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COMMENTS

OVER-THE-COUNTER SECURITIES MARKETS

I

REGULATION OF SECURITIES TRANSACTIONS

Following the 1929 collapse, much attention has been centered on the role of the security exchanges in our economy. Whether or not improper operation of the securities markets had caused the instability of the national economy was not clearly apparent. However, as many persons believed that such was the case, or that such operation was at least a major factor in the economic ills of the country, the "crash" and the resulting investigations provided the impetus for a reform program in the investment banking segment of our economy, and one phase of this program dealt with securities.

The Congress enacted legislation, providing for the establishment of a Securities and Exchange Commission.¹ This Commission was clothed with authority to supervise the issuance, sale and trading of securities, the operation of the securities markets and the personnel of these markets. The Securities Act of 1933² was enacted to eliminate misrepresentations, deceit and other fraudulent practices in the issuance and sale of new securities by requiring that a full and fair disclosure be made of all material facts regarding securities which are offered for sale to the public in interstate commerce. This Act provides that, with certain exceptions, before a security may be offered or sold, a registration statement must be filed with the Commission and that it must be effective.

From the beginning of federal regulation it was recognized that control of the national securities exchanges would not alone assure protection to investors. To have omitted the over-the-counter markets from the regulatory scheme would have to a large extent dissipated the benefits from the regulation of the organized exchanges. The Congress therefore enacted the Securities Exchange Act of 1934³ to eliminate fraud, manipulation and other abuses in the trading of securities both on the organized exchanges and in the over-the-counter markets. Because of the lack of information regarding the nature and problems of the over-the-counter markets at the time this Act was passed, the Commission was granted such general powers of regulations as

1. 48 STAT. 885 (1934), 15 U.S.C. § 78 (1941).

2. 48 STAT. 74 (1933), 15 U.S.C. § 77 (1941).

3. 48 STAT. 881 (1934), 15 U.S.C. § 78 (1941).

were "necessary or appropriate in the public interest . . . to insure to investors protection comparable to that provided . . . in the case of national securities exchanges."⁴ As a result of the recommendations made by the Commission, this Act was amended in 1936 and 1938.⁵ These amendments have greatly increased the power of the Commission to regulate over-the-counter transactions.

Securities transactions in the over-the-counter markets are regulated by Section 15 of the Securities Exchange Act of 1934. It is the purpose of this comment to deal with some of the specific problems encountered in the registration of over-the-counter brokers and dealers, the transactions in such markets and the organization and function of the National Association of Securities Dealers, Inc.

II

NATURE OF OVER-THE-COUNTER MARKETS

The over-the-counter markets are sometimes referred to as the unorganized securities markets in which there is no concentration of traders but where there are meetings of individual supply and demand as contrasted with the organized markets on the national exchanges, where there are meetings of collective supply and demand. They have also been referred to as the "irregular markets," although recognized to be in some cases fairly well organized. The activity in these markets consists of an uncounted number of separate transactions of which no publicized record is kept and where there is no general information available either as to the volume or price in any given transaction. Each firm which participates in over-the-counter trading relies upon independently acquired information as to what other firms are buying and selling or are likely to buy and sell. As there are no published records of the various transactions, no ticker services and no control agencies where the investing public can check the prices at which securities are currently selling, it must rely on whatever ask and bid quotations are circulated and published.⁶ Some dealers circulate bid and asked quotations among other dealers for the purpose of stimulating business and these are private services which enable the over-the-counter houses to make their quotations available to one another. At the present time the National Association of Securities Dealers, Inc., furnishes quotations on unlisted securities. The various quotations of the average bid and asked prices which are published in local and national newspapers, though they constitute the public's only readily available source of informa-

4. 48 STAT. 895 (1934), 15 U.S.C. § 78o (1941).

5. 49 STAT. 1377 (1936), 52 STAT. 1070 (1938), 15 U.S.C. § 78o (1941).

6. Price quotations distributed by the National Quotation Bureau, Inc., are for the confidential use of brokers and dealers and the public cannot subscribe.

tion, do not purport to represent the highest bids and the lowest offerings available at the time, but are merely offers and bids between which it is believed that sales of such securities may be made.

In quality the over-the-counter issues range from the highest grade bonds to the most speculative stocks. However, there are certain characteristics inherent in these informal markets which make them the natural media for dealing in certain types of securities. Securities which have a limited distribution; small capitalization; high price; those which lack a speculative interest and those which are highly desirable for the portfolios of insurance companies, investment trust and institutional investors, will be found in these markets. The securities of banks and insurance companies; institutions whose public prestige would not survive the publicity of speculative onslaughts were their issues bought and sold on an organized exchange; the obligations of the federal and various state governments and municipalities are sold almost exclusively over-the-counter. Securities of corporations which wish to avoid regulation under the Securities Act of 1933, may also be found in these markets.

In these over-the-counter markets will be found not only persons who have the same varied interests as those who engage in transactions on the organized exchanges but also individuals who are seeking investments in securities which cannot be obtained on those exchanges. Individuals who deal in huge blocks of securities and individuals who seek the secrecy of those markets to avoid liability will be found here also.

Although there are no reliable statistics with respect to the volume of trading, there is reason to believe that both the value of the total issues dealt in and the volume of such issues are enormous and that the volume of trading far exceeds that of the securities listed or admitted to unlisted trading privileges on the organized exchanges. However, as many of the securities dealt in are those of small concern, the dollar value of the securities listed on the exchanges is undoubtedly greater than those traded in the over-the-counter markets.

III

REGISTRATION REQUIREMENTS

At the present time there are two types of control or supervision exercised over these markets. The first type of control centers on the restriction of mailing facilities; the other type, which will be discussed later, emphasizes self-policing.

All brokers or dealers who use the mails or any means or instrumentalities of interstate commerce to effect any transaction, or who induce either

the purchase or sale of a security otherwise than on a national securities exchange are required to register with the Commission, unless such activities are in "exempted"⁷ securities or in commercial paper.⁸ Those dealers and brokers whose business is exclusively⁹ intrastate are not required to register with the Commission. Before a broker or dealer may be registered, it is necessary to submit an application to the Commission "which shall contain such information in such detail . . . as the Commission may . . . require . . ."¹⁰ Except as otherwise provided, registration is effective thirty days after the receipt of the application by the Commission.

The old concept that registration would be required where one was making or creating a market for both the purchase and sale of any security, except in the exempt securities was abandoned, in favor of the test that the use of any means of interstate commerce to *effect or induce* either the *purchase or sale*, otherwise than on a national exchange, determines the necessity for registration. This greatly increased the authority and control of the Commission over this segment of the security transactions. For registration purposes therefore it is the scope of the business rather than the character of the market for the securities in which the broker-dealer is engaged that determines whether he is exempt from registration or not.

IV

GROUND'S FOR DENIAL OR REVOCATION OF REGISTRATION

The Commission has authority by order to deny, suspend, revoke or cancel registration of any broker or dealer. The Commission has held that although Section 27 of the Act gives the federal courts exclusive jurisdiction over violations of the Act,¹¹ this does not deprive the Commission of jurisdiction to conduct such proceedings as are provided for by Section 15 or of any other administrative proceedings which are provided for by the Act.¹² The Commission has authority to postpone the effective date of registration for a period not to exceed fifteen days¹³ and such time may be extended after

7. See Rules X-15A-1, 2 and 3 where the Commission has accorded exemption to certain securities. The reference to rules made in this comment will be to the rules promulgated by the Securities and Exchange Commission.

8. The term as used here includes the "commercial paper, banker's acceptances or commercial bills" as exempted by § 15(a).

9. Originally those persons whose transactions were predominately in intrastate commerce were exempt from registration. Section 15, 48 STAT. 895 (1934), 15 U.S.C. § 78 (1941).

10. 48 STAT. 885 (1934), as amended, 15 U.S.C. § 78o (1941).

11. Section 27 of the Securities Exchange Act of 1934 provides that "The district courts . . . shall have exclusive jurisdiction of violations of this title . . . and of all suits in equity and actions at law brought to enforce any liability or duty created by this title. . . ."

12. Walton & Co., 5 S.E.C. 112 (1939).

13. Note 10 *supra*.

and hearing before the Commission will issue an order either granting or denying the application.

The Commission's authority is to be exercised only after appropriate notice and opportunity for hearing has been given. The Commission has held that the "appropriate notice" required, may be given by registered mail or confirmed telegram. At the present time, the application form used in requesting registration includes a statement¹⁴ which gives consent to such notices. The Commission has held that a registered letter forwarded to the address shown, although returned "Unclaimed" or "Cannot be found" did not impair the sufficiency of such notice, because of the consent given when the application form was signed and that such letter nevertheless was adequate notice.¹⁵ Where there is actual notice, the Commission may take any action it deems necessary, and it may issue an order denying or revoking registration whether the respondent appears before the Commission or not.¹⁶ However, where there is no actual notice given to the respondent, the Commission in one case, although it found that there was evidence which might warrant revocation, stated that "there is no evidence in the record indicating that the violation is willful" and since the respondent did not appear the Commission stated that "we withhold our final findings in this matter until he comes in to be heard."¹⁷

In almost all instances, before disciplinary action can be taken it is necessary that there be a finding that the violation was "willful." The Commission has stated that "a violation to be 'willful' as that term is used in Section 15(b) . . . does not mean that the respondent must be aware of the fact that he is violating the law; he may willfully violate the law even though he is ignorant of the legal consequences of his act."¹⁸ Where a respondent was required to submit certain reports and he was at the time under a temporary injunction and his records were in the possession of the state, the Commission held that his failure to submit the reports as required was "willful."¹⁹ Where the violations are the result of conduct marked by a careless disregard

14. The application form states in part, "the registrant (or applicant) consent that notice of any proceedings before the Commission in connection with this application or with registration hereunder may be given by sending such notice by registered mail or confirmed telegram to the person named before, at the address given."

15. Charles Fletcher Baxter, Securities Exchange Act Release No. 3901, Jan. 8, 1947; *accord*, Henry Leach, Securities Exchange Act Release No. 3877, 1946; Trusteed Collateral Corp., 3 S.E.C. 144 (1938); Lewis S. Parsons, 2 S.E.C. 199 (1937); Gerald Owens, 1 S.E.C. 416 (1936).

16. Trusteed Collateral Corp., 3 S.E.C. 144 (1938).

17. Herman Lucas, 4 S.E.C. 33, 34 (1938); *accord*, J. Albert Haines, 4 S.E.C. 31 (1938). In both cases the Commission did suspend the registrant's right to use the mails and instruments of interstate commerce in securities transactions, pending final determination.

18. Herbert R. May, Securities Exchange Act Release No. 4061, at p. 7, March 12, 1948; *accord*, Harry Marks, Securities Exchange Act Release No. 3906, 1947. Cases collected at p. 14; Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

19. Sylvan Perry Spies, Securities Exchange Act Release No. 3900, Jan. 8, 1947.

as to whether or not one had the right to act, the Commission will always hold that such violations are "willful."

The Commission will consider the conduct of a registrant, prior to his registration, in determining whether revocation is or is not in the public interest.²⁰ In considering whether or not registration should be granted after a prior revocation and a previous denial of registration, the Commission in granting registration, reviews the record "as it relates to his future trustworthiness and the need, if any, for protecting the public interest by continuing to exclude him. . . ." ²¹ The Commission has on occasion granted registration subject to certain conditions, *inter alia*, that such person act only as an agent in transactions with the public.²² Once the Commission has determined that there is a violation and that it is "willful," it must then consider what action is necessary "in the public interest" to protect the investing public.²³ This test of what is "in the public interest" is probably the most elusive standard yet devised by the legislature or applied by an administrative tribunal.

Under the present rules, registration once effective is continuous although it is subject to cancellation, suspension or revocation by the Commission and the registrant may withdraw from registration upon giving appropriate notice and subject to certain conditions imposed by the Commission.²⁴ The Commission has pointed out that the revocation of registration "would not forever preclude him or any firm of which he is a member from applying some time in the future for registration." ²⁵ As the individuals engaged in trading in the over-the-counter markets have become more and more familiar with the scope of securities legislation and the application of the various rules, some few of these persons have attempted in devious way to thwart its intended purpose. As a result of these few individuals seeking new and novel methods of accomplishing their fraudulent purposes, the work of the Commission is necessarily dynamic in nature. A few of the problems with which the Commission is constantly faced in determining the advisability of registering an applicant or revoking registration will now be briefly considered.

20. Benard J. Johnson, Securities Exchange Act Release No. 3729, Aug. 31, 1945.

21. George Lewis Ohstrom, Securities Exchange Act Release No. 3498 at p. 3, Oct. 28, 1943. Healy, dissenting.

22. Charles A. Massie, Securities Exchange Release Act No. 3641, 1945; Charles A. Massie, Securities Exchange Act Release No. 3660, 1945.

23. Where the Commission had determined that the respondent had "willfully" violated the Securities Act of 1933 and was enjoined from engaging in the securities business in one state, it stated that "under Section 15(b) . . . these findings constitute a basis for revocation if, in addition, we find revocation in the public interest." Edwin W. Shaw, Securities Exchange Act Release No. 3988 at p. 4, Aug. 29, 1947.

24. See Rule X-15 B-6.

25. M. S. Wien & Company, Securities Exchange Act Release No. 3873 at p. 3, Nov. 5, 1946.

(a) *Material Fact*

Where the applicant or other persons has²⁶ prior or subsequent to registration willfully made or caused to be made in any document or proceeding before the Commission any statement which in the light of the then existing circumstances was false or misleading with respect to any material fact, the Commission may deny or revoke registration.²⁷ The Commission has held that an address was to be considered a material fact and registration has been denied where one willfully refused to disclose his correct business and residence address in the application.²⁸ A failure to report a change of address is also a material fact.²⁹ As this indicium would seem to indicate clearly the scope of the interpretation, it is deemed to be sufficient to say that *any* fact which the Commission may require in order to maintain adequate supervision over registrants will be construed to be a material fact.³⁰

(b) *Prior Criminal Convictions*

Where the applicant or registrant or other party has been convicted within ten years prior to the date of the application or registration on a charge involving the purchase or sale of securities or arising out of the conduct of the securities business, such is expressly stated to be grounds for denial or revocation of registration.³¹ In construing this provision the Commission has held that where a registrant pleaded *nolo contendere* to an indictment charging a felony involving the purchase and sale of securities and the court passed sentence on such plea, that this person had been "convicted" within the meaning of this provision.³² Where one had been convicted by a state for selling securities without a license registration was denied.³³ The Commission has nevertheless granted registration where the one applying had been convicted of a felony involving the fraudulent sale of securities.³⁴ In this case the evidence indicated that the applicant was not a principal in the fraudulent transaction. The Commission stated that it may, "Consistently with the public interest, permit registration to become effective."³⁵

26. This term is used to include "any partner, officer, director, or branch manager . . . (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer." Sec. 15(b).

27. Sec. 15(b) (A).

28. Harry George Ames, 1 S.E.C. 250 (1936); *accord*, Industrial Engineering Co., 1 S.E.C. 486 (1936), S. J. Barlett, 1 S.E.C. 236 (1935).

29. See Herman Lucas, 4 S.E.C. 33 (1938).

30. Willful failure by applicants to give the names previously used or by which they were previously known is a ground for revocation. B. W. Sargent, 2 S.E.C. 310 (1937).

31. Sec. 15(b) (B).

32. Leo G. Siesfeld, 11 S.E.C. 746 (1942).

33. Harry H. Natanson, 1 S.E.C. 852 (1936). The Commission looking to his conduct subsequent to his conviction, held that it was in the public interest to deny the application.

34. F. H. Winter & Company, 11 S.E.C. 122 (1942).

35. *Id.* at 123, 124.

(c) Injunctions

Registration may be denied or revoked where a party is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security.³⁶ Where the registrant had been permanently enjoined by a state court from engaging in certain activities the Commission held that revocation was in the public interest.³⁷ Where the registrant had consented to the entry of a permanent injunction by a court of competent jurisdiction, restraining him from engaging in and continuing certain practices in the sale of securities, the Commission has held that this decree could not be collaterally attacked in a proceeding involving the revocation of registration.³⁸ The Commission has not denied registration where an injunction was not in effect at the time that the application was filed.³⁹ A subsequent request for registration has been granted where the previous denial was grounded principally on a temporary injunction which was in effect but was vacated prior to the second application.⁴⁰

(d) Violation of Rules and Other Statutes

The over-the-counter markets perform three distinct functions: the primary distribution of new securities, the secondary distribution or the redistribution of large blocks of outstanding securities and the usual individual trading of small numbers of shares. As a result of the first function, brokers and dealers are subject to the Securities Act of 1933 and any willful violation of any provision of that Act⁴¹ and the Securities Exchange Act of 1934 or any rule⁴² promulgated under either Act in effecting this primary distribution will be basis for the denial or revocation of registration, if such is found to be in the public interest. The policy of the Securities Act of 1933 to provide full disclosure of every essentially important point is applicable not only to the distribution of a new issue but to the redistribution of outstanding securities which have "taken on the characteristics of a new offering by reason of

36. Sec. 15(b) (C).

37. *Fischer & Company*, 11 S.E.C. 911 (1942). Cf. *Emmett R. Nawn*, 11 S.E.C. 1107 (1942).

38. *James F. Morrissey*, Securities Exchange Act Release No. 3920, March 6, 1947. Cf. *S.E.C. v. Jones*, 85 F. 2d 17 (C.C.A. 2d 1936), cert. denied, 299 U.S. 581 (1936).

39. *Gerald Owens*, 1 S.E.C. 416 (1936).

40. *C. C. Wilson*, 1 S.E.C. 502 (1936).

41. For case involving the question as to what is a "single issue" see *Herbert R. May*, Securities Exchange Act Release No. 4061, March 12, 1948. For case involving interpretation of scope of words "sale" and "offer to buy" see *Van Alstyne, Noel & Co.*, Securities Exchange Act Release No. 3791, Feb. 28, 1946.

42. For failure to comply with the provisions of Rule X-15 C1-9, in the preparation of a pro forma balance sheet, which deceived a purchaser as to the time condition of the issues, and the revocation of registration for such failure see *Leedy, Wheeler & Company*, Securities Exchange Act Release No. 3593, July 27, 1944.

the control of the issuer possessed by those responsible for the offering."⁴³ Where there was no registration of securities in connection with a secondary distribution through underwriters, the Commission suspended the respondent from NASD for the failure to register this secondary distribution, holding that the brokerage exemption of Section 4 (2) of the Securities Act of 1933 was inapplicable to a distribution over a national exchange by an underwriter acting for a party who controlled the issuer.⁴⁴ The same result would doubtless follow where the redistribution was made exclusively in the over-the-counter markets.

V

CONTROL OF ACTIVITY IN THE OVER-THE-COUNTER MARKETS

Under the ideal operation of the over-the-counter markets, anyone who is ignorant of the intrinsic merit of a security would pay a price which would not differ greatly from the worth of such security as estimated by many informed investors. Congress, in order to establish such an ideal operation, has by Section 15(c) attempted to prevent fraud, deceit and manipulation and to afford the same protection to securities traded in the over-the-counter markets as is afforded to those securities dealt in on the national securities exchanges. Brokers and dealers who are required to register under the Act and those who are not required to register are prohibited from using the channels of interstate commerce to engage in any transaction by means of any fraudulent, deceptive or manipulative device "to effect any transaction or to induce the purchase or sale of any security . . . otherwise than on a national securities exchange . . ." ⁴⁵ Brokers and dealers are also forbidden to use the channels of interstate commerce to effect any transaction in or to induce *or attempt to induce* the purchase or sale of any security in connection with which such person engages in any act or practice which is fraudulent, deceptive or manipulative or to make fictitious quotations.⁴⁶

In view of the purpose of Section 15, the Commission originally took the view that this was sufficient authority to extend to the over-the-counter markets the same protection as was afforded to those securities regulated by Section 9 of the Act. The Commission published a rule which crystallized this viewpoint. However, the rule was suspended in so far as it applied to over-the-counter securities.⁴⁷ The Commission has continued to maintain that

43. H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).

44. Ira Haupt & Company, Securities Exchange Act Release No. 3845, Aug. 20, 1946.

45. Sec. 15(c) (1). Commercial paper, banker's acceptances and commercial bills are exempted from this provision.

46. Sec. 15(c) (2). In addition to the exemptions granted in Sec. 15(c) (1), any exempted security is also exempted by this provision.

47. Rule G b 4, later renumbered X-10 B-4 S.E.C.

the substantive law was unchanged by the suspension of this rule and that transactions in unregistered securities, which would be violations of Section 9 if in registered securities, are equally illegal under Section 15(c) (1) and that such transactions were illegal at common law.⁴⁸ The Commission later adopted Rule X-15(c) 1-2⁴⁹ which appears to be all inclusive. The Commission has taken the view that although this rule is based on fraud and deceit, that the fraud concept is broad enough to match the statutory prohibitions relating to listed securities.

The various types of fraudulent activities in the purchase and sale of securities such as matched orders, wash sales and other fraudulent schemes which were previously prosecuted in this country under the common law of fraud and deceit and the mail fraud statutes are now prosecuted as well under Section 15(c), when such trading is in the over-the-counter markets. Because of the lack of publicity wash sales and matched orders are difficult to detect in the over-the-counter markets and as there appear to be no prosecutions of such activity, they are excluded from consideration in this comment. The violations of the Act and the rules of the Commission that are of most importance concern those involving manipulation by volume buying and selling, problems of prevailing market prices, secret profits and price maintenance and stabilization.

(a) *Manipulation*

In *Rex v. DeBereinger*, an early English case⁵⁰ dealing with the raising and lowering of prices the court stated that, "It may be admitted . . . that the raising or lowering the price of the public funds is not *per se* a crime. A man may have occasion to sell out a large sum, which may have the effect of depressing the price of stocks, or he may buy in a large sum, and thereby raise the price on a particular day and yet he will be guilty of no offense."⁵¹ The court in that case held, however, that ". . . the end is illegal, for it is to create a temporary rise in the funds without any foundation, the necessary consequence of which must be to prejudice all those who became purchasers during the period of that fluctuation."⁵² This question of improper purpose in the

48. See Comment, 56 YALE L.J. 509, 531 (1947).

49. Rule X-15(c) 1-2 provides: "(a) The term 'manipulation, deceptive, or other fraudulent device or contrivance' as used in Section 15(c) (1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any such person. (b) The term 'manipulation, deceptive, or other fraudulent device or contrivance' as used in Section 15(c) (1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading."

50. 3 M.&S. 67 (1814).

51. *Ibid.* 73.

52. *Ibid.* 75.

execution of otherwise normal securities transactions was squarely raised again in *Scott v. Brown*, a later English case.⁵³ Though there was nothing in the case to suggest any objective abnormality in the intended purchases, because of the subjective element the purpose of the parties being to mislead the public as to the market for the security, the contract was held to be fraudulent. In *United States v. Brown*,⁵⁴ a pool had agreed to raise the price of a security. The court in holding this to be a fraud, stated in part, "Judges have properly set their faces sternly against any practices by which the right of fair dealing between man and man is in any way infringed, and, whenever there is any false representation made by word or act in behalf of a pool for the purpose of inducing the public to come into the market and buy securities, it is held to be a fraud, and contracts between insiders are held to be illegal and against public policy." There is no clear evidence that the doctrine of *Scott v. Brown* was ever followed in this country,⁵⁵ prior to the federal legislation. Prior to the Act, the view seems to have been that in the absence of fraud, misrepresentation or deceit, if the individuals were not connected with the corporation, or had not in some way assumed obligations either to the market or to the investors in the corporation, that a group could purchase with the sole aim of raising the price or could sell with the sole aim of depressing it and the law would leave them alone. Prior to the securities legislation the intent of the parties, on which the English view was grounded, was not controlling even though the activity was apparently hurtful to the investing public.

Under the Securities Exchange Act of 1934 it is unlawful to effect a series of transactions which will either raise or lower the price of a security "for the purpose of inducing the purchase or sale" of such security by others. Therefore the legality of the acts of any person, who in his trading affects the market prices of a security, is determined by his intent. Intent alone will determine whether such person is guilty of manipulation or not. Manipulation has been defined as the generic term which is used to identify the employment of artificial stimuli for the primary purpose of controlling the prices or the volume of transactions or securities traded on the exchanges.⁵⁶

In the first two cases⁵⁷ involving over-the-counter manipulations prosecuted under this Act, the dealers who were quoting the stock in the National Quotation Service and newspapers, edged up their bids and actually purchased stock on a rising price scale, thus effectively raising the market price preparatory to a public distribution of the same stock. The Commission held that this conduct was the equivalent of a series of transactions raising the market

53. [1892] 2 Q.B.D. 724.

54. 5 F. Supp. 81 (S.D.N.Y. 1933), *aff'd*, 79 F. 2d 321 (C.C.A. 2d 1935).

55. 31 COL. L. REV. 264 (1931); 56 YALE L.J. 509, 517 (1947).

56. See Comment, 46 YALE L.J. 624 (1937).

57. Barrett & Co., 9 S.E.C. 319 (1941); Masland, 9 S.E.C. 338 (1941).

price of registered securities to induce the purchase of such securities by others and violated Section 15(c) (1). The failure to disclose to purchasers that the market price was so affected was a violation of Rule X-15C 1-2 and therefore a violation of Section 15(c) (1). "Though buying or selling in volume upon an exchange is not at present defined as a manipulative device, although definite price changes may result, it is not altogether settled that mere buying in volume is not per se manipulation when there is knowledge that prices will be affected."⁵⁸ Though objectively the acts may be the same, the sole distinction between the legality and illegality of such acts is the *purpose* for which they are undertaken. The definition of the word "purpose" has not been clearly established. In the Congressional Committee hearings it was said to be synonymous with intent. It is apparent, however, that the term is less inclusive than the specific intent of the criminal law which is strictly defined as the knowledge which a reasonable man has or should have in the light of surrounding circumstances, that certain consequences will follow as a result of his acts. Though the trading by one may cause others to enter the market and raise the price and this consequence is agreeable to the purchaser this is not the decisive element. The Act does not, without showing of the intent to induce others to come into the market, prohibit such activity. That others enter the market may be incidental to an underlying aim of securing a profit from anticipated price changes caused by the "natural" force which makes prices. In manipulation, the principal object and the immediate end to which the activity is directed, is the inducing of others to trade in such securities. It is this subjective difference in the primary objective that constitutes the line, often a tenuous one, dividing the legal from the illegal. In the determination of the subjective element of "purpose,"⁵⁹ this may mean no more than a provable motive of financial interest in a higher or lower market. It has been suggested that "if a dealer has a financial interest in a higher price for a security it might be prudent for him either to drop his trading altogether or else to limit it to what might be termed 'stabilization'; for if his trading does raise the price, his purpose will be suspect, and he may be charged with manipulation."⁶⁰

Another situation which involves manipulation through actual buying and selling is that of "market sponsorship." Although in a broad sense the whole structure of the over-the-counter trading is built on market sponsorship, there are two situations where an over-the-counter broker-dealer finds it profitable to "make a market" for particular issues. The first is in small issues, where

58. *S.E.C. v. Andres*, 88 F. 2d 441 (C.C.A. 2d 1937); see Comment, 46 *YALE L.J.* 624, 629 (1937).

59. See Comment, 56 *YALE L.J.* 624 (1947) and for "proof of the purpose" see 46 *YALE L.J.* 624, 633-8 (1937); 38 *COL. L. REV.* 393, 406 (1938); 47 *YALE L.J.* 622, 643 (1939).

60. 10 *GEO. WASH. L. REV.* 639, 651 (1942).

trading is infrequent and where there is no continuous market for the security. In this situation, in order to produce a liquidity for such securities, the broker-dealers buy the securities and then later "create a market" in order to dispose of them. In such a situation a great degree of control over the volume of trading and the price of such security may be exercised by the broker-dealer by varying the ratio of his buying volume to his selling volume. In the second situation, although there may be volume trading, if there is a sudden increased demand for these securities and the broker-dealer, in order to replenish his *own* depleted supply of such securities, attempts to persuade those persons holding such securities to sell, in doing so he is "creating a market." In both of these situations, the price paid for such securities will represent the judgment of the broker-dealer rather than the independent judgment of a large number of investors. Here again, the legality of what may appear to be an otherwise daily routine will be the underlying motive of the broker-dealer in consummating such transaction. If the prices at which such purchases and sales occurred did not reasonably approximate the market value of such security, this would be considered manipulation. The Commission has held these prohibitions against manipulations are directed not only against the defrauding of unwary investors but with equal force against the impediments to a free and open market created by artificial stimulants or restraints.⁶¹ Where one creates a market, the Commission has held that even if there was no misrepresentation as to the existence of the market and one merely states the price at which he was willing to do business, this would still be a violation of Rule X-15(c) 1-2 in omitting to state the material fact that he was "making the market," and therefore such is a violation of Section 15(c).⁶²

(b) *Prevailing Market Price*

The problem as to what price a broker-dealer may charge for the securities he buys or sells has no clearly defined answer. The test that is applied is whether such was reasonable with regard to the prevailing market price. The Commission has held that "a statement by a broker or dealer with respect to the price of a security carries with it the implied representation that such price bears some reasonable relationship to the prevailing market price." This prevailing market price as of any given day is extremely difficult to ascertain, since the actual ask and bid prices which would be available for such time represent merely the prices between which it is believed business may be transacted. In the *Allender* case,⁶³ the Commission discussed the probative weight of the National Daily Quotation Sheets, and indications of the market price

61. Masland, 9 S.E.C. 338 (1941).

62. Jack Goldberg, 10 S.E.C. 975, 980 (1942), *accord*, Duker & Duker, 6 S.E.C. 386 (1939).

63. 9 S.E.C. 1043, 1057 (1941).

of securities among wholesalers which is in turn used as an indication of the market prices in retail transactions. When evidence of the prevailing market price is lacking, the Commission has held that a dealer is under a duty to confine himself to a reasonable mark-up over wholesale levels and that his *contemporaneous* purchase price at wholesale would be taken as a prima facie indication of the prevailing wholesale price. It is necessary to consider the cost to the broker or dealer, since that may or may not be the same as the prevailing market price, depending upon the fluctuations of the market after the date the broker-dealer purchased the security; the term "cost" and "prevailing market price" may well be different figures. In considering whether a price is a "fair" price, this will be determined to some extent by the "mark-up." The term "mark-up" is used to refer to the spread between the prevailing market price and the sales price to the public.⁶⁴ The NASD at one time adopted a policy that five per cent would be considered the mark-up which did not violate high standards of ethical conduct which it had established for securities dealers.⁶⁵ The application of this five per cent mark-up has been consistently rejected by the Commission, and the Commission has never laid down any arbitrary standard for the measure of a fair and just mark-up.

A broker-dealer is under a duty to advise the purchaser of the market price of the security,⁶⁶ the various charges and the capacity in which he is dealing with such person. It may be impossible for him to deal with such person in more than one capacity. A broker is required by the rules of the Commission⁶⁷ to make disclosures as to the source and amount of his compensation, the date and time of the transaction and the name of the other party. The concealment of the market price may be achieved by fraudulently representing that the sales were at the market, by a passive omission to state the market price or by taking active steps to see that the purchaser remained ignorant of the prevailing market price. In one such case involving this latter type of fraudulent authority, the registrant requested that an organized exchange dealer not send into the state in which the respondent was doing business any quotations on certain securities.⁶⁸ The Commission has repeatedly held that no broker or dealer could exploit the ignorance of customers or their confidence in him and that he may not charge them prices which bear no reasonable relationship to the market.

64. Lawrence R. Leeb, Securities Exchange Act Release No. 3450, 1943.

65. Letter of NASD to members dated Oct. 25, 1943.

66. S.E.C. has no authority to adopt a rule requiring general disclosure of prevailing market quotations where transactions are in "exempted securities," as they are specifically excluded from § 15(c)(2). Securities Exchange Release Act No. 3940 (April 2, 1947).

67. Rule X-15C1-4. This rule, however, does not insure complete investor protection as such disclosure may be made *after* the customer's agreement to the transaction.

68. Guaranty Underwriters, Inc., Securities Exchange Act Release No. 3481, Sept. 11, 1943.

In addition to the actual mark-up, the Commission will look to all of the surrounding circumstances and will give great weight to the disclosure. In a case⁶⁹ where the respondent was not charged with fraud nor with the violation of any rule or statute, but where such party was appealing from disciplinary action taken against him by NASD, the Commission was presented squarely with the reasonableness of the mark-up which admittedly ranged from over four per cent to over eleven per cent above the cost price. The firm was engaged in the so-called riskless transactions for the most part, that is, acting as principal, the firm purchased securities only after it had received the order from the customer. The evidence disclosed that the salesmen had made full disclosure to the customers at the time the order was received as to the capacity in which the firm would act and that the price to the customer would include a mark-up over the cost price stated in terms of points⁷⁰ to the nearest one-eighth of a point. Such disclosure was also made on the written confirmation which was sent immediately after the firm's purchase. In this case the Commission emphasized that the disclosure made by the respondent was to be taken into consideration in determining whether there had been a violation of business ethics, stating that "while an undisclosed mark-up which is not so excessive as to constitute fraud might nevertheless violate business ethics, it does not follow that the same mark-up, accompanied by a full disclosure, is always a violation of business ethics."⁷¹ The Commission stated that it would consider "not only the size of the mark-up but . . . all pertinent circumstances, including disclosure, bearing on its reasonableness. . . ." ⁷² The Commission, after considering the general conduct of the firm's business, including the special advisory⁷³ service rendered customers, held that there was no breach of business ethics.

The Commission requires⁷⁴ that a broker disclose in his confirmations⁷⁵ "the source and amount" of any commission or other remuneration, and this must be done "at or before the completion of the transaction"⁷⁶ in connection with the transaction confirmed. A confirmation which did not disclose to customers the price which the firm paid for the securities and did not itemize

69. Herrick, Waddell & Co., Inc., Securities Exchange Act Release No. 3935, March 25, 1947.

70. The Commission commented on this and stated that it believed that disclosure in terms of dollars and cents would in most cases be more helpful than disclosure in points, but the method as such was not condemned.

71. Herrick, Waddell & Co., Inc., Securities Exchange Act Release No. 3935 at p. 9, March 25, 1947.

72. *Ibid.*

73. Only if such service is incidental to the conduct of the business and no special compensation is received, is a broker-dealer exempt from registration as an Investment Adviser. Sec. 202(a)(11)(C) Investment Advisers Act of 1940. 54 STAT. 847 (1940), 15 U.S.C. § 80 (1941).

74. Rule X-15 C 1-4.

75. See note 67 *supra*.

76. For the disclosure of the information as required by Rules X-15 C 1-4, 5 and 6 "at or before completion of the transaction" see article by David Saperstein in the Financial Reporter, Sept. 9, 1937.

the fees was held not to comply with the rules and for this and other violations registration was revoked.⁷⁷ Confirmation as principal without disclosing either the commissions or profits enabled one respondent to conceal the substantial profits which it derived from the "churning" of the customer's account.⁷⁸ It is well settled that by the mere form of the words employed as a confirmation, a broker cannot transform himself into a principal at will.⁷⁹ Where the elements of agency exist only the specific and informed consent of the customer is sufficient to change such a relationship.

The duty of disclosure has been placed on broker-dealers in other situations than that of disclosure of information to the persons with whom they are directly dealing. The Commission has held that where purchases of securities by corporate "insiders" operate as a fraud and deceit upon the sellers,⁸⁰ that under such circumstances if a broker-dealer representing such "insiders" has full knowledge of the concealment of the information and the abuse of the insiders' position, that the broker-dealer is charged with an affirmative duty to make appropriate disclosure to the sellers or to dissociate himself from the fraud. Failure to take such action when dealing with one who had discretionary powers over customers' accounts, has been held to be in violation of 15 (c)(1) and the rules promulgated under such provision.⁸¹ This duty of the broker-dealer is dependent upon his "knowledge." The Commission has stated that in the absence of a clear and unequivocal admission "we are compelled to accept conduct as its only true index. Such evidence is inherently circumstantial in nature and we must, therefore, consider all the facts together with such inferences as may properly be drawn, to determine whether a finding can be made that respondent had such knowledge."⁸²

(c) *Secret Profits*

The severity with which the Commission has dealt with those respondents who have been found to have made secret profits should prove to be an adequate deterrent for such conduct by brokers and dealers. As an agent is liable for any secret profits, regardless of how small they may be, any question as

77. Investment Registry of America, Inc., Securities Exchange Act Release No. 3772, Jan. 10, 1946.

78. Behel, Johnsen & Company, Inc., Securities Exchange Act Release No. 3967, June 24, 1947.

79. Oxford Company, Inc., Securities Exchange Act Release No. 3769, Jan. 3, 1946.

80. Ward LaFrance Truck Corp., Securities Exchange Act Release No. 3445, 1943.

81. Hay, Fales & Company, Securities Exchange Act Release No. 3697, June 7, 1945; cf. Alexander Smith, Securities Exchange Act Release No. 3785, Feb. 5, 1946.

82. Hughes & Treat, Securities Exchange Act Release No. 3811, at p. 7, April 24, 1946. The Commission found that the respondent had no such knowledge. Cf. Burley & Company, Securities Exchange Act Release No. 3838, Aug. 5, 1946. Where one assisted in effecting transactions with dummy accounts carried with another firm and such person failed to keep proper records of such transactions, the Commission held that such individual "had reason to know" of the fraudulent transactions.

to the relationship of cost price to the market price in these cases is immaterial. Where the Commission found that the respondent had been deducting from the amounts due to customers, charges for commissions purportedly paid to exchange brokers, when in fact the sales had actually been made directly to other customers of the respondent firm, such practice of making secret profits was held to be grounds for revocation.⁸³ Where the respondent advertised that its fee for "selecting" securities was five per cent of the purchase price or less, the Commission held that charges which ran as high as nine per cent were excessive and that such were secret profits.⁸⁴ Where a partner of the respondent firm established accounts with another firm and caused such other firm to purchase securities for these accounts, which the respondent firm thereupon bought at increased prices as agent for its customers, the Commission held that as such partner had not revealed his personal interest in the transaction that such was a secret profit.⁸⁵ In one case where the customers had given their consent, the respondent sold their securities and purchased with the proceeds other securities which he had recommended. In the acquisition of the recommended securities, respondent purportedly purchased them for its own account and then sold them to the customers at a profit, confirming the sale as a principal. Following such a pattern for a three year period, the capital in three of the accounts with which the respondent had dealt had been turned over four and one-half times. The Commission held that this "churning" was motivated by a single purpose—to produce large profits for the respondent. The Commission stated that while " 'churning' may occur where a firm confirms as agent and discloses its commissions . . . the registrant's practice of confirming as principal . . . facilitated perpetration of the . . . fraud. . . ." ⁸⁶ To determine whether or not there has been a "churning" and a taking of secret profits, the Commission will look to see whether the transactions are excessive in size and frequency in the light of the financial resources in the customer's account. Where dummy accounts were established with another firm and the trading through these accounts permitted the active partner of the respondent to make secret profits, the Commission revoked the registration of the respondent firm, even though the respondent had made restitution of the secret profits and also of the commissions it had received.⁸⁷

A higher standard of fair dealing is imposed on those who deal with discretionary accounts than on others. Rule X-15 C 1-7(a) specifically defines

83. Knowledge of the fraudulent transactions. Investment Registry of America, Inc., Securities Exchange Act Release No. 3772, Jan. 10, 1946. In order to prevent the fraudulent results of cross-trading, the Commission by Rule X-15 C 1-4 requires that a broker disclose or offer to disclose the other principal.

84. *Ibid.*

85. Burley & Company, Securities Exchange Act Release No. 3838, Aug. 5, 1946.

86. Behel, Johnsen & Company, Inc., Securities Exchange Act Release No. 3967, June 24, 1947.

87. Burley & Company, Securities Exchange Act Release No. 3838, Aug. 5, 1946.

"fraudulent device" to include excessive trading effected in discretionary accounts. However, the Commission has expressly pointed out that the fact that the rule above applies only to discretionary accounts does not mean that excessive trading in an account which is not technically a discretionary account can not constitute a violation of Rule X-15 C 1-2, as this rule expressly provides that its scope is not limited by any specific definitions or terms in other rules, adopted pursuant to Section 15(c). In all the cases involving secret profits the Commission has followed the common law, by requiring compliance with all the fiduciary duties of agency.⁸⁸

(d) *Price Maintenance and Stabilization*

In effectuating the purposes of the Act, one of which is to abolish any artificial price, consideration of the question of stabilization raises a very difficult problem. The term "stabilization" as used generally as well as used in this Act refers to that action regarding price changes, as distinguished from action affirmatively initiating changes in price stabilization is forbidden in section 8 (a) (6) to the extent that such may be in contravention of the rules of the Commission. Although the power to regulate stabilization under this section applied only to securities registered on national securities exchanges, the Commission has taken the position that the power given under Section 15(c) to define manipulative practices includes the power to regulate stabilization in the over-the-counter markets. In the case of securities previously issued, the Commission permits the "pegging" at any price previously reached without manipulation. In case of a new issue, for which there has been no previous market, the Commission will permit any interested person to create and support a market at any price he deems expedient, even though such a "market" may collapse when the support is withdrawn.⁸⁹ Where the offering price of a new issue is "at the market," any broker-dealer in any over-the-counter market who is engaged in stabilizing the price of that security, is prohibited from representing that such security is offered "at the market," unless he has grounds to believe that a "market" for such security exists other than made, created or controlled by him.⁹⁰ To safeguard shareholders and investors, the Commission has gone into considerable detail in its regulation of the stabilization activities connected with the offering of a registered security "at the market."⁹¹ The Commission has also imposed very strict controls on the stabiliza-

88. *Johnson v. Winslow*, 155 Misc. 170, 279 N.Y. Supp. 147 (Sup. Ct. 1935), *aff'd mem.*, 246 App. Div. 800, 285 N.Y. Supp. 1075 (1st Dep't 1936), *aff'd*, 272 N.Y. 467, 3 N.E. 2d 872 (1936), *reargument denied*, 272 N.Y. 512, 4 N.E. 2d 423 (1936).

89. See n. 20, 10 GEO. WASH. L. REV. 639, 646 (1942).

90. Rule X-15 C 1-8.

91. 56 YALE L.J. 333 (1947) n. 81 at p. 348 and n. 102 at p. 353. For recent case involving an attempted stabilization by one who controlled the issues and the registrant, see *The Federal Corporation, Securities Exchange Act Release No. 3909*, Jan. 29, 1947.

tion activities of underwriters and broker-dealers in all transactions relating to stabilization of securities. Once an underwriter starts to stabilize a new security at some arbitrary level chosen by himself, he cannot thereafter raise the price while still distributing the securities. Once a position is taken in a new security, if the price drops for a time and in order to raise the market price again to the "pegged" price such underwriter is forced to purchase shares of that security, he is not permitted to sell any of this accumulated inventory unless he has remained out of the market until such time as the price of the security is no longer affected by his previous activity. The Commission has held that price maintenance agreements were impediments to a free market,⁹² and this position does not appear to be changed.⁹³ The Commission has taken the position that price maintenance agreements are not per se in violation of anti-trust laws, and that stabilization of securities has a proper function in the activities of underwriters and broker-dealers in the issuance of securities.⁹⁴ On the contrary, the anti-trust division of the Department of Justice has maintained that price-fixing agreements are per se in violation of the Sherman Act.⁹⁵ In view of these two conflicting views of two very powerful governmental agencies, the future legality of price maintenance agreements and stabilization activities is certainly not free from doubt.

VI. THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

The Congress has provided for a system of cooperative regulation of the over-the-counter markets, through the activities of voluntary associations of dealers and brokers who are doing business in these markets.⁹⁶ Certain standards are established for the registration of these self-regulatory groups either as a national securities association or as an affiliated securities association. Among these requirements are that such association must be either nation wide in scope or representative of some economically cohesive region. As the Congress intended that the regulation of the over-the-counter markets should be achieved in part through the efforts of such an association, it is necessary that such an association be capable of discharging this duty before it may be registered with the Commission as either a national or affiliated association. There is no requirement that such an association must be registered with the Commission, and dealers and brokers are not prohibited from trading in securities in in-

92. NASD, Inc., Securities Exchange Act Release No. 3700, June 11, 1945.

93. Securities Exchange Act Release No. 2446, 1940. In approving the continuation of stabilization activities under S.E.C. regulation, the Commission found that "there are times when the 'freelplay' of the 'forces' of supply and demand may, if unrestricted, produce socially or economically undesirable consequences."

94. The Commission has stated "our view of both price maintenance contracts and stabilization operations is that they are objectionable on principle but necessary under existing conditions. Securities Exchange Act Release No. 3700 at p. 38, June 11, 1945.

95. 56 YALE L.J. 333, 340 (1947).

96. Sec. 15 A.

terstate commerce in the over-the-counter markets in the event no such association is registered. At the present time there is only one such association in existence, the National Association of Securities Dealers, Inc. which was granted registration as a national association on August 9, 1939.⁹⁷ This organization is an outgrowth of the Investment Bankers Conference, Inc. The Commission has stated that "In order that every reasonable opportunity may be afforded such association or associations as may become registered . . . to exercise as broad a regulatory function as possible, the Commission has refrained from any substantial amplification of its own rules for regulation of over-the-counter markets."⁹⁸ The over-the-counter brokers and dealers have a choice either of joining the NASD and have some voice in making the rules that govern them or to be regulated directly by the Commission.

(a) *Organization and Purpose*

The latest available figures as to membership in the NASD indicate that there are 2,614 members of this organization.⁹⁹ The figure is probably somewhat over ninety percent of all those eligible for membership. Although membership in NASD is not a prerequisite to doing business in interstate commerce, as is registration with the Commission, those firms who are members of the NASD are required to do business with any broker or dealer who is not a member at the same prices, commissions and fees as are accorded to the general public. As a result of this economic discrimination which is sanctioned by the Act,¹⁰⁰ membership in NASD is almost imperative to the continuance of an over-the-counter securities business. A source of income of many of the over-the-counter firms is the commissions paid to them as members of selling groups in the distribution of new securities. From this it will be seen that NASD membership is essential to most brokers and dealers and their expulsion from membership is almost tantamount to expulsion from the industry. This same economic coercion to join the NASD, is used to insure full compliance with the rules that the NASD or the Commission promulgates.

The jurisdiction of NASD is limited to the over-the-counter markets. The NASD is governed by District Committeemen and also by a Board of Governors. The establishment of rules of fair practice and their enforcement are the most important activities of the NASD. The Quotation Committee has done much to secure quotations of unlisted securities for publication in newspapers

97. Application by National Association of Securities Dealers, Inc., 5 S.E.C. 627 (1939).

98. 5 S.E.C. ANN. REP. 58 (1939).

99. 13 S.E.C. ANN. REP. 49 (1947).

100. In the absence of legislative permission, this economic discrimination against new members would probably be a violation of both the state and the federal anti-trust laws. See *Chamber of Commerce of Minneapolis v. Federal Trade Commission*, 13 F. 2d 673 (C.C.A. 8th 1926).

and financial publications and has done much to provide brokers and dealers with information as to the prevailing market prices.

Any action by the NASD which establishes a rule, or any policy which has the force and effect of a rule, must be submitted to the membership for approval, as this is required by the NASD by-laws. Such rules must also be submitted to the Commission for its approval.¹⁰¹ The Commission has held that the NASD rules were broader than a mere prohibition against fraud. With regard to the position of the NASD as stated in the "5% letters," which deal with the mark-up in prices that brokers or dealers could make without violating the rules of the association, the Commission held that this policy was not a rule nor had the effect of a rule, therefore the Commission would not abrogate or approve them on merits apart from individual cases where such a policy was specifically applied.¹⁰²

(b) *Membership*

Any broker or dealer engaged in over-the-counter trading, who is registered with the Commission may be admitted to membership, unless such firm is disqualified by the Act. The suspension or expulsion from membership does not depend on *willfulness* but only on public policy. Any disciplinary action by NASD either against a member or in denying membership to any applicant is subject to review by the Commission.¹⁰³

Where there has been a previous revocation of registration by the Commission NASD is not permitted to grant admission¹⁰⁴ unless such is ordered by the Commission. Where one of the partners of the applicant who sought membership in NASD had been expelled from membership in a national exchange more than five years before, the Commission in reviewing the NASD action held that although there were no grounds for the denial of registration by the Commission, that because the partner's previous conduct had been inconsistent with just and equitable principles of trade it would not be appropriate to direct membership in the NASD.¹⁰⁵ Later this applicant sought membership in the NASD for the second time. The NASD reported to the Commission that it would accept the applicant as a member, upon receiving the Commission's approval. The Commission held that this applicant, who was within the exclusionary category set forth in Section 15 A (b) (A) had a duty to present

101. Sec. 15 (A) (j).

102. Rules of the NASD, Inc., Securities Exchange Act Release No. 3623, Nov. 25, 1944.

103. Sec. 15(A)(g).

104. Sec. 15A(b)(4) and Section 2, Article E of the NASD by-laws, ban from NASD membership one who has been expelled from NASD for conduct inconsistent with just and equitable principles of trade unless the Commission approves or directs such admission.

105. T. A. Sisto & Co., 7 S.E.C. 647 (1940).

facts to justify such admission and had failed to do so.¹⁰⁶ The Commission looked to evidence of the partner's conduct other than as a broker-dealer to determine whether it would permit the firm membership in NASD.

One case¹⁰⁷ involving the denial of membership was decided on the issue of whether or not such firm was disqualified from membership where the partners of such firm had been officers, directors and shareholders of a broker-dealer whose registration had been previously revoked.¹⁰⁸ The Commission had granted registration of the applicant, but the NASD denied its application for admission to membership on the ground that the partners of the applicant had been "a cause" of the prior revocation. The Commission, in a review of the action taken by NASD, held that where a broker-dealer whose registration had been revoked but was subsequently allowed by the Commission to become registered, that the disqualification is removed in that he is no longer subject to an order of revocation and that such a firm is no longer disqualified. The Commission issued an order "requiring" applicant's admission.¹⁰⁹ The Commission in this case held, however, that the individual of the firm making application had not been "a cause" of the prior expulsion.

In another case¹¹⁰ involving the denial of membership by the NASD the Commission directed the applicant's admission on the ground that "under the circumstances, it is incumbent upon the NASD, if we are to sustain its action of disapproval, to present adequate reasons in addition to the *disability* arising from the . . . expulsion . . ." ¹¹¹ In this case, the Commission at the time it granted registration to this applicant, for a limited purpose, clearly recognized that a disability continued and here the person was held to have been "a cause" of the prior expulsion.

In a case where the firm was found guilty of a willful violation of the Act, but because of extenuating circumstances the Commission did not revoke the registration, but did suspend the firm from membership in NASD for sixty days, the Commission denied a motion to shorten the period of such suspension.¹¹² The Commission stated that it recognized that this suspension would cause the firm to suffer a loss of business and that its organization would be adversely affected, but that such were the natural consequences of the remedies contemplated by Congress.

106. T. A. Sisto & Co., Securities Exchange Act Release No. 3614, Nov. 1, 1944.

107. Foelber-Patterson, Inc., Securities Exchange Act Release No. 3847, Aug. 4, 1946.

108. Central Securities Corp., 11 S.E.C. 98 (1942).

109. Note 94 *supra*.

110. Lawrence R. Leeb & Co., Securities Exchange Act Release No. 3898, Jan. 6, 1947; *accord*, Sylvan Perry, Spies, Securities Exchange Act Release No. 3900, Jan. 8, 1947.

111. *Id.* at p. 4. [Italics added].

112. E. H. Rollins & Sons, Incorporated, Securities Exchange Act Release No. 3683, April 18, 1945.

(c) Continuance of Membership

No broker or dealer may remain a member of NASD while it has an officer, director or employee who was "a cause" of the expulsion of a member, unless the Commission approves or directs such continuance in membership. One applicant sought to have the Commission permit an individual, who had been previously expelled from NASD membership and who had later withdrawn from registration, to engage in the securities business as a partner or employee of the applicant. The Commission considered the nature of the past violation, the penalty, the conduct of the individual subsequent to expulsion and his general character. As the NASD had recommended favorable consideration of the request and the staff of the Commission approved the applicant's continuance in membership, the Commission approved the continuance in membership with such person acting either as a partner or employee.¹¹³

The Commission has permitted the use of a procedure whereby the firm making application for such continuance in membership has not been required to disclose publicly its identity.¹¹⁴ The Commission stated that it has been advised that the publicity of such a proceeding had had the effect of discouraging NASD members from taking any steps to obtain approval of employment of persons who would otherwise be disqualified. The Commission has on occasion ordered the applicant's continuance in membership, noting that its disposition of such request would also have the effect of a ruling as to the individual's status as a registered representative of the applicant.¹¹⁵

CONCLUSION

Since its establishment, the Securities and Exchange Commission has apparently accomplished much by its investigations and prosecution of the various fraudulent activities which have been engaged in, in the over-the-counter markets. It is perhaps undoubted that this public control of these securities markets has insured a degree of investor protection which would have never been achieved under unrestrained "free competition." However, the very nature of the over-the-counter markets and the difficulty of determining the "fair price" at which a dealer is permitted to sell securities, leads this writer to believe that before maximum investor protection will be assured, it is essential that all the securities which are dealt in in these markets must be registered with a national organized exchange. It is submitted that a national

113. NASD, Inc. (re Greene & Company), Securities Exchange Act Release No. 3836, July 31, 1946.

114. NASD, Inc. (re John J. Bell), Securities Exchange Act Release No. 4034, Dec. 11, 1947.

115. NASD, Inc. (re Edward E. Trost), Securities Exchange Act Release No. 3955, April 29, 1947. Cf. NASD, Inc. (re Minnesota Securities Corporation), Securities Exchange Act Release No. 4033, Dec. 11, 1947.

securities exchange should be established for the registration and trading of securities which are concurrently bought and sold exclusively in the over-the-counter markets, exempting those securities which are dealt in exclusively intrastate; and with this additional device, the Commission will thereupon have adequate authority to supervise these markets, which are currently referred to by many as the "under-the-counter" markets. When the price trend of securities is again on the decline and the complaints of over-the-counter investors have increased, then perhaps the Congress will feel that the time is ripe for this additional federal legislation.

L. GUY CLINTON