study's public hearings, the exchange changed the language of its response to the complainant from "investigate" to "inquire," changed its procedures so that it now forwards to the investor a facsimile of the firm's letter without editing it and advises the customer of its arbitration proceedings in its first response.

For a detailed discussion of the handling of public complaints by the exchange see ch. XII.

of violation of bookkeeping and financial rules. Exchange officials themselves have indicated that its examination program is of little value in detecting improper selling by its members or their salesmen. The limitations on the program as an enforcement aid in this area are demonstrated by the fact that exchange examiners do not visit branch offices of member firms unless accounting records are kept in those offices, although, as has been suggested above, selling excesses by the large NYSE member firms most commonly occur in branch offices. The exchange examiners check customers' accounts for churning, but do not check supervisory practices or interview registered representatives.

In addition to the sources of information described above, the exchange may learn about possible selling practice violations from other sources, including its member firms and its review of requests for extensions of time under regulation T. The Commission also may refer to the exchange information which comes to it concerning possible violations of exchange rules by its members.

In order to supplement its detection techniques, the department of member firms conducts visits to branch offices of member firms to observe office decorum and branch office atmosphere. These "decorum visits," as they are known, are made periodically to branch offices located in "problem areas" in Metropolitan New York City, and annually to all branch offices in Florida. However, these visits do not purport to attempt to detect substantive selling abuses, but are primarily directed at determining whether the branch offices are in good physical condition and whether the employees are conducting themselves in a manner which is suitable for a business office.

For some time the exchange has evidenced concern over the limitations of its sources of information on selling methods of member firms. In 1955 and 1959, two periods marked by speculative activity, the exchange experimented with staff interviews of member firms' customers regarding selling practices. In the first survey 98 customers in the New York metropolitan area were questioned on a broad range of subjects. The survey, according to the statement of Exchange President Funston in testimony at the study's public hearings, "did not uncover any indications that tips or rumors originating from member firms were playing a role in customers' decision to buy or sell securities." It did, however, record that 40 of the 97 persons interviewed reported hearing tips about securities, of which 24 came from 16 member firms, and 8 persons reported acting on tips from their respective brokers. It also recorded that 25 percent of the interviewees reported complaints regarding their brokers' services, most prominent among which were complaints relating to "high-pressure selling tactics." Following the survey, partners of six member firms were cautioned by the exchange staff on the impropriety of the dissemination of tips and rumors by registered representatives, and the exchange expanded the program of decorum visits to branch offices noted above and spot checking by examiners of the accounts of active traders.

The second survey, limited to 37 completed interviews, also reported no indication that tips and rumors played an important role in customer decisions, with only 3 interviewees reporting tips from brokers.

In December 1960 a staff memorandum from Funston noted:

> I view it to be the responsibility of the exchange to check on the selling techniques of our member firms, just as we presently check on their financial capacity, their advertising methods, and caliber of their personnel, and so forth.
>
> This seems to me to go far beyond making a survey on the extent of tips and rumors spread by registered representatives. Indeed, it amounts to checking up on the integrity of the entire sales approach of member firms to their customers.
>
> * * * * * * *
>
> To repeat, I think it is important that we devise a way of checking, on a continuing basis, on the selling activities of our member firms, and that this becomes a routine part of the exchange's services to the members and the public * * *.

One outgrowth of this memorandum was a "crash" survey of selling practices instituted by the exchange during the speculative spring of 1961. A sample of 179 investors whose accounts were picked because of their purchases of low-priced, highly speculative issues were interviewed by an outside agency to determine the extent to which such issues had been recommended by salesmen and the appropriateness of the recommendations, and to discover any evidence of churning. In the majority of the cases, the issues had not been recommended by a salesman. In those cases in which the recommendations did come from the registered representatives, most of the customers were persons of adequate means. The exchange investigated 11 questionable situations which were reported, and determined that only 2 accounts had been mishandled, both by the same salesman. He was dismissed by his employer and censured by the exchange, but it subsequently approved his employment by another member firm.

Another result of the Funston memorandum was a research program conducted for the exchange by the Psychological Corp., in the summer of 1961, in order to develop a practical and efficient research method which could be used to determine the character and extent of questionable sales practices of member firms and their salesmen.

The Psychological Corp. secured responses to 700 personal and telephone interviews and mail questionnaires. Based on the results of its survey, it reported that no instances of a clear-cut actionable case of a selling violation were uncovered, and noted that the proportion of customers involved in violations may be so very small that even repeated large-scale samplings might not uncover questionable selling practices. The report concluded that a consumer survey would appear relatively unfruitful to provide well-documented cases of selling violations, but might have a deterrent effect on unethical selling practices if systematically undertaken as a quality control program to improve customer relations.

Concluding from these surveys that random-sampling interviews were less effective than case investigations, the exchange late in 1961 formed a new unit of supervision and control, which at the time of the study's public hearings had one full-time employee and one part time, and is to be expanded to five full-time and four part-time employees by the end of 1963. A new manual on supervision of selling practices has been distributed to member firms, and a series of conferences on supervision techniques are intended to supplement the manual. Potentially the exchange's most important step is a proposed branch office inspection program separate from its existing examination program, under which inspectors will visit every branch office on a 3- to 4-year cycle. The inspector will be expected to review supervisory procedures and policies with the office manager, to interview each registered representative, and review with him his individual customer accounts from the point of view of suitability, and, to the extent feasible and desirable as a result of the registered representative interviews, to talk directly with individual customers.

(*c*) *Enforcement.*—The penalties which can be imposed upon the member, allied member, or member organization for violations of the exchange's rules on selling practices include expulsion, suspension, fine, and censure. The salesman is subject to the latter three penalties and to withdrawal of his registration with the exchange,[212] in which event he is effectively barred from employment by any NYSE member firm. Only upon a finding by the exchange of "conduct contrary to high standards of commercial honor or just and equitable principles of trade" will the salesman also be effectively excluded from employment by other NASD members as well.[213] The exchange also has the power to withdraw its consent to a member's establishment of a branch office, but this power has never been used to close improperly operated branch offices.[214]

The number of disciplinary proceedings instituted by the exchange against members, allied members, and member organizations which relate directly to the principal objectionable selling practices discussed in this report have been only a small portion of the total number of its proceedings. From January 1, 1957, through September 30, 1962, only 7 of the 66 disciplinary proceedings involving members, allied members, and member organizations charged violations of rules concerning selling practices, and of these, 6 concerned violations of the "know your customer" rule which is based upon failures to protect the firms from improper activities of customers. In only one case were partners of a firm charged with inadequate supervision of the selling activities of registered representatives, and the discipline imposed was considerably less severe than the discipline imposed on the registered representatives involved despite evidence of partners' knowledge of the activities of the salesmen.

In view of the limited nature of the exchange's reports to the Commission of the results of disciplinary cases involving registered representatives, it is difficult to determine the exact nature of the conduct which gave rise to the action. During the period January 1, 1957, to September 30, 1962, the exchange disciplined 396 registered representatives. Of these, 110 resulted in suspension and 42 resulted in withdrawal of the salesman's registration with the exchange. The Special Study examined the underlying files relating to 85 of these actions, which were selected because they appeared to involve selling abuses of the type discussed here. These files reveal one instance of discipline based on violations of a suitability standard,[215] one case

[212] Amendments to exchange rules in 1963 have for the first time authorized the exchange staff to impose fines on salesmen, and have given the salesmen the right to appeal adverse findings to the board of governors regardless of action by their employer firms.

[213] NASD bylaws, art. I, sec. 2(a)(D). Since 1957 there appears to be no case involving a registered representative where this finding was made and reported either to the Commission or to the NASD.

[214] NYSE, rule 342.

[215] This salesman was censured by the exchange after his employer had dismissed him and reported the matter to the exchange. He was subsequently hired by another member firm.

involving the sale of speculative securities in violation of firm policy (but not of exchange rules),[216] and seven cases involving unauthorized transactions. The remainder of the cases studied did not appear to involve selling practices in which investors were victimized as a result of salesmen's improprieties. For example, of 38 actions under the "know your customer" rule only one (mentioned above) was based on findings that the salesmen recommended unsuitable securities to his customer, while each of the remaining 37 cases involved the possibility of financial loss to the firm rather than the customer.

(4) *Other exchanges' controls over selling practices*

All of the registered national securities exchanges, like the NYSE,[217] are required by section 6 of the Exchange Act to have rules providing for the expulsion, suspension or disciplining of a member for conduct "inconsistent with just and equitable principles of trade," and, like the NYSE, have all adopted rules which conform to the general requirement of the statute. In addition they have rules more specifically related to selling practices, although with the exception of the Amex, they are generally less detailed and elaborate than the rules of the NYSE. Specific rules of some or all exchanges, for example, prohibit fraud,[218] churning of discretionary accounts,[219] and include "know your customer" [220] and supervision [221] sections. None of them has a rule expressly prohibiting unsuitable recommendations similar to the rule of the NASD.

Whatever rules are on their books, however, one cannot escape the conclusion that the controls exercised by these exchanges have at most a very minor impact on the selling practices of the securities industry. The conclusion springs from a number of causes. Except for the Amex, the other exchanges are, compared to the NYSE, all small both in their size and in the volume of trading they carry on. Many of the member firms of each of the four largest regional exchanges [222] are also members of the NYSE or Amex, and as to such dual members the regional exchanges generally rely on the NYSE and Amex to perform such necessary policing functions as examining their books and records.

The study surveyed the enforcement of the two largest regional exchanges: The Midwest and the Pacific Coast Stock Exchanges. Relatively few customer complaints are received by the exchanges, and the principal method of detecting violations of their rules on selling practices is their examination program. However, in one situation, the PCSE received complaints from four customers of a particular registered representative, alleging unauthorized transactions, high-pressure selling, unsuitable recommendations and other improper selling practices. The exchange turned the complaints over to the mem-

[216] This salesman was censured and required to pass a new examination. He too had first been dismissed by his employer, who had reported the matter to the exchange. He too was subsequently hired by another member firm.

[217] The other registered exchanges are the American, Boston, Cincinnati, Detroit, Midwest, National, Pacific Coast, Philadelphia-Baltimore-Washington, Pittsburgh, Salt Lake, and Spokane Exchanges, the Chicago Board of Trade, and the San Francisco Mining Exchange. Four other exchanges have received exemption from registration under the Exchange Act; the Colorado Springs, Honolulu, Richmond, and Wheeling Stock Exchanges.

[218] E.g., Midwest Stock Exchange Rules, art. XVII, rule 1.

[219] E.g., Boston Stock Exchange Rules, sec. 8, Philadelphia-Baltimore-Washington Stock Exchange rules, rule 774(c).

[220] E.g., Pacific Coast Stock Exchange, rule X, sec. 1.

[221] E.g., Id., rule X, sec. 2.

[222] The Boston, Midwest, Pacific Coast, and Philadelphia-Baltimore-Washington Stock Exchanges.

ber firm which employed the registered representative, without questioning the registered representative or making a thorough investigation of its own.

The examination programs, geared as they are to the books and records of the member firms, suffer from the same deficiencies as the programs of the Commission, the NASD and the NYSE when it comes to detecting some of the more objectionable practices. The Midwest examination program is carried on by a vice president, an examiner, an analyst, and accountants from a major accounting firm, and reaches Midwest-only member firms once a year. Midwest examiners are instructed to look at customer account cards for overtrading, and for the kinds of securities contained in the account, and to review firms' selling literature for overoptimistic projections of the performance of recommended stocks. They do not visit the few branch offices of Midwest-only firms. The Pacific Coast Stock Exchange has four employees engaged in reviewing each PCSE-only member firm's operations once each year and occasional spot checking such particular matters as capital requirements. Customers' accounts are checked for overactivity, though this is admittedly difficult to detect, and no check is made for suitability, nor are branch offices visited.

The regional and mining exchanges have had very few disciplinary proceedings involving violations of selling practice rules. A review by the study of all disciplinary proceedings reported to the Commission by 10 of these exchanges [223] for the 10-year period from January 1, 1953, to December 31, 1962, showed that of a total of 117 reported disciplinary proceedings, not more than 12 could be considered to involve violations of selling practice rules.

(5) *State controls*

The study's review of selling practices and controls has not focused on the effect of State law in this area. It must be noted nevertheless that most States do have laws relating to illegal sales of securities. These laws, variable as they are in content and administration, add another layer of controls over improper selling practices.

The blue sky laws in force in 48 States [224] affect selling practices directly by the imposition of antifraud provisions and indirectly, in most cases, by provisions which require registration of persons engaged in the securities business [225] or registration or licensing of securities. The antifraud provisions of most of these States operate by means of investigation, injunction, and prosecution. Generally they empower the State administrator to issue public warnings, to investigate suspected fraudulent activities, to take injunctive steps to stop them, and as a last resort provide sanctions for violations of State law. The antifraud provisions of the Uniform Securities Act, which has so far been adopted by 15 States since its promulgation by the Conference of Commissioners on Uniform State Laws in 1956, are patterned after the antifraud provisions of the Federal securities laws discussed above,[226] and provide for criminal prosecution for willful violations, injunctive proceedings to stop violations, and administra-

[223] The Chicago Board of Trade and San Francisco Mining Exchange were excluded from the review.
[224] Delaware and Nevada have no blue sky laws.
[225] See ch. II.B and II.C, above.
[226] See sec. 6.b(1).

tive proceedings to deny, suspend, or revoke registration of broker-dealers and their agents engaged in such activities.

The States are, however, restricted in the effect which their activities may have by their geographic limitations, and the common use of long-distance telephone calls in boiler-room operations limit the protection which even a strong State law and administration can provide for their own residents. More typically, State administrators are handicapped in enforcing their laws by limitations of manpower and budget, and prefer to concentrate their limited resources on preventing abuses by administering the registration provisions of their law. A 1958 survey [227] of blue sky laws indicated that the number of State injunctive and criminal proceedings is small.

7. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The predominant concern of the securities industry is the sale of securities, and in pursuit of this activity members of the industry make use of many of the standard techniques of merchandising. Some segments of the industry appear to be earnestly promoting high standards of selling while others seem only to be earnestly promoting sales. In its review of selling practices the study has given principal attention to abuses and improper practices, but no quantitative measurement of the extent of these practices is intended to be reflected. On the other hand, it has noted areas in which firms and segments of the industry have instituted techniques to raise standards and to assure fair dealing, in its highest sense.

Public investors are attracted to securities markets through the extensive use of sales promotion activities, which include advertising in almost all media of communication as well as market letters, research reports, lectures, and even investor contests. In style and emphasis these range from the "institutional" approach to the highly flamboyant, and the former is not necessarily the exclusive domain of the more conservative firms. Whatever style is used, one of two themes predominates: the trust and confidence which the customer should place in the firm because of its superior research facilities and experience, or the potential profits to be reaped by investors from the purchase of its merchandise. When characterized by restraint and the proper regard for the facts, the use of each theme is legitimate, but there are many pitfalls for the unwary in advertisements making spurious claims of research expertise and responsible analyis on the one hand, and unbridled appeals to gambling instincts on the other.

The one indispensable factor in selling securities is, of course, the individual salesman, who has direct contact with the customer. Most salesmen perform the dual function of prospecting for new customers and servicing existing ones. Aggressive prospecting is encouraged throughout the securities industry, although more extreme forms, such as the "cold turkey" telephone call to unknown persons, are generally frowned upon. In all dealings with public customers, whether or not the customer relies on the salesman in making his investment decision, broker-dealers and salesmen are obliged to conform their activities to the fair-dealing standards of the industry. These standards include a recognition of the customer's financial resources, obli-

[227] Loss & Cowett, Blue Sky Law 86 (1958).

gations, and needs. Where there is total reliance on the salesman's recommendations, as in discretionary accounts, or partial reliance, here is an even greater obligation for the salesman to be guided by the best interests of his customer. Human nature being what it is, however, considerations other than the welfare of the customer may divert his attention from these obligations. Principally, these considerations are the salesman's compensation and the merchandise which his firm may provide for him to sell.

Compensating salesmen on a commission basis is an almost universal practice. Many are paid a draw against commissions, but the direct stimulus of the commission to the production of business still remains. Many firms increase this awareness by paying the salesman a larger percentage of all commissions in a month in which his total commission business exceeds a certain figure. While some firms have insulated salesmen somewhat from direct dependence upon the amount of commissions they earn, the prevailing trend has definitely been the other way.

In addition to volume, the salesman's compensation for a given transaction varies according to other factors. One important such factor is the NYSE minimum commission rate schedule, which, with its prohibition against splitting commissions with nonmembers, diminishes or eliminates commissions for salesmen of nonmember firms from transactions executed on that exchange. Commissions from customers' purchases of over-the-counter stocks are frequently higher for all salesmen—including those of most NYSE member firms—than commissions from sales of listed stocks. The directness of the impact of compensation is demonstrated by the effectiveness of extra compensation paid to salesmen in distributions of blocks of securities. Under this stimulus, there is usually little problem in disposing in a few hours of a block which might normally take days to sell. The potential influence of such factors as these on the economic incentives of salesmen is clear.

The extensive variety of securities sold to the public makes specialization inevitable, and it is desirable to the extent that it affords to the investor the benefit of expert valuation by a dealer of his merchandise. One risk that specialization involves for the public, however, is exemplified by the type of firm which obscures its specialization at the same time as holding itself out as willing and able to give impartial advice on investments of all kinds. Within this category are the firms specializing in speculation, whose salesmen concentrate on selling low-price stocks of high-risk companies without knowledge of or concern for the financial circumstances or needs of their customers, and sometimes without even a superficial knowledge of the securities they offer. An even more menacing specialty is the boiler room, which characteristically sells obscure or worthless stocks to unknown and unseen members of the public through long-distance telephone campaigns and by means of glowing and thoroughly misleading descriptions and forecasts, and other devices.

High-pressure selling, particularly during the recent bull market, has not been confined to the boiler rooms and other marginal firms, but has been found to exist even in the branch offices of some large, well-known NYSE brokerage firms. During the study, complaints were received from the public concerning objectionable selling by salesmen for large member firms. Limitations on the time and manpower available to the study precluded investigation of every complaint, but the limited number that were investigated confirmed the existence of unethical and improper selling practices among salesmen of larger firms and, combined with the study's other findings, confirmed that they were not mere isolated instances. Examples were disclosed in public hearings. One involved overtrading customer accounts and check-kiting in a branch office atmosphere of indifference to rules. It also involved neglect of the problem by home office supervisory personnel. A second showed the highly communicable nature of speculative fever, with salesmen of a number of leading NYSE member firms vigorously soliciting sales of a stock which at best might be described as marginal, some of them using high-pressure telephone calls, repeating a totally misleading picture of the company's position and prospects based on grossly inadequate information, and ignoring the suitability of the investment for their customers. The third case involved a total breakdown in supervision resulting in the aggressive sale of stock of a highly risky new issue to public customers on the basis of unwarranted predictions of earnings and suggestions of the firm's interest in the company, with salesmen taking sizable positions and subsequently selling their own holdings at the same time they were recommending purchases or discouraging sales by customers.

Broker-dealers are charged with the responsibility of supervising the activities of their employees by the Federal securities laws and the rules of the NASD and the exchanges. The larger firms, where problems of supervision are most acute simply because of their size, have established elaborate systems of internal supervisory controls. In firms with numerous branch offices a complex organizational structure may exist, but all firms and authorities emphasize that the key to proper supervision is the branch manager. In almost all large firms the branch manager is required to review all transactions on a daily basis, and in many he must approve large or unusual orders, new customer accounts, and transactions of new and inexperienced salesmen. Despite the heavy burden of administrative duties and supervisory responsibilities carried by branch managers, few firms have chosen to relieve them of the burdens of servicing their own customer accounts, and most continue to compensate them for such business on a commission basis.

Centralized, or home office, controls form a second keystone of internal supervision. Principally these consist of senior supervisory personnel (an executive committee of partners, regional and national managers, or some similar organization), an internal audit system, and electronic data processing equipment (EDP) upon which almost all large firms rely and without which they would be unable to conduct their businesses. EDP, which can make possible daily home office review of all branch office transactions and can promptly disclose unusual activity of any kind in any branch, is indeed a valuable tool of supervision, but no machine alone can supervise men. As indicated by the cases developed in the public hearings, unfortunate situations in branch offices can go undetected despite the use of EDP. Its proper use as a supervisory tool requires training, skill, intelligence, and vigilance on the part of those who use it.

The types of selling practices which the industry generally seeks to exclude but which occur with sufficient frequency to warrant special vigilance on the part of supervisors and supervisory systems include overtrading of customer accounts, misrepresentations and high-pressure sales tactics, and recommendations of securities unsuited to the customer's financial resources and investment objectives. Of the three, overtrading generally receives most attention in internal supervision systems. Procedures to detect overtrading are included at almost every level in most large firms from branch manager to home office review, and EDP may be used to detect obvious abuses in this area. The evidence of overtrading found by the study even in firms which use these procedures, however, suggests either inadequate review of the information developed or inadequacy of the existing procedures themselves in light of the volume of transactions involved. Effective control of salesmen's oral representations is obviously difficult, but firms could place greater emphasis on regular branch manager conversations with customers, thorough investigation of customer accounts, and continuing training in ethical selling methods. Most firms appear to place little emphasis in their supervisory processes on the important NASD requirement of suitability of recommendations. In recent months a significant segment of the brokerage community has shown a growing awareness of the importance of adequate supervision, evidenced both by public pronouncements and internal revisions of firm policies.

The Commission, the NASD and the NYSE—the three principal regulatory bodies exercising control over the selling practices of securities firms and their salesmen—each has a set of rules covering the major problems which exist in this area. However, the adequacy of the substantive rules which delineate legal and ethical standards of selling in the industry are not always matched either by the techniques available to detect violations or the enforcement action applied after detection.

The Federal securities statutes and rules protect investors, both by prohibiting specific improper selling practices and by requiring disclosure of material facts in securities transactions. In addition, the anti-fraud sections of the securities laws prohibit fraudulent schemes and devices peculiar to the sale of securities, and the Commission relies primarily on these sections in its enforcement actions directed against illegal selling activities. A substantial portion of the Commission's enforcement activity has been directed at firms of the boiler-room type, although proceedings against large and well established firms have been instituted when the facts warranted such action.

The emphasis of the Commission's enforcement program on the more serious frauds and the boiler rooms has several reasons. Under the statutory scheme of the Exchange Act, contemplating both Federal regulation and industry self-regulation, a natural division of labor allocates to the Commission control over clearly illegal selling practices—typified by the boiler room or the confidence man's tactics—while improprieties in the nature of unethical practices are left to the industry bodies. The pattern of legal sanctions also contributes to this emphasis, since the Commission can institute administrative proceedings only to revoke a broker-dealer's registration or to suspend or terminate membership in the NASD, but it cannot apply intermediate sanctions or proceed directly against a salesman. For isolated instances of illegal selling in a large, essentially well-run firm, the Commission's sanctions may often be too severe to justify their use.

Despite techniques which aid the Commission in identifying boiler rooms, such as its broker-dealer inspection program, its improved inspection procedures, and its use of NASD records and complaints from the public, the unscrupulous brokers and salesmen who compose the boiler-room blemish on the community are able in many cases to induce large numbers of public customers to invest in worthless securities before effective action can be taken. The recommendation in chapter II to raise qualification standards will help to reduce the incidence of boiler-room selling.

The NASD rules governing selling practices are sufficiently broad and inclusive to cover the major abuses found to exist in this area, as enumerated above. Unlike the Commission, the association can impose a wide range of sanctions which encompass censure and fine as well as the most drastic actions of suspension and expulsion, but although it can apply sanctions to the salesman directly, it cannot proceed directly against a salesman without involving the firm.

The methods used by the NASD to detect violations of rules among its members and their employees are not well geared to uncover selling practice abuses. The association does not, because of its relative anonymity, receive a significant number of public complaints; its examination program emphasizes financial and bookkeeping matters rather than selling methods, it makes almost no examination of the branch office—the seat of a substantial proportion of the selling abuses among the larger firms; and it has no procedure by which it can evaluate the efficacy of its members' supervision systems.

These limitations on the association's detection system do not appear to have handicapped it in its identification of boiler rooms. However, to facilitate the disposition of actions against such firms, proceedings are frequently based on violations of rules other than those relating to selling practices, especially violations of the net capital rule. This practice unfortunately tends to allow unscrupulous salesmen to go to work in other firms, since they have not been named as causes in the proceedings. The benefit derived from simpler proceedings may therefore be overshadowed by the fact that their salesmen continue in circulation.

In its decisions, the NASD demonstrates its ability to deal with boiler rooms either through findings based on violations of the financial and bookkeeping rules or on occasion through opinions relating to selling abuses which seem to set high ethical standards for its members, particularly in the area of suitability. For improper selling practices occuring in firms other than boiler rooms, the NASD procedures are less effective and its results less impressive.

Even member firms of the New York Stock Exchange are by no means immune to the problems of objectionable selling practices. In general the rules of the exchange, which are superimposed on its members in addition to NASD and Federal rules, are adequate to cover the types of practices which have been disclosed in the course of the study. Its methods of detection of violations of these rules, however, have left much to be desired. Its stock-watching program, valuable as a tool in detecting manipulations, has little application to the types of selling practices which are the subject of this chapter. Its examination program, which, like the Commission and NASD inspection programs, primarily focuses on the books and records of member firms, is valuable too for detecting bookkeeping violations and signs of financial instability, but is equally impotent to detect improper selling. Finally, it has treated complaints from public customers, which are often a fruitful source of information on improper conduct of salesmen, in a manner which at best contributes little to the effective enforcement of its rules.

The exchange has for some time been concerned about the limitations of the sources which it has had, and since 1955 has made sporadic efforts to determine other methods by which it could obtain knowledge of improper selling by salesmen of member firms. However, progress by the exchange has been slow. Only after two customer interview programs in 1961 had convinced the staff that random sampling interviews were less effective than case investigation did the exchange establish a unit of supervision and control for selling practices. Only after the study's public hearings disclosed extensive evidence of improprieties among salesmen of member firms did it expand the unit beyond its previous one full-time employee and one part time. The limited number of disciplinary proceedings concerned with the types of objectionable practices here discussed also suggests either the inadequacy of the exchange's detection program or its reluctance to acknowledge that such practices are a matter of concern.

The Special Study concludes and recommends—

1. The supervision by broker-dealers of the selling activities of their personnel, particularly in branch offices, should be generally strengthened by the adoption of appropriate procedures including, but not necessarily limited to: the designation of one home office senior executive responsible for internal supervision and regulatory and self-regulatory matters generally; increasing the branch manager's supervisory role while deemphasizing his selling activities in branches having large numbers of salesmen; and in large firms with many branches, the tightening of home office control procedures, with more extensive use of electronic data processing equipment programed to expose overtrading, undue concentration in speculative securities, and other potential abuses.

2. The self-regulatory agencies should establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms. While the recent publication of the New York Stock Exchange's guide to supervision and management of registered representatives and customer accounts represents a significant step in this direction, the implementation of the standards there set forth will call for strengthening of surveillance. The NASD control procedures in respect of selling practices are also in need of substantial strengthening. More regular and frequent examinations of branch offices are called for, and examinations should include interviewing salesmen, and in appropriate cases customers, when accounts show heavy trading or concentration in speculative issues.

3. The Commission should adopt rules to facilitate and reinforce controls by firms, the self-regulatory bodies, and the Commission over selling practices. Such rules should, for example, require: that every retail transaction be designated "solicited" or "unsolicited" in the permanent records of a broker-dealer; that all customer complaints be kept in a single file and available for inspection and examination by the Commission, the NASD, and the exchanges; and that customer account cards or similar records include such information as investment goals, occupation, and type of service desired.

4. Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of "suitability" of particular securities for particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement. The NYSE, which has less clearly recognized suitability as a standard of conduct, should make greater efforts to define its content and undertake necessary surveillance and enforcement. This area would seem to be a particularly appropriate one to be dealt with through statements of policy (similar to that now applicable to investment company selling literature), which can provide the necessary balance between generality and specificity of standards. Such statements of policy should cover such matters as: possible guidelines as to categories or amounts of securities deemed clearly unsuitable in specified circumstances; practices deemed incompatible with standards of suitability, such as indiscriminate recommending or selling of specific securities to other than known customers; and approved and disapproved practices in the handling of discretionary accounts.

5. The importance of disclosure for the protection of investors has long been recognized in securities regulation, and it is of particular value in connection with selling practices. The present mandatory, officially filed disclosures by issuers (reports and proxy statements), extended and improved as recommended in chapter IX, should have wider and more prominent use in selling activities, and the obligations of broker-dealers in this regard should be appropriately defined by the self-regulatory agencies and the Commission. These obligations might include such matters as: actually consulting available officially filed data prior to recommending or selling specific securities; furnishing copies to customers in appropriate cases; and advising customers whether officially filed information is available with respect to any security recommended for purchase.

6. The almost universal industry practice of compensating salesmen in proportion to the volume of business produced may be assumed to be inherent in the nature of the business, but certain of its particular aspects may tend to introduce undue pressures or biases into the selling process. This would appear to be another appropriate area for continuing attention of the self-regulatory agencies, with the view to evolving rules and standards, in line with the best existing practices, that might eliminate or reduce the more extreme forms of pressure or bias

in selling. Among possible measures in this direction that should be considered by broker-dealer firms and the self-regulatory agencies would be: making monthly compensation less specifically dependent on each month's production; eliminating a step-up of commission rates for transactions in a given month on reaching a stated volume for the month; discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential; and requiring disclosure of extra compensation in respect of particular types of transactions.

7. The sanctions now available to the Commission in respect of selling practice and similar violations—revocation of a firm's registration with the Commission, or expulsion from or suspension (for up to 12 months) of membership in an exchange or national securities association—are sometimes unsuitable to the needs of particular cases, especially where the disciplinary action relates to only one or few salesmen or only one of many branch offices of a firm. The Commission should have more flexible powers to deal with the latter type of situation, so that it may invoke measures appropriate for dealing with particular kinds and degrees of misconduct rather than being limited to the choice between no sanction or an excessive or inappropriate one.

C. Research and Investment Advice

1. INTRODUCTION

In the discussion of the selling practices of broker-dealers, the report has noted the extensive use of investment advisory material as a selling tool. A torrent of published advisory material in the form of letters, reports, and magazines covering the market, particular industries and individual companies, goes to the public from this source. For many firms distribution of this material has become an integral part of their business. Adding to this flow is advisory material from other sources, especially the "advisory services," whose publications offer investment advice to large subscription followings. Taken as a whole, these materials raise broad issues of the nature of the responsibilities of their disseminators to those whom they advise, and the extent to which their activities are consistent with the responsibilities.

Both the volume and variety of the written investment information and advice originated by broker-dealers, who for the most part furnish it free to their customers as a part of their effort to sell securities, are impressive. Merrill Lynch, Pierce, Fenner & Smith, Inc., the largest retailer of securities, in September 1962, had a regular circulation to its customers of over 200,000 for its fortnightly magazine, Investor's Reader. In a 3-month period in 1961, E. F. Hutton & Co. had an average circulation of its monthly, Market and Business Survey, of 67,000 copies. Walston & Co., over the same period, printed a total of 437,000 copies of its daily market letter. The research department of Shearson, Hammill & Co. distributes several different publications to the public, including a monthly Research Bulletin with a regular circulation of about 85,000, their Special Report on individual securities and industries, a four-page brochure, Business and Securities, distributed to all customers with their monthly statements, and weekly and daily letters called Market Comment. Smaller New York Stock Exchange member and nonmember firms also circulate their own materials extensively. For example, Cohen, Simonson & Co. distributed 8,000 copies of its monthly market letter during a 3-month period in 1961. Aetna Securities Corp., a nonmember firm with six registered representatives, in 1961 distributed 6,200 copies of one report on an unlisted security. Raffensperger, Hughes & Co., with nine registered representatives, in the same year circulated 3,000 copies of a single report. Frank Ginberg & Co., with seven representatives and a one-man research department, has circulated as many as 2,000 copies of its reports on individual securities. While no reliable statistics exist concerning the numbers or total circulation of this material, the New York Stock Exchange has estimated that its member firms distributed approximately 32,000 different market letters, research reports, and analyses during 1955, and that the number had almost doubled by 1961.

Paralleling the extraordinary growth in the volume of free printed materials distributed by broker-dealers has been that of the subscription publications, which also cover a broad field. These include large publishing houses with numerous publications, some purely informational, others offering advice. They include one firm with only one advisory publication but with an 80,000 circulation at one time in 1961, several firms with more than one advisory publication (some firms have their own publications competing with one another) with numerous subscribers to each, and firms with a few hundred or less subscribers. There are firms which sell their materials only to others in the securities or investment advisory businesses. Some publications limit their consideration to over-the-counter securities, convertible debentures and warrants, securities in a particular industry, or so-called "special situations." Many others are based upon special analytical techniques such as "point and figure charts," or interpretations of the significance of odd-lot transactions.

All of the firms contributing to this stream of investment advice, as well as a number of firms and persons offering personal investment guidance on a fee basis, are registered with the Commission either as broker-dealers under the Exchange Act, or as firms and individuals offering advice for a fee under the Investment Advisers Act, or both. As of June 30, 1962, there were 5,868 broker-dealers registered under the former act and 1,836 registered investment advisers under the latter act, of whom a considerable number are also broker-dealers. New registrations under both acts have increased rapidly in recent years. The focal point of this portion of the study has been the investment advice of these advisers.

There is, of course, another large and diversified group conveying investment advice to the public who generally are not registered with the Commission. This group is composed of lawyers, accountants, insurance companies and banks, magazines and newspapers of general circulation—financial and otherwise—whose columns and articles discuss specific securities and sometimes make specific recommendations, publishers of hard-back and paper-back books about the stock market, and even distributors of phonograph records telling how to invest.

However, investment advice from registered broker-dealers and investment advisers appears to have the greatest influence upon investor conduct, because of its volume and its nature, which is the presentation of particularized investment recommendations. Many persons, including those who play important parts in this advisory activity, feel that the conduct of these advisers played a major part in stimulating the bull market which preceded the severe market decline in the spring of 1962.

For most such firms, investment advice originates with a person whose full- or part-time job it is to "research" particular securities and industries; in many firms he is called an "analyst." The study has reviewed the education, experience, and other qualifications of analysts, noted their classification by some firms into "senior" and "junior" categories, and discussed the total lack of established standards or criteria for qualification as an analyst.[228] A brief examination of their critical role in the advisory process is called for.

There are essentially two broad approaches to the evaluation of securities, known as the "fundamental" and "technical" approaches. Individual analysts by and large adhere to one approach or the other, with those using the fundamental approach often known as security analysts and those using the technical approach known as market analysts.

Security analysis is the basis for the great bulk of investment advice in all forms. The fundamentalist studies—in varying degrees, depending upon the purpose and thoroughness of his examination—such basic matters as the company's financial statements, earnings, the ratios of the stock's price to the company's earnings and cash flow and their significance, dividends, management, sales, markets, competition, products, and product changes. Also of concern to him are the many economic and political forces which affect the company, the price of its security and market prices in general.

Technical or market analysis concentrates almost exclusively upon stock market action per se. It is concerned with the patterns of securities prices and the volume of trading, with "what the market is saying," the interior action of the market itself. This may be presented by such devices as "point and figure" charts or through analysis of the conduct of various types of investors by examining such sources as odd-lot transactions and "insiders' tranactions." [229] The technician studies trends in the immediate past in the hope that they will give indications of movements in the immediate future. He is more concerned with timing than the fundamentalist, and as a result the investor who acts on his recommendations tends to be more oriented toward trading than investing.

Both approaches carry significant weight in the securities industry. While most broker-dealers with research departments lean heavily on the fundamental approach, a substantial number have technicians on their staffs. Because of the nature of the materials used, a research staff needs fewer technicians than fundamentalists to keep its information current. Several of the technicians have large followings in the investment community.[230] Most subscription publications rely on the

[228] See ch. II.E, above.
[229] For a discussion of the reporting of insiders' transactions see ch. IX.
[230] See the examples described in Seligman, "The Mystique of Point-and-Figure," Fortune, March 1962, pp. 113, 115. See generally Seligman, "Playing the Market With Charts," Fortune, February 1962, p. 118.