SECURITIES AND EXCHANGE COMMISSION
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A brief summary of financial proposals filed with and actions by the S.E.C.

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REPORT FILED BY SEC ON MARKET STUDY

The Securities and Exchange Commission today filed with Congress pursuant to Public Law 87-196, the first segment of the Report of the Special Study of Securities Markets on the adequacy of investor protection in the securities markets. The Chapters submitted are as follows:

Chapter I - Introduction

Chapter II - Qualifications of Persons in the Securities Industry.

Chapter III - Broker-Dealers, Investment Advisers and their Customers--Activities and Responsibilities.

Chapter IV - Primary and Secondary Distributions to the Public.

Chapter IX - Obligations of Issuers of Publicly Held Securities.

In his transmittal letter, Chairman William L. Cary observed that, while the Report makes very clear that important problems do exist, grave abuses do occur, and additional controls and improvements are much needed, the picture presented is not one of pervasive fraudulent activity. In this respect it contrasts markedly with the findings in the early thirties preceding the enactment of the Federal securities laws. The Report demonstrates, Chairman Cary indicated, "that although many specific recommendations on rules and practices are made, neither the fundamental structure of the securities markets nor of the regulatory pattern of the securities acts requires dramatic reconstruction," and the study confirms the strength of those laws and the heightened sense of obligation of the financial community. Moreover, Chairman Cary stated: "The Report should not impair public confidence in the securities markets, but should strengthen it as suggestions for raising standards are put into practice."

"The functions of this Report and of any changes proposed are to strengthen the mechanisms facilitating the free flow of capital into the markets and to raise the standards of investor protection," Chairman Cary continued, "thus preserving and enhancing the level of investor confidence." The tremendous growth in the securities markets over the past twenty-five years, including increased public participation, the spectacular development of the over-the-counter market, and the number of companies "going public" for the first time, imposed strains on the regulatory system and revealed structural weaknesses. Some of these problems, Chairman Cary notes, "resulted from inadequacies in established enforcement machinery, both government and industry. Others reflect patterns of conduct now tolerated, but which, upon exposure and analysis, appear incompatible with the public interest." The voluntary adoption of higher standards by many responsible members of the financial community support this view; and it is these voluntary standards which regulation should reflect and make generally applicable. "The importance of the capital markets to our national economic progress," Chairman Cary further commented, "does not permit anything less than the most fair and efficient operations. Government and industry regulation and the efforts of the financial community must continue to be directed against practices which undermine the integrity of the securities markets and which can only be harmful to the economic growth of this country and to the investors who furnish the funds for that growth."

In this connection, Chairman Cary observed that, while the Report focuses upon shortcomings in the industry and in the self-regulatory authorities, in certain respects it is an express or implied criticism of the Commission as an institution. The Commission has not fully exercised its powers, nor coped effectively with all of the problems confronting it, he indicated.

The inquiry by the Special Study was conducted under the supervision of its Director, Milton H. Cohen; and its Report, Chairman Cary indicated, will be the most comprehensive of its kind in over twenty-five years. The Special Study was given freedom to analyze and point out problems as they appeared to it; in this repsect, the judgments, analyses and recommendations in the Report are those of the Special Study and not the Commission. However, Chairman Cary stated, "the Commission has worked very closely with the Study throughout and has gone over every section of the Report. We believe that the Report is a thoroughly responsible document. We do not embrace every recommendation as our own, but we do accept them as a sound point of departure for proposals to the Congress, for rule making by the Commission and by the self-regulatory agencies, and for discussions with the industry. Like the Study, we at the same time recognize the complexities and subtleties of the problems presented." The remaining chapters of the Report, the Chairman indicated, are nearing completion but are not available at this time essentially because of the scope of the undertaking. While the Study, with the assistance of the Commission and its regular staff, made every effort to carry out the Congressional mandate for a broad and thorough study, the breadth of the obligation was not evident at the outset and a proper fulfillment necessitates some delay.

The Chapters delivered to Congress today deal with important and basic areas and practices in the securities markets; in many respects they disclose problems calling for vigorous and prompt responses by the Commission and the industry. On its part, the Commission will shortly recommend to Congress certain legislative proposals where the present statutory scheme appears inadequate. An important part of these reflects the Commission's continuing belief in self-regulation as an ingredient in protection of the investor. Certain deficiencies, Chairman Cary observed, can be treated through rule making by either the Commission or the self-regulatory agencies; others can be resolved only by a more uniform and voluntary adoption of improved procedures by the members of the industry.

The first legislative proposal (Chapter II) will deal with the standards of qualification for entry into the securities business. "It is self-evident," Chairman Cary observes, "that the standards of conduct of the securities industry are vitally dependent on the integrity and competency of its personnel. Obviously, no system can be devised which eliminates all potential wrongdoers. But the Report of the Special Study concludes that the minimal controls furnished by existing regulations are inadequate." With the exception of the major exchanges, there is a notable ease of entry under both Federal law and the rules of the National Association of Securities Dealers, Inc., the self-regulatory agency for the over-the-counter market. Significant standards of character, competence, and minimum capital have not been generally imposed. Nor has attention been sufficiently directed to the unique problems of supervisors, such as branch managers, and research analysts. Furthermore, certain sections of the industry, notably distributors of mutual funds and real estate securities and also investment advisers, are not subject to the discipline of self-regulation. In addition, present statutory sanctions available to the Commission unduly limit the range of its actions against violators.

Accordingly, the Commission will recommend legislative proposals (1) authorizing standards of character, competence and financial responsibility as conditions for entry into the business, to be established and administered by the NASD, which will complement similar regulation by the exchanges of their members; (2) requiring all firms and individuals to be subject to the authority of one of the self-regulatory agencies; (3) granting the Commission direct disciplinary controls over individuals and perfecting NASD controls in this area; and (4) providing the Commission with intermediate sanctions over firms and individuals short of outright revocation of a firm's broker-dealer registration.

A closely related problem has to do with the adequacy of controls, external and self-imposed, in the area of selling practices and investment advice. The examples of sales techniques cited in Chapter III of the Report of the Special Study, Chairman Cary noted, "show a striking spectrum: from the illegal operations of boiler rooms to the disciplined patterns of the responsible, reflecting elaborate supervisory procedures and voluntary codes of conduct. Even in the latter, which represent high standards of achievement, serious lapses have occurred." Certain excesses also appear to have developed in the investment advisory materials of both broker-dealers and investment advisers, as evidenced by fanciful recommendations based on little more than mere rumor. In urging that "uniform application of the best industry practices would seem to be in order," Chairman Cary suggests that legislation is not presently recommended since powers exist in the self-regulatory institutions and the Commission to advance selling and investment advisory practices.

Another legislative proposal concerns the public distribution of securities by companies "going public" for the first time. In Chapter IV of its Report, the Special Study places particular emphasis on the so-called "hot issue" phenomenon that accompanied the active and rising markets of the late 1950s and the early 1960s and which presented another critical trial for both the regulatory pattern and industry practices. Particular weaknesses developed, the elimination of which should strengthen the distribution mechanism without impairing access to the capital markets; most of these can be remedied by rules of the Commission and the NASD, with one important exception. That exception has to do with the present statutory requirement that a prospectus must be delivered to purchasers in a registered public offering during a period of 40 days after the offering. The Report demonstrates that, particularly in the case of new issues, dramatic price movements may result from uninformed investor action and that maximum exposure of financial and public information is critical to securing knowledgeable evaluation of these securities. Accordingly, Chairman Cary stated, the Commission will recommend to Congress that, in the case of new issues, the 40-day period be extended to 90-days or such shorter period as the Commission may prescribe by rule or order.

The Report of the Special Study (Chapter IX) further demonstrates, Chairman Cary notes, "that the long standing contrast in the disclosure-oriented protections afforded investors owning securities listed on national exchanges and investors owning securities traded in the over-the-counter market is not warranted." The Report emphasizes the fundamental importance of adequate disclosures by issuers as a most vital means of investor protection; it also points out the broad range of problems and abuses in the securities markets, including improper selling practices, misleading public relations, irresponsible investment advice, and erratic "after markets" for new issues, all of which can be greatly mitigated by the more complete availability and dissemination of financial information. Another void in investor protection in the over-the-counter market relates to insider trading. An insider of a listed company must report his transactions in the company's stock; his short-swing trading profits in the stock are recoverable by the company; and he is prohibited from selling the stock short. Listed companies are also subject to the disclosure requirements of the Commission's proxy rules. No such requirements apply to over-the-counter companies.

The policies expressed in these disclosure and related requirements "should also be applicable in the over-the-counter market," Chairman Cary stated; and, accordingly, the Commission will recommend the extension to certain over-the-counter companies of the sections of the Securities Exchange Act of 1934 requiring the filing of annual and periodic reports, compliance with the proxy rules, and protections against insider trading--a phased program of coverage which should gradually include all those companies with 300 or more stockholders. In the cases of bank stocks, which appear to account for about 20% of the issues of the over-the-counter market, disclosure requirements could be administered by appropriate Federal bank regulatory authorities in order to integrate these controls with the existing patterns of bank regulations.

A further legislative proposal to be recommended by the Commission will be directed to the wholesale quotations systems in the over-the-counter market, which will be the subject of the forthcoming Chapter VII of the Report of the Special Study. At present, according to Chairman Cary, the National Quotations Bureau dominates the business of over-the-counter wholesale quotations. While the Bureau has operated with a conscientious regard for the responsibility which its function and dominant position entail, this "crucial segment" of the over-the-counter market has had inadequate controls, Chairman Cary notes, and numerous abuses involving quotations have been perpetrated by broker-dealers. Moreover, developments in electronic data processing have foreshadowed the emergence of new and perhaps revolutionary quotation systems. "In view of the vital significance which these systems can have to the functioning of the over-the-counter market," Chairman Cary observed, "they should not be allowed to emerge without due regard to the welfare of the market and to the public interest." Accordingly, the Commission will recommend to Congress that operators of quotation systems like the Bureau be required to register with the Commission and adopt and enforce rules of fair practice.

Other legislative measures to be recommended by the Commission may include security credit regulation, which would be submitted only after full coordination with the Federal Reserve Board. Not all of the legislative recommendations of the Special Study reflected in the five chapters delivered to Congress have not yet been adopted by the Commission; and these Chairman Cary indicated, "are the subject of our continuing study and may be proposed to the Congress at a subsequent date. To secure the benefit of industry view on our legislative proposals, we shall immediately request leaders of the financial community to form liaison committees." Chairman Cary further observes: ". . the Report of the Special Study is only a prelude; it discloses many problems whose resolution will require the efforts of the Commission, the exchanges, the

NASD and the industry itself. To these we will now turn our attention. Our legislative recommendations to the Congress will be an important element, indeed a prerequisite for needed improvements. However, much of the action may be taken through the self-regulatory agencies, through exercise by the Commission of existing powers and through the influence of leaders in the securities industry to raise standards." In fact, Chairman Cary points out, many improvements in industry practices have been effectuated since the Special Study commenced its inquiries.

Special Study Transmittal Letter

Assisting Mr. Cohen in the direction and supervision of the study and investigation conducted by the Special Study and the preparation of the Report, and co-authors of a letter transmitting copies of the five chapters of the Report to the Commission, were: Ralph H. Saul, Associate Director; Richard H. Paul, Chief Counsel; Sidney M. Robbins, Chief Economist; and Herbert G. Schick, Assistant Director. In their transmittal letter, Mr. Cohen and his associates state that the basic objective of the Special Study "was an evaluation, in the light of both quantitive and qualitative changes /in the securities industry/, of the theories and mechanics of direct governmental regulation and industry self-regulation originally envisaged" by the Federal securities laws. The Report, they observe, reflects the intent of Congress, as evidenced both by the language of the statute and its legislative history, that the Commission conduct a broad study of the rules, practices and problems in the securities industry and markets. The vast scope and size of the Report and the complex nature of the problems with which it deals made it impossible to deliver the entire Report as a single unit at this time.

Chapter I of the Report sets forth general data highlighting the growth of the securities industry and provides the background for many of the subjects explored. As indicated in Chairman Cary's letter, Chapters II and III are concerned with the broad range of persons and business entities engaged in the securities business, and examine the standards and controls relating to their entry into and removal from the business and their activities and responsibilities in the course of that business and the related controls. Chapter IV deals with primary and secondary distributions of securities, with particular emphasis on "new issues," while Chapter IX contrasts the reporting, proxy solicitation and "insider" trading requirements applicable to listed securities with the near absence of similar protective provisions applicable to over-the-counter securities.

In Chapters V, VI, VII and VIII of its Report, the Special Study will explore the functions, structures and problems of markets in which securities are traded after their distribution. Chapter V is a general introduction to this group of chapters. Chapter VI covers the exchange markets, particularly the New York Stock Exchange; and it will review the functions and activities of various specialized categories of members, particularly specialists, odd-lot brokers and dealers, and floor traders, as well as the subjects of short selling and commission rate structures. Chapter VII will discuss the over-the-counter markets, their vast and heterogeneous nature, both wholesale and retail aspects and quotations systems, and present controls over all of them, while Chapter VIII will examine into the various interrelationships among trading markets, including patterns of distribution of securities among exchange and over-the-counter markets, institutional participation in various markets, over-the-counter trading in listed securities, and the regional exchanges as "dual" and primary markets.

Chapter X of the Report will deal with the purposes, effects, and enforcement of securities credit and margin regulations and some inconsistencies and anomalies of the present regulatory pattern, while Chapter XI will concern itself with certain aspects of open-end investment companies ("mutual funds") which are covered neither by the recent industry study conducted by the Wharton School of Finance and Commerce nor by continuing inquiries of the Commission's Division of Corporate Regulation. It also will contain the results of an investor survey and treat specifically with selling practices, contractual plans, and certain problems in connection with fund portfolio transactions. Chapter XII will deal with the self-regulatory pattern, which is largely unique to the securities industry, evaluating the regulatory functions of the NYSE and other exchanges as well as the NASD and certain quasi-regulatory agencies and assessing the role of the Commission in relation to all of them.

In Chapter XIII of its Report, the Special Study will report on its study of the May 1962 market break, which afforded an opportunity to study certain aspects of the securities markets, already studied under more normal conditions, in the circumstances of a precipitous decline. Chapter XIV, still tentative in nature, is reserved for a few general topics that may fit neither within the scope of any of the previous chapters nor within the limits of a further transmittal letter. When all chapters are completed, it is also planned to prepare a summary volume bringing together all conclusions and recommendations set forth in the several chapters.

In their letter, Mr. Cohen and his associates state that, although the prevalence of gross abuses such as were characteristic of the era preceding enactment of the securities laws has not been shown, many serious problems do exist and important improvements are needed; but they further indicate that, while the framework of regulation needs considerable adjusting and strengthening, its basic design appears to have stood the test of time and to have worked effectively in most areas. They observe further that, while it is inevitable that a report on the results of any such inquiry will give greatest attention to problem areas, "the emphasis in this Report on present shortcomings should neither obscure nor detract from the many aspects of the securities business and its regulation and self-regulation which afford reason for pride and satisfaction . . . Many of the substantive recommendations in the Report can, indeed, be regarded as attempts to raise the entire securities industry to the best standards which the industry itself proclaims and to the highest levels of attainment which some of its participants have in some sectors achieved."

Given the scope and complexity of the studies undertaken, the Special Study comments, and the limited resources of time and manpower available, "it would be presumptuous to suggest that the Special Study could propose complete or 'final' answers to all the questions that call for answers. No such effort is made in the Report. For some of the problems considered, fairly immediate and specific measures are recommended; for others, broader long-range programs are outlined; and for some of the most knotty there is merely an indication of possible approaches--sometimes alternative or multiple ones--that may point the way to future solutions."

Prompt adoption of measures specifically recommended and rapid implementation of the longer-range programs hopefully will be the earliest fruits of the Study; but, Mr. Cohen and his associates point out, "perhaps an equal contribution will have been made in the areas where solutions are least clear, for surely one goal of any study of this kind is to create a ferment of thought and discussion. Where the Report has not itself produced answers, it may at least have posed the important issues for which the securities industry and regulatory authorities must seek solutions." In this connection, the Special Study urges that broad-gauged studies should be a major part of the Commission's regular and continuous activities; and it further suggests that the Commission should have a permanent staff group, small but expertly-manned, that is free from routine administration and assigned the responsibility of observing and measuring important trends, identifying and evaluating new developments, and from time to time making special studies of particular subjects. Long-range planning and broad policy-making, it is indicated, have been too much subordinated to day-to-day administration. Not the least benefit of more continuous activities of this kind, Mr. Cohen and his associates observed, "would be their invigorating effect on the self-regulatory institutions and their admonitory effect on members of the industry generally," as is evidenced by the "quite remarkable" display of fence-mending, roof-patching and even foundation-strengthening which has occurred within the industry since the Special Study commenced its inquiries, many of which are seen as "in some degree a valuable by-product of the Study itself."

Finally, Mr. Cohen and his associates observe that it is important that the public's understanding of the securities markets and the securities business "not be clouded by many illusions and misconceptions which now surround them" if the securities industry is to operate on the level of ethical standards at which its regulatory and self-regulatory organizations aim. "It is an excellent thing," their letter continues, "to aspire toward high standards of professionalism, undivided loyalty to customers, expert and unbiased investment advice, more responsibility of specialists, greater diligence and responsibility of underwriters, more liquidity and stability of markets, stronger regulatory and self-regulatory protections, and so forth--the list is legion--but it is an entirely different thing to encourage the investing public to believe that the aspiration is now the fact. Mere lip service or exaggeration in these matters may do more harm than good, because the investing public may be led to expect too much in the way of certainty and protection, may fail to appreciate the risks inherent in investment, and may not exercise the vigilance and care required of the investor even under a statutory philosophy that emphasises caveat vendor instead of caveat emptor. Perhaps the most pressing need of all, without any diminution of efforts to improve the securities markets in the respects mentioned and in other respects, is to foster accurate and realistic public understanding. This has been a major function, and hopefully will be a major result, of the Special Study and its Report."

Chapter I

In the introductory Chapter I of its Report, the Special Study presents a review of the legislative history of the Joint Congressional Resolution which (1) authorized the conduct of "a study and investigation of the adequacy, for the protection of investors, of the rules of national securities exchanges and national securities associations, including rules for the expulsion, suspension, or disciplining of a member for conduct inconsistent with just and equitable principles of trade," and (2) directed the Commission to report the results thereof to Congress "together with its recommendations, including such recommendations for legislation as it deems advisable." This legislative history, the Report notes, makes it clear that a very broad study was contemplated of "almost all aspects of the securities business and the securities markets." However, in view of time limitations and the necessity for giving maximum assurance that whatever data were presented and whatever conclusions were expressed would be reliable and meaningful ones, it was necessary to be selective and to exclude many subjects that might well have been considered under the potential scope.

No part of the Report has been submitted in draft form, for comment or correction or any other purpose, to any of the private persons or groups referred to or potentially affected by the contents.

In order to facilitate a better understanding of the particular problem areas reviewed and the conclusions and recommendations presented in subsequent chapters of its Report, the Special Study outlines in Chapter I the present regulatory structure (under the Federal securities laws) and the pattern of self-regulation now existing within the industry (based largely upon the rules of the principal exchanges and the NASD). It also sketches a picture of the various aspects of the securities business which today comprise the exchange and over-the-counter markets, described as "a complex mixture of disparate elements" which encompasses both the markets for distribution of securities into public hands and the markets for continuous trading in outstanding securities.

According to the Report, the tools and techniques utilized by the Special Study were many and varied; principally, they include formal and informal questionnaires, interviews with individuals and groups, private and public hearings, examination of records and files of firms and organizations, analyses of data accumulated in the Commission's administration of the Federal securities laws, and review and correlation of prior studies by the Commission and by other persons and organizations. The work of the Study was performed largely by a special staff which generally averaged about 65 persons, with special assistance from time to time of other Commission personnel and, on occasions, outside groups or consultants.

In an "Overview" of the securities industry as it exists today, Chapter I of the Report also (1) reviews the operations of the exchange and over-the-counter markets and the nature and extent of the "public interest" in such markets; (2) presents various data on the composition of such markets in terms of the securities which comprise both the exchange ("listed") and over-the-counter markets and the volume of trading in such securities; (3) discusses the makeup of the broker-dealer community, the varying functions and services performed, the principal geographic areas of operation, the relative size of individual firms, and the turnover within the industry, the principal types of broker-dealer activities engaged in and the amount of gross income produced from each of several types of operation, the concentration of both exchange and over-the-counter business among firms, and the influx of new recruits which have swollen the ranks of securities salesmen within recent years, many with little or no experience; (4) reports briefly on that segment of the industry which engages in research and analysis concerning securities and renders investment advice, either for a fee or as part of the conduct of a securities business; (5) compares the securities industry to the general economy as a whole in terms of persons employed, relative income and other factors; and (6) discusses the growth of the securities industry over the years, the expansion of the markets, both in terms of the distribution of new issues and the increased volume of trading in outstanding securities, the increase in the number of individual investors, the marked increase in the number of broker-dealer firms and the number of salesmen they employ, and the growth of the industry relative to the rest of the economy.

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CHAPTER II

QUALIFICATIONS OF PERSONS IN THE SECURITIES INDUSTRY

Improvements in the regulatory controls over the qualifications of broker-dealer firms engaged in the securities business and their personnel were recommended in Chapter II of the Report of the Special Study of Securities Markets delivered to Congress today by the Securities and Exchange Commission. The Special Study urges "adequate, effective controls" over who may enter the industry based on standards encompassing competence, character and integrity, and financial responsibility.

"Customers of any firm subject to federal jurisdiction," the Report observes, "should be able to assume that the firm's principals, the salesmen with whom they deal, the salesmen's supervisors, and the persons responsible for the investment advice upon which they rely, have met at least minimal standards of competence and integrity and have at least a minimal commitment to their business." However, this is not true, for despite the exemplary practices followed by many firms, including many of the larger member firms of the New York Stock Exchange, there is a great contrast "between the best that has been accomplished and the deep deficiencies that still exist." The large numbers of new investors and new broker-dealer firms and their salesmen attracted to the securities industry in recent years have created "a problem of major dimensions."

The Report points out that under existing federal law there is a right of free access and unlimited entry into the securities business for anyone, regardless of qualifications, except those excluded on the basis of prior securities violations. The steady growth in the very numbers of investors and participants, according to the Report, has made this concept obsolete. "Neither the industry nor the government nor the investing public can afford the burden of a policeman on every corner," it adds, and states that "the gateway to the industry is the point where government and industry should look first for the solution."

The right of free entry, according to the Report, has resulted in a "high incidence" of inexperience in the securities business on the part of principals of new firms, as well as a lack of awareness of and respect for a broker-dealer's obligations to the investing public. Almost 28% of 210 new firms whose 1961 broker-dealer registration applications were examined by the Special Study had no experienced principals; 54% of all of the principals of all 210 firms had no securities experience at all, while 73% had less than two years' experience. Furthermore, the initial capital commitment of a large number of the new firms was found to be "nominal or at best unduly modest." It is this group of new and inexperienced firms which is "responsible for a heavy preponderance of the offenses drawing the most severe penalties" from the National Association of Securities Dealers, Inc., and has greatest difficulty in maintaining adequate records and complying with the Commission's net capital ratio requirements. The Report also notes the low level of experienced principals of new firms registering as investment advisers. Of 79 new firms registered in a three month period in 1961, 63% of the principals had no prior experience in the securities business and 53% of the firms had no experienced principals.

Securities salesmen, the Report points out, are the link between members of the public and the firms with which they deal. In selling securities, they often serve their customers as investment advisers, and even engage in "financial" or "estate" planning involving counseling the investor on his entire financial situation. Yet during the bull market of 1961 more than one quarter of all salesmen registered with the NASD had less than one year's experience in the securities industry, while even at the end of 1962, the market break year, one salesman out of seven was similarly inexperienced. The Report notes that "the incidence of inexperience is particularly high among mutual fund salesmen." Besides the problem of inexperienced salesmen, according to the Report, the securities industry is afflicted with "a reservoir of boiler-room 'floaters'," who may carry the "virus of high pressure salesmanship" from firm to firm. As for the training given salesmen, the Report describes a wide range of practices from the best training programs given by a few large NYSE member firms, to "the worst, or no training at all."

The Report contrasts the "critical position" of branch managers and other supervisors of salesmen with "the industry's reluctance to recognize that persons in this capacity serve functions distinct and different from the roles played by those whom they supervise." The most significant fact concerning supervision developed in its survey, it states, was the great extent to which supervisors engage in selling to their own customers, with over 90% of all supervisors engaged in selling activities. It notes, however, steps taken by the NYSE and the NASD to improve qualifications of supervisors since the Special Study began its work. The Report also comments on the lack of governmental and self-regulatory requirements relating to the competence of persons, other than salesmen as such, who are responsible for disseminating investment advice, whether through broker-dealers or registered investment advisory firms.

In its specific conclusions and recommendations, the Report urges amendments to the securities laws extending the existing statutory bars to the industry to include convictions within ten years of all crimes involving theft, fraud, embezzlement, defalcation or criminal breach of fiduciary duties, not limited as at present to securities violations. The Report also recommends that broker-dealers and registered investment advisers be required to file with the Commission and keep reasonably current certain detailed information which they are not now required to supply, including information on major activities, branch offices, size and composition of sales staffs and research departments, and managers, supervisors and persons in charge of research.

The Special Study also points to the anomalous situation in the framework of industry self-regulation which permits many broker-dealer firms and registered investment advisers to remain outside of any official self-regulatory group so that their activities are subject only to direct regulation by the Commission. Over 1000 broker-dealer firms registered with the Commission, including some large mutual fund sales organizations and firms selling real estate syndications, were not members of the NASD, and registered investment advisers who are not engaged in selling securities have no self-regulatory organization. The Report suggests that membership in "an appropriate self-regulatory group" be a "prerequisite" to registration with the Commission as a broker-dealer or investment adviser, and adds that if compulsory membership should not prove feasible, non-members should be required to pay extra fees to the federal government to defray the added costs of direct governmental supervision.

Noting that the individual rather than the firm is "the appropriate 'unit' for many regulatory purposes," the Report also calls for a system of direct individual licensing covering individual salesmen, supervisors and other categories of personnel, and procedures under which in any event disciplinary action can relate directly to individuals without necessarily involving their employers. The individual registration would be part of a program under which, according to the Report, "standards for entry into the securities business should encompass (a) competence, in the sense of knowledge and experience, (b) character and integrity, and (c) financial responsibility--the first two applying essentially to individuals and the third essentially to firms. The Report states that there have been significant accomplishments in all three areas, but adds that "there are serious gaps and deficiencies that need to be remedied promptly." It calls for considerable improvement, refinement and coordination of present examinations and examination programs, with a standard examination covering a core of basic subjects and supplemental questions for supervisors or principals, or as desired by any particular authority. Certain recognized specialties should call for special questions, limited examinations and a limited license. Apart from examinations, the Report suggests minimum experience requirements for individuals in "crucial roles" such as principals and supervisors.

Perhaps the most important qualification needed for the securities business, the Report states, is character and integrity. It urges the establishment "as rapidly as possible" of "a system involving local 'character and fitness' committees, as in the legal profession." More immediately it notes that responsibility for maintaining a proper level of character and integrity of all personnel must reside in individual firms, but calls for "effective enforcement of this responsibility by the self-regulatory agencies," and for greater emphasis in training and examination programs on regulatory and ethical standards.

The Special Study also recommends that a minimum capital requirement be established for any broker-dealer firm entering the securities business of $5000, plus $2500 for each branch office and $500 for each salesman employed at any time, subject to exceptions to be worked out and an appropriate adjustment period. In view of the special obligations and responsibilities of underwriters of public offerings, the Report recommends a minimum net capital for underwriters of $50,000 plus 2% of the aggregate amount of underwriting commitments or undertakings in the last 12-month period.

CHAPTER III

SELLING PRACTICES

In a Report on the study and investigation of "selling practices" in the securities industry conducted by its Special Study of Securities Markets, which was delivered to Congress today by the Securities and Exchange Commission, the Special Study notes "the existing gap between the industry's stated goal of high standards, and the existing conditions in the market place," and calls for positive action by the industry and the regulatory organizations.

In a broad review of the practices involved in the sale of securities other than mutual funds, the Study observes that it gave principal attention to abuses and improper practices, but no "quantitative measurement of the extent of these practices is intended to be reflected." Nevertheless, it concludes, "serious abuses have occurred, and problems exist which unless corrected could cause grave damage to the industry as well as to the public investor." In a discussion of "specialists in speculation," or broker-dealers who concentrate on selling stock of promotional and unseasoned companies, the Study states that "the merchandise they offer and the selling methods they use preclude concern on their part for the interests of their individual customers." The Study also describes boiler-room operations with their characteristic sales by fraud, misrepresentation and material omissions. It notes that "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."

Among the larger firms, the Study notes, regulatory problems primarily involve inadequate controls and lapses in supervision. These firms, according to the Report, generally attempt to sell securities in an ethical manner. Nevertheless, it states, abuses have occurred which in some cases have rivaled those caused by boiler-room salesmen, and details cases which arose in particular branches of three large firms. It says that "there is no evidence that these practices are typical of how business is conducted by most of the larger firms," but that regardless of their frequency they represent problems "too important to be ignored."

Broker-dealers are charged with responsibility for supervising the activities of their employees, the Report notes, and it reviews the systems which they have instituted to detect certain common abuses, particularly overtrading of customers' accounts, misrepresentations, and recommendations of securities not suitable for their customers. According to the Report, "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 supervision, the Report states, is "facilitated by, or possible only because of electronic data processing equipment," but it adds that the information produced by the machines must be reviewed by persons with the skill, experience and time necessary to make optimum use of of the data provided. While such controls have been most effective in detecting churning, the Report notes a general absence of fixed procedures to uncover abuses with respect to suitability. It further notes that during the last year "representatives of a significant segment of the brokerage community have exhibited a growing awareness of the importance of adequate supervision."

The rules and sanctions controlling selling practices which are administered by the Commission, the National Association of Securities Dealers, Inc., the exchanges and the states are also evaluated in the Report. Commission disciplinary proceedings relating to selling practices, it observes, have been primarily directed at situations involving firms engaged in a course of conduct designed to sell securities by illegal means or boiler-room tactics, although they are not exclusively directed at boiler-rooms. Lesser abuses are more often handled by the self-regulatory bodies. The NASD, the Report states, "has in effect a framework of rules which are intended to control the most prevalent objectionable selling practices," and its rule on suitability undoubtedly "has the most far-reaching potential for dealing with improper selling practices," but its methods of detection of such practices are not well developed. The New York Stock Exchange similarly has adequate rules and sanctions, according to the Study, but its methods of detection "have left much to be desired," and it has treated complaints from public customers, 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."

In its conclusions the Report states, "some segments of the industry appear to be earnestly promoting high standards of selling while others seem only to be earnestly promoting sales." It recommends that the supervision by broker-dealers of the selling activities of their personnel should be strengthened, and suggests the designation of a senior executive in the home office to be responsible for internal supervision and regulatory matters, increasing the branch manager's supervisory role while de-emphasizing his selling activities, and tightening home office control procedures. It also calls on the self-regulatory agencies, particularly the NYSE and the NASD, to "establish clearer standards and stronger surveillance and enforcement procedures to assure more effective supervision by their member firms." It recommends that the Commission adopt additional rules related to detection of improper selling practices, including requirements that retail transactions be marked "solicited" and "unsolicited," that firms maintain a central file of customer complaints, and that firms record certain basic information regarding customers.

It also states that "Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of suitability of particular securities for particular customers," and urges the adoption of "Statements of Policy" which "can provide the necessary balance between generality and specificity." Noting "the importance of disclosure for the protection of investors," it concludes that officially filed company reports and proxy statements "should have much wider use in selling activities," and that broker-dealers should be obligated actually to consult such data before recommending securities, to furnish copies to customers in appropriate cases, and to advise customers when it is not available.

As to the prevailing industry practices of compensating salesmen in proportion to the volume of business produced in a given month and paying varying rates of commission for different types of securities, the Report concludes "that certain of its particular aspects may tend to introduce undue pressures and biases into the selling process." Among possible measures for consideration by the self-regulatory agencies suggested by the Study to "eliminate or reduce the more extreme forms of pressure or biases in selling" are making monthly compensation less specifically dependent on each month's production, eliminating commission rate step-ups based on production in a given month, discouraging undue compensation differentials for sales of different categories of securities where advisory bias may result from the compensation differential, and requiring disclosure to customers of extra compensation in some situations.

The Report finally notes that the sanctions now available to the Commission in respect of selling practices are sometimes unsuitable to the needs of particular cases, and recommends more flexible powers for the Commission, "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."

Research and Investment Advice

As a result of its investigation of the nature of published investment advice distributed to the public by broker-dealers and registered investment advisers, the Special Study concludes that irresponsible dissemination of advice has been responsible for injury to public investors and to the reputation of the investment community and "should receive more positive and effective attention from the self-regulatory agencies." The Special Study also recommends that reckless dissemination of written investment advice "should be expressly prohibited by statute or by rules of the Commission and the self-regulatory agencies and should be made expressly subject to civil liability."

Noting the impressive volume and variety of written investment information originated by broker-dealers, for many of whom its distribution has become an integral part of their businesses, and the lesser but far from insignificant amount of material published by investment advisers who are not engaged in the purchase and sale of securities, the Special Study observes that the materials "raise broad issues of the nature of the responsibilities of their disseminators to those whom they advise." The impact of such advice on the securities markets and the important role of the securities analyst, according to the Report, are "dramatically illustrated" by the history of the Dunn Engineering Corporation, which went into bankruptcy shortly after its enthusiastic recommendation by broker-dealers and subscription publishers. The case demonstrates, the Report states, "the broad gap which can exist between reality and the rosy recommendations of the advisers, and the injury to investors which can result."

In reviewing material distributed by broker-dealers, the Special Study notes that despite differences in emphasis, style, quality and quantity, the material is basically designed to stimulate purchases. Recommendations to sell are for the most part deliberately avoided, according to its Report, and beyond a general classification as to investment goals, little effort is made to evaluate risks for the investor. While the research which the material represents may be "the result of anything from the ultimate distillation of a long and painstaking analysis of the recommended company, its industry and the economy as a whole, to mere 'cribbing'," ordinarily little information is given about the extent or method of research, the person responsible for the recommendation, or any interest in or intentions as to the securities recommended on the part of the firm distributing it. Material produced by subscription publishers, the Report indicates, was similar in many respects, particularly in the predominance of recommendations to purchase (although recommendations to sell are not as scarce), and in the lack of information on the subject of the publishers' positions and intentions as to recommended stocks.

Common to material of all kinds, the Report observes, is the suggestion, express or implied, that the recommendations are the product of research, but a survey of research practices "revealed wide variations in the practices followed and the adequacy of research staffs to perform the functions they were called on to perform." The Study adds that "the occasional circulation by broker-dealers under their own name of material prepared by public relations counsel of the company whose stock is recommended or by advertising firms or others represents an abdication of responsibility."

The Report states that while investors expect the advice they receive to be responsibly prepared and impartial, or that any basis for bias will be disclosed, because of the conflicts of many advisers this is not always what they receive. It notes inconsistent views among broker-dealers on the propriety of recommending securities in which the firm is disposing of its position, and reports evidence among broker-dealer and investment adviser firms of "scalping," or buying of securities about to be recommended in anticipation of the market impact of the recommendation and selling immediately thereafter.

"The investing public gets only modest protection from existing government and industry controls over the form and content of investment advice," the Study says. It notes that the Commission concentrates on selling literature of boiler-room type broker-dealers, and adds that "the self-regulatory agencies have been slow to accept their responsibilities in the area." Registered investment advisers, it comments, "operate largely in an area which lacks any guiding self-regulatory organization."

The Study concludes that a minimum protection for investors is that "firms should not be permitted to represent that they perform research and advisory services which they are not reasonably equipped to perform," and that the NYSE, "instead of indiscriminately encouraging its members to advertise their research and advisory facilities, should adopt standards governing the representations its members may make in this regard." The NASD, it adds, should provide similarly for its membership. Such agencies, it urges, should also "assume responsibility for eliminating irresponsible and deceptive practices by their member firms," including the establishment of standards and more effective market letter surveillance. The Report also recommends that "Reckless dissemination of written investment advice" be expressly prohibited and made expressly subject to civil liability and, as recommended in Chapter II, that registered investment advisers other than broker-dealers be organized into an official self-regulatory association.

Protection of Customers' Funds and Securities

Noting that the broker-dealer community performs quasi-banking and custodial functions for its customers and in doing so regularly handles assets of "enormous value," the Special Study reports that existing provisions for the protection of those assets are generally satisfactory. In certain respects, however, it recommends improvements.

The Report of the Special Study reviews the "financial" and "bookkeeping" procedures and practices of brokers and notes that they result in the generation of large amounts of "free credit balances" (customers balances subject to immediate withdrawal) and other customers' cash equities that frequently are at the risks of brokers' businesses. Brokers also routinely have custody of large amounts of their customers' securities, either in margin accounts or for safekeeping, and they are frequently pledged with banking institutions or lent to other broker-dealers or investors. The rules designed to safeguard broker solvency and control the identification, pledging and lending of customers' securities are therefore, the Report notes, "fundamental to the health of the securities business," since "substantial unprotected losses," in addition to injuring the investing public, "would cause serious harm to the industry's reputation."

The Report, recognizing the excellent solvency history of brokers and the relatively small amounts of losses suffered by the public from brokers' failures, as well as the technical difficulties and disruption that segregating customers' cash balances might cause, concludes that complete segregation is unnecessary "at this time on the basis of past experience." As "minimun protection," nevertheless, it suggest that brokers be required to maintain liquid reserves in a manner similar to Federal Reserve banks and that they be required to inform their customers regularly of the amounts and status of balances held.

Insofar as customers' securities are concerned, the Report concludes that the best practices required by the self-regulatory agencies (stock exchanges and the NASD) in relation to segregation (identification), pledging and lending are adequate, but that to insure universal observance throughout the industry, especially by brokers not subject to self-regulatory control, the Commission should adopt comparable requirements.

The Report also makes recommendations for minor improvements in the Bankruptcy Act, so that it "correlates adequately" with the provisions for the protection of customers' assets.

Delivery of Securities

The ability of broker-dealer firms to make prompt delivery of securities to their customers is a matter of concern both to the securities industry and to the public, according to the Report of the Special Study. The Report focuses on "fails to deliver," particularly during periods of heightened market activity, which indicate that present securities handling, clearing and delivery methods may be inadequate to meet any sustained increase in volume.

The term "fails to deliver" has a technical meaning indicating the failure of a broker-dealer firm on the delivery side of a securities transaction with another broker-dealer to deliver a certificate at the agreed settlement date to the opposite side. While the term does not include delayed deliveries of securities to customers, the Report indicates that fails to deliver are an important cause of these delayed deliveries.

The Report discusses the rise in volume of fails to deliver in early 1961. A study by the NASD showed that, among 2,600 or more than half of its members, the volume of fails to deliver rose from $657 million in December 31, 1960 to $1,295,000,000 on March 31, 1961 and $1,491,000,000 on April 28.

The Report indicates that one reason for concern over fails to deliver is the effect which consequent late deliveries of securities to customers may have on public confidence in the securities industry. The Report notes that the industry itself is aware of this problem and that, as recently as August 1962, the NYSE cautioned against late deliveries of securities to customers and warned that it "can impair normal broker-customer relations" among customers who expect prompt delivery. The Report also considers the possible adverse effects which fails to deliver might have upon the financial stability of broker-dealers.

A number of suggestions are made as to possible means of reducing the volume of fails to deliver. The Report states that certain amendments to the rules of the exchanges and the NASD might reduce their volume at any given time. It further recommends, however, that certain more basic changes in securities clearing, handling and delivering methods be considered. Among these are the expansion of over-the-counter clearance facilities, and various means for reducing the volume of physical transfer and delivery of securities by the establishment of centralized securities handling systems and depositories.

The Broker-Dealer as Corporate Director

The role played by broker-dealers as directors of publicly held corporations also is reviewed in the Report of the Special Study. Of 4,964 broker-dealer firms replying to a questionnaire survey made by the Special Study, 476 stated that officers, directors, partners, or employees of the firm were directors of one or more companies whose stock was traded on an exchange, and 995 had representation on the boards of over-the-counter companies. Many broker-dealers told the Special Study that they regard service as directors of companies whose securities they underwrote as a part of their responsibility both to these issuers and to customers who had purchased the securities. They emphasized the value to many public companies with inexperienced managements of having an experienced financial adviser on the board of directors. From the stockholders' point of view, the broker-dealer would ensure that up-to-date information concerning the company was disseminated.

It is pointed out in the Report, however, that some broker-dealers are reluctant to act as directors for any of several reasons, perhaps including the Commission's decision in late 1961 that the anti-fraud provisions of the securities laws had been violated where a partner of a broker-dealer firm effected transactions in a listed security for his wife's account and for discretionary accounts of customers, on the basis of advance knowledge of a reduction in the company's regular dividend, received from an employee of the broker-dealer firm who was a director of the company.

The Report discusses difficulties that may arise from the availability to a broker-dealer, as director, of information not available to the public. The firm may be making an over-the-counter market, selling to its customers, or recommending to its advisory clients the securities of a company concerning which it has inside information. "Broker-dealer firms have a great variety of views and practices in this area," according to the Report. "Some firms take the position that inside corporate information is available for their benefit and that of their customers; others attempt to maintain a wall of insulation between the individual when serving as director and the same individual in relation to his firm, its trading department, and its retail customers. Other firms avoid or prefer to avoid directorships entirely, because of the conflicts problem or for other reasons."

This part of the Report concludes with a brief discussion of potential conflicts of obligation and interest in the securities industry generally. It refers to the "multifarious possibilities" of such conflict, which "make it difficult, if not dangerous, to generalize as to the problems presented or possible remedies. Their total elimination is out of the question; theoretically, it would involve complete segregation of functions--a remedy often invoked or suggested where conflicts are considered." But segregation as a specific remedy for conflicts in the complex securities business "could not be a simple segregation in any traditional sense but would have to involve fragmentation of the business to a point where (as facetiously pointed out in a recent magazine article) each investor would have his own broker who would not be permitted to act for any other customer or for himself."

The Report states, however, that the conduct of broker-dealers performing potentially conflicting functions may need to be the subject of increased regulatory and self-regulatory concern. In particular, it urges that the self-regulatory agencies (the exchanges and the NASD) and the Commission "should institute more positive, continuing programs for the study of important problems of conflict of interest in the securities business, with a view to speaking out on particular questions in the form of cautionary messages, policy statements, codes of ethics, or rules of fair practice, as circumstances may require."

CHAPTER IV

PRIMARY AND SECONDARY DISTRIBUTIONS TO THE PUBLIC

New Issues

The Special Study of Securities Markets of the Securities and Exchange Commission, in Chapter IV of its Report delivered to Congress today by the Commission, presents the results of its examination of the offering to the public of "new issues" of securities. In a 164-page report, the Special Study described in detail the market for new issues which existed in the years 1959 to 1961 and proposed recommendations designed to protect investors. It also released the results of a separate study on the post-offering experience of small companies which went public during the past decade.

The Report describes particularly the "hot" issues which went to high premiums within a few days or even hours after the original offering. During the years from 1959 to 1961 the public eagerly sought unseasoned, speculative securities in certain "glamour" industries in the expectation that they would quickly rise to a substantial premium and "more than any single activity or incident, it is this climate of speculative fervor which provides a key to the new issue phenomenon," but the Report also notes that "the premium prices of particular stocks were the results of the mechanics of the market and in many cases of the techniques and activities employed by particular broker-dealers."

The Report was based largely upon an intensive examination of 22 new issues offered to the public during the period from 1959 to 1961 which went to a premium immediately after their offering. (Details about each of these issues are in an appendix to the chapter.) By November 1962, only 7 of these issues were still traded above the initial offering price, 1 was at the offering price, 13 were below the offering price and 1 had merged with another company. An analysis of a larger group of 792 unseasoned common stock issues offered in 1961 shows that 85 percent sold at a premium immediately after the offering but only 22 percent were still being traded above their offering prices by September 1962. Of the issues which more than doubled in price, almost two-thirds were selling below their offering price in September 1962. No price quotations were available at all in September 1962 for 12 percent of the registered unseasoned common stock issues and 48 percent of the Regulation A unseasoned common stock issues offered in 1961.

The Report describes the role of the underwriter in the new issue phenomenon. While many of the older underwriting firms exercised careful investment banking judgment in determining which companies were suitable for public ownership, the Report notes that other firms, under pressure from customers and salesmen hungry for new issues, lowered their standards of quality and size of issuers whose securities they would underwrite. Many smaller underwriting firms managed by individuals who themselves were new to the securities business were hastily organized to participate in the new issue boom. The Report states that some of the companies whose stock was offered publicly by some of these firms had "the slimmest chance for survival" and their stock "could be sold by their underwriters only through questionable or clearly illegal techniques."

The Report examines how the establishment of the terms of the offering was affected by the climate of "excitement and expectation of profit" accompanying the new issue phenomenon. In the pricing of a new issue, underwriters could not help but be influenced by the knowledge that the issue would go to a premium. Under these circumstances, the Report observes, a high offering price might not be justified by traditional standards of value, "yet a low offering price, which might seem to be called for by a sober regard for fundamentals, merely assured an initial premium that whetted the public's appetite for the next new issue." For the careful underwriter, these conflicting considerations posed a difficult dilemma; for others, it was an opportunity to set low offering prices in the expectation of withholding substantial portions of the issue in the accounts of insiders to be sold out to the public at premium prices.

Many broker-dealer firms obtained options, warrants, or stock from the issuer, either as part of their underwriting compensation or in connection with prior interim financing. Although the argument is made that "non-cash compensation" is necessary to compensate for risks assumed in the underwriting of unseasoned issues, the Report points out that, in the offering of securities in the glamour industries during 1959-1961, the securities almost invariably went to a premium and that non-cash compensation was granted more frequently in "best efforts" underwritings, where no risk was assumed. Also, it was observed that "non-cash" compensation, instead of serving as a substitute for cash compensation, tended to appear in those offerings with the highest rates of cash compensation. Some firms surrounded their disposition of such stock with careful safeguards; and, in fact, these managing underwriters tended not to dispose of their holdings shortly after the offering. Others, however, distributed their holdings in the immediate after-market at substantial premiums.

The Report indicated that the "hotness" of hot issues was increased by the fact that over-the-counter trading began simultaneously with effectiveness of the registration statement. "Stocks frequently were being quoted at premium prices in the after-market before all customers knew of their allotments, before the closing at which the managing underwriter remitted the proceeds of the offering to the issuer, and before customers received their stock certificates. Thus, the trading markets for new issues tended to reflect a distorted picture of demand and supply. While potential buying interest in an issue was often communicated to trading firms prior to the offering date, potential selling interest in the after-market was more difficult to assess and was seldom adequately reflected."

Practices which had the effect of further limiting the available supply of stock contributed to after-market premiums, according to the Report. Some of these practices were quite legitimate, others questionable and still others manipulative. The size of total offerings of many new issues was relatively small; and it was often further reduced by selecting customers who were expected to retain their allotments, by placing allotments in discretionary accounts, by failing to notify customers that they had been allotted stock, and by failing to deliver stock certificates to customers. Participants in some offerings placed shares in the accounts of firm partners and employees, relatives, and persons affiliated with other firms with whom there were reciprocal arrangements. These withheld shares often were later offered to the public at premium prices. In some firms registered representatives opened fictitious accounts in which they had an interest for the purpose of receiving allotments of "hot issues."

With such limitations on the floating supply, the after-market price of a new issue was susceptible to even slight changes in public demand. Demand often was stimulated by active solicitation and the use of publicity techniques which could be expected to cause the price to rise dramatically.

In revealing the results of its separate study of 960 small companies which went public in the years 1952-62, the Special Study noted that, as of the end of 1962, 37 percent of them either could not be located after diligent efforts or were inactive, liquidated, dissolved or in receivership or reorganization. The Report stated that the new issue boom provided an opportunity "to sell stock in companies that in a different climate would not have been deemed ready or appropriate for public financing" and stressed that the "determination of the suitability of issuers for public financing has traditionally been part of the role of the underwriter, a role demanding particular skill, experience and a sense of responsibility." The Report pointed out that many of the broker-dealers who undertook the role of underwriters were lacking in these qualities and were substantially judgment-proof with respect to their statutory liability under the Securities Act.

"The role of the government," the Report stated, "is to insure disclosure of information and the fairness of the markets in which securities are distributed and traded." The disclosure requirements of the Securities Act are of special importance to purchasers of new issues of a speculative nature, particularly in periods of intense demand and more particularly to purchasers at premium prices in the after-market. However, many purchasers of securities "redistributed" in the after-market at premium prices did not receive the prospectus or offering circular--even when their purchases were solicited by underwriters and other members of the distributing group, despite the Securities Act requirement that broker-dealer firms must deliver the prospectus during a 40-day period after commencement of the offering.

The Report noted, however, that an accurate prospectus may be of "little value to a purchaser who does not care about a company's asset value, operating history or prospects but who buys only in the expectation of a premium." In this climate, the distribution and trading of unseasoned or "first" issues should receive particular attention, both by the Commission and the National Association of Securities Dealers, Inc. "with a view to preventing practices that have contributed unnecessarily to 'hotness,' while not interfering with normal and legitimate practices in connection with underwriting of 'first' or any other issues or the flow of venture capital into new business."

The Report's recommendations in addition to the requirement described in Chapter II of the Report for a minimum capital requirement for broker-dealer firms engaging in an underwriting, include the following:

1. Adoption by the Commission and/or the NASD of appropriate rules to eliminate or temper certain factors which produce artificially high premiums. Among the rules appropriate for consideration and adoption would be:

(a) Prompt notice to customers following commencement of an offering as to allotments resulting from solicitations or indications of interest prior to the offering.

(b) Prompt delivery of certificates to purchasers.

(c) Prohibition of trading markets for a brief period after the effective date (except for permissible stabilizing activities).

(d) Clarifying restrictions on obtaining indications of interest or orders to purchase in the after-market before commencement of the offering.

(e) Limitations on underwriters' soliciting purchasers at premium prices in the immediate after-market.

2. Conditioning acceleration of the effective date of a registration statement or clearance of a Regulation A filing in the case of first issues upon delivery of a substantially final prospectus or offering circular to each expected purchaser in the original distribution at least two days before any sales are made.

3. Extension from 40 to 90 days of the period for required delivery of the prospectus in the case of "first" issues of common stock (the Special Study recommends that the 40-day prospectus-delivery requirement be eliminated in offerings of securities by issuers subject to the continuous financial reporting requirements).

4. Strengthening by the NASD of its enforcement of prohibitions against "free-riding."

5. Publication by the NASD, in implementation of its program for review of underwriting arrangements for unseasoned issues, of summaries of specific rulings.

6. A requirement that underwriters receiving non-cash compensation in a public offering shall report to the NASD and the Commission with respect to the exercise of options or warrants, transfer thereof, or disposition of shares.

7. Clarification by the Commission of the application of its rules relating to market activities by persons interested in a distribution of securities.

Unregistered Distributions

The Report of the Special Study also includes recommendations designed to provide investors and the Commission with limited information concerning "unregistered distributions" of securities.

The Report noted that in 1961 unregistered distributions totaled at least $588 million, an amount more than one-fifth as large as the aggregate amount of primary, registered common stock offerings for the same year, and about one-half as large as registered distributions by controlling persons. It was also pointed out that individually unregistered distributions may be as large as registered distributions and may require the same concentrated selling effort, including the formation of a syndicate, special compensation to participants and the use of selling literature. The Report observed that unregistered distributions are of growing importance in the securities markets because of the increasing participation of institutional investors.

In certain kinds of unregistered distribution of listed securities, effected on the floor of the New York Stock Exchange, participants are required by the Exchange to disclose to customers certain information concerning the distribution both at the time of solicitation and in the confirmation. In connection with distributions in the over-the-counter markets, however, including over-the-counter distributions of Exchange-listed securities, there are no comparable requirements for disclosure of information about the distribution to investors.

"If a distribution emanates from the issuer or a controlling stockholder," the Report states, "it is the theory of the Securities Act that the issuer, selling stockholder (if any) and underwriter can and should supply comprehensive data about the issuer and the distribution itself. But if the distribution is from any other source, even though the factual distinctions may be narrow ones and the needs of investors may be no different, no disclosures are required even as to the distribution itself (except in the case of certain but not all exchange distributions). Granting that the basic distinctions in kinds and amounts of disclosure must be maintained for practical reasons, there is no reason why certain basic data with respect to the distribution itself cannot be provided just as readily in the case of an unregistered distribution as in the case of a registered one. The needs for protection of investors are no less great in the former case than in the latter." The Report noted that the material facts concerning the distribution itself are fully known to the broker-dealers handling it.

The Report of the Special Study recommends that broker-dealers managing an unregistered distribution meeting certain standards of size be required to file with the Commission a brief notification which would include information concerning the distribution. The Report states further "consideration should be given, also, to the feasibility of requiring, with respect to all or specified categories of unregistered distributions, an interval of time, say 48 hours, between the filing of the notification and the commencement of the distribution." It also recommends that any broker-dealer participating in an unregistered distribution as principal or as agent should be required to advise each customer in the confirmation of the substance of the matters to be set forth in the notification and appropriate portions thereof at the time of solicitation.

The Intrastate Exemption

The Report of the Special Study also includes recommendations covering certain intrastate offerings of securities exempt from registration with the Commission. Under the proposed requirement, issuers or controlling persons proposing to make "substantial public offerings" in reliance upon the exemption provided in the Securities Act for intrastate offerings would give the Commission advance notice of such offerings.

The required notification would include information concerning the principal business of the issuer; the amount, purpose, and place of the offering; identification of any person on whose behalf the offering is made; a description of the manner in which the offer or sale is to be accomplished; and disclosure of any recent or other proposed offerings by the issuer. Filing of such notification would not be a condition to the availability of the exemption, but any failure to file would be subject to the usual penalties for violation of the Commission's regulations.

It is clear from the legislative history of the intrastate exemption, according to the Report, that Congress intended to exempt only sales within a state of the entire issues of local issuers; and such an exemption is typically available for the offering by a small businessman of a limited amount of securities to his friends, relatives and business associates. The exemption is available only if the entire issue of securities is offered and sold only to persons resident within the state in which the issuer is both incorporated and doing business. Although the volume of offerings made pursuant to the intrastate exemption is unknown, evidence cited in the Report indicates that it is substantial.

The Report points out that, under the intrastate exemption, the sale of a single share to a non-resident nullifies the exemption for the entire offering (as may a purchaser's reoffering to a non-resident), and gives rise to possible liability under the Securities Act. Moreover, although the exemption from registration does not carry with it an exemption from the anti-fraud provisions of the Act, the Commission has no reliable means of learning of the existence of such offerings, with the result that it is difficult to provide adequate protection to investors against fraud.

The records of Commission enforcement actions reveal abuses which have attended such exempt intrastate offerings. While the primary responsibility for investor protection with respect to intrastate offerings would seem to rest with the States (the securities administrators of many States have made most valuable contributions to this objective), most state administrators lack the resources adequately to supervise and investigate selling practices in widespread public offerings. Consequently, Commission enforcement of the Securities Act anti-fraud provisions "remains, as Congress intended it to be, a significant factor in providing the needed protection."

The recommendation does not relate to the availability or terms of the exemption, but rather to providing information to the Commission as to its use.

Real Estate Securities

In the Report on its study of real estate syndications and real estate corporations, the Special Study concludes that the principal problems of that area "relate to the speculative nature of some of the real estate securities being offered to the public, the extent of compensation and other direct and indirect benefits reserved to the promoters of such securities, and the manner in which such securities are sold to the public." It recommends self-regulatory controls and other measures to provide increased protection to public investors who purchase real estate securities.

Responsible persons both inside and outside the industry are concerned, according to the Special Study, about some of the real estate investments offered to the public. Its Report notes a widespread view that "competition among syndicators has inflated real estate prices far above true values, with the result that prime commercial residential properties which can legitimately provide the 10 percent or higher 'return' or cash-flow that investors have come to expect are few and far between." Consequently, some promoters have turned to situations where "the investor's risks are substantially increased."

The Report also notes that many benefits often reserved by promoters, such as the fairly common reservation to the syndicator of the proceeds of mortgage refinancing, and the dilutionary impact built into the Class B stock of many real estate corporations, may affect the quality of securities offered. It states the view of industry leaders that these problems occur only because investors are "all too willing to exchange future benefits for present promises of distributions." The Special Study adds that an outstanding feature of real estate corporations "has been the frequency with which the corporation entered into transactions in which the promoters and controlling persons of the corporation had an interest of considerable magnitude."

The business of real estate syndications, the Special Study observes, is essentially the product of the accelerated depreciation deduction permitted by the Federal income tax laws, with limited partnerships, corporate entities and investment trusts in the real estate area, all designed to take maximum advantage of relevant Internal Revenue Code provisions on the deductibility of depreciation on real property improvements. Purchasers of real estate securities rely to a large degree on the appeal of two interrelated promises: "anticipated cash-flow distributions," and "tax shelter;" and each involves rather technical tax concepts which should be clearly understood by the purchaser but, according to the Report, often are not. The Report suggests that investors may not understand that while the use of accelerated depreciation permits a syndicate or real estate corporation to have a substantial portion of its cash-flow distributions in its early years fall under a "tax shelter," so that 50 percent or more of the indicated 10 percent or greater return on his investment may be promised as "tax free," distributions ultimately become totally taxable, unless there is a refinancing or the property is sold.

The Special Study also comments that the cash distribution policies of real estate corporations have been of increasing concern, and notes that their distributions have frequently been made from sources other than normal cash-flow, although the recipients of the distributions might have believed otherwise. Its Report notes that in June, 1962, the Commission promulgated Rules 13a-15 and 15d-15 requiring quarterly reports on sources and amounts of distributions by cash-flow real estate corporations. It also notes the Commission position requiring prominent disclosure in a prospectus of certain elements of risk or overreaching in real estate offerings, but adds that "the impact of the vanishing tax shelter might be brought out with greater clarity" and that some industry members question whether sources of cash-flow are disclosed with sufficient particularity.

In addition, the Special Study points out the danger of irresponsible selling practices in the field of real estate securities, since even a sophisticated investor may have difficulty in evaluating the tax aspects or factors of risk and promoters' benefits of an offering. It observes that the absence of an effective self-regulatory securities organization with jurisdiction over the industry and the lack of qualifications, training and supervision of many of the salesmen are matters of concern, and that the existing regulatory structure does not assure that salesmen of real estate securities have even the degree of competence and responsibility required for sellers of other securities. Most sellers of real estate syndication interests (but not sellers of stock of real estate corporations or units of real estate investment trusts) are not subject to the modest examination requirements of the NASD, and many underwriters have refrained even from registering with the Commission, presumably on the ground that they are engaged exclusively in an intrastate business. The Report indicates that, as to the exemption from federal regulations of intrastate offerings, it is clear that there have been violations of the exemption, but their extent cannot be estimated.

The Special Study Report concludes with a recommendation that all distributors of and dealers in real estate securities in interstate commerce be required to become members of a registered securities association, and that all persons engaged in selling real estate securities be subject to the same registration requirements and high qualifications standards recommended by the Report for the securities industry generally. It further urges the Commission to continue a study of the problem of speculative offerings, promoters' benefits, insider transactions, distributions and the information furnished to security holders, to determine whether the Commission's power to compel disclosure is adequate to deal with these complex problems.

Integration With Previous Filings

The Report of the Special Study also recommends measures which would simplify the disclosure requirements of the Securities Act for companies already subject to the continuous reporting requirements of the Exchange Act.

The Securities Act requirement of fair and adequate disclosure in the sale of new securities (or secondary distributions by controlling stockholders) is designed to assure ample and reliable data upon which investors may base their investment decisions. Under current rules, a company which for years has filed annual and other periodic reports with the Commission (including certified financial statements) is generally subject to the same prospectus and related disclosure requirements as a new, promotional company. Moreover, prospectuses are required to be delivered in connection with a registered block of shares but not in connection with a simultaneous trading transaction in outstanding shares of the same class. The SSSM report suggests that in many situations the burdens of disclosure might be significantly reduced and the benefits increased if disclosure requirements were more systematically integrated with the periodic reporting requirements of the Exchange Act (such periodic reporting, now applicable principally to listed securities, would be extended to a large segment of over-the-counter companies under another recommendation of the Special Study).

Specifically, the Special Study recommends that the Commission prescribe a simplified "short-form" registration statement and prospectus, for use in offerings of securities by companies which have built up a reservoir of published information through compliance with the periodic reporting requirement. These documents would contain data concerning price and spread; underwriting arrangements; if a primary offering, the proposed use of the proceeds or if a secondary, the reasons for selling; capitalization; summary of earnings; recent developments in business and other material occurrences not previously reported; financial statements, and a specific reference to previously filed data. The Report further recommends that the "waiting period" between the filing and effective date of statements be kept to a minimum for short-form filings, and that the present requirement that all dealers deliver prospectuses to purchasers of registered shares for 40 days after the offering date be eliminated where the short-form filing procedure has been used (the prospectus to be furnished only to the original distributees).

It is pointed out in the Report that the entire program is based on the assumption that the standard of care in preparing and reviewing information filed under the Exchange Act would be generally as high as under the Securities Act. The program is part of the Report's total emphasis on continuous disclosure and wider use and dissemination of filed reports.

CHAPTER IX

OBLIGATIONS OF ISSUERS OF PUBLICLY HELD SECURITIES

Extension of Disclosure Requirements to Non-Listed Companies

In Chapter IX of the Report of the Special Study of Securities Markets, delivered to Congress today by the Securities and Exchange Commission, the Special Study discusses the obligations of issuers of publicly held securities and recommends disclosure and wide dissemination of financial and corporate information regarding issuers of securities traded over-the-counter, as well as improved measures for protecting investors in both listed and unlisted securities.

Specifically, the Report recommends legislation extending the protections of Section 13 (financial reporting) Section 14 (proxy regulation) and Section 16 (controls on insider trading) of the Securities Exchange Act to investors in over-the-counter issues (the three sections now apply to exchange-listed securities). The report states: "Disclosure is the cornerstone of federal securities regulation; it is the sine qua non of investment analysis and decision; it is the great safeguard that governs conduct of corporate managements in many of their activities; it is the best bulwark against reckless corporate publicity and irresponsible recommendation and sale of securities." It seems "wholly indefensible" in terms of logic and public policy, the Report adds, that most investors in over-the-counter securities should be afforded drastically less protection than is provided for investors in exchange listed securities. It also notes that other chapters dealing with, for instance, selling and advisory practices, corporate publicity and over-the-counter trading demonstrate the compelling need for the application of such safeguards to securities traded over-the-counter.

In order to evaluate the financial reporting practices of issuers of over-the-counter securities, the Special Study queried a random sample of 1618 such companies. Of these, 25 percent sent no financial reports at all to their shareholders and such information as was supplied by the rest was found deficient in many respects.

Proxy solicitation materials were also found inadequate. Twenty four percent of the companies surveyed solicited no proxies at all during 1961 and in a large majority of the solicitations for elections of directors shareholders were not even given the names of the nominees; they were "asked blindly to vote for the present management."

Extension of controls on "insider trading" is also needed, the Report notes, since many over-the-counter companies are "insider controlled" and insiders now enjoy "unparalleled opportunities" to use confidential corporate information for personal gain from short-swing trading profits in the over-the-counter stocks of their corporations.

The Report points out that the absence of the investor protections it recommends puts the over-the-counter market itself at a disadvantage. The lack of reliable financial information makes investment advice particularly difficult and costly. Increased costs, added to the want of statutory protections, lead many investors to avoid such securities. The Report states: "Adequate disclosure (would) tend to insure that sound companies will be the ones that will receive investors' funds."

In order to determine which over-the-counter issuers should be covered by the protections of Sections 13, 14, and 16 of the Exchange Act, the Study analysed the 1618 over-the-counter companies in terms of numbers of shareholders, asset size and stock-trading interest. It was found that those in the group with 300 or more shareholders manifested marked evidence of stock turnover and broker-dealer interest as contrasted with companies with fewer shareholders. The Report rejects asset size as a criterion in selecting the companies to which statutory protections should be applied. "An investor in a small enterprise is as entitled to solicitude as one in a large, and indeed, in most instances needs it more," it declared. In summary, the Report states that "at and above the 300 shareholder level trading activity, as measured by transfers and dealer interest, becomes significant for a majority of the issuers affected."

The Report recommends a "phased program" to extend the needed protections by degrees. In order not to impose too severe an administrative burden, it suggests that in the first two years issuers with at least 750 shareholders might be covered, for the next two years issuers with at least 500 shareholders, and thereafter and permanently, an appropriate standard would be 300 shareholders.

The Report discusses separately banks and insurance companies and concludes that they also should be included among the companies covered. Analysing the financial reporting and proxy solicitations of banks, the Report finds that "they fell far short of the standards imposed under Sections 13, 14 and 16." Twenty percent of the banks studied did not send any financial data at all to their shareholders and a great majority of those that did failed to include profit and loss statements. Proxy materials were also judged "inadequate." In 92 percent of the elections of directors examined, for instance, the names of the nominees were not given and in 97 percent, their backgrounds were not stated. The Report reviews current state and federal controls over banks and, apart from recent improvements relating to national banks, finds them of "limited value to investors" and primarily designed for the protection of depositors.

Similarly, the Report urges that insurance companies also be covered, since state regulation of insurance companies is directed to the protection of the holders of insurance policies, not investors in insurance company securities. "Insurance companies . . . exhibit all of the inadequacies in reporting and proxy solicitations characteristic of the total group studied. They should not be exempted when the benefits of those sections are extended to unlisted securities."

The Report also concludes that there is "no need for a general and broad exemption from Section 16(b) (which provides for corporate recovery of short-swing trading profits of insiders) in respect of broker-dealers making markets in securities of issuers on whose boards of directors they are represented. Entirely apart from the merits of broker-dealers' services on corporate boards generally the combination of making a market in an issue . . . and representation on the board of the issuer appears to be, in most if not all circumstances, an unnecessary one; and when consideration is given to the potential conflicts of interest inherent in the combination . . ., the balance clearly does not lie in favor of a general and broad exemption." To take care of unusual cases in which it might be shown that a broker is indispensable both as director and market maker, the Report recommends the use of exemptive powers of the Commission on a case by case basis.

In order to distinguish those over-the-counter securities which will be required or might elect to comply with the disclosure and protective provisions of Sections 13, 14 and 16, the Report recommends as a "distinguishing hallmark" for quotations and other purposes the term "OTC-Listed."

Along with certain adjustments in the provisions or application of existing investor protections, the Report urges wider dissemination of officially filed data. It further suggests that the Commission and the self-regulatory agencies should "foster in various ways, wider dissemination of publicly-disclosed information and its more consistent use in selling and advisory processes." Specifically, the Special Study recommends that "filed reports of issuers could immediately be duplicated and distributed, for example, to all regional offices of the Commission and District offices of the National Association of Securities Dealers, Inc. and, upon request and at a nominal charge, to any broker-dealer or member of the public." It also urges "continuous educational measures of various kinds" regarding prospectuses and their contents.

Corporate Publicity and Public Relations

Upon the basis of its study of the impact on the securities markets and public investors of corporate publicity and public relations, the Special Study recommends the establishment of higher standards by corporate managements, public relations firms, financial news media, members of the securities industry, and the self-regulatory agencies, and consideration of legislation by Congress and rule revisions by the Commission affecting the problems disclosed.

While stating that corporate publicity can "act as a valuable supplement to the disclosures required by the securities acts," the Report of the Special Study adds that "where publicity perverts the concept of full disclosure, where the purpose or effect is manipulative, the impact of public relations becomes a matter of concern." It also notes increasing evidence of "abuses of the public relations function" and "disturbing signs that public relations consultants and corporate public relations departments have been used for purposes contrary to the letter and the spirit of the securities acts."

Rather than exhaustively surveying prevailing corporate practices in financial public relations, the Special Study made an intensive study of the activities of 46 companies, all of which had conducted significant public relations activities or had extreme price fluctuations in their stock, with particular emphasis on five companies whose activities stood out as demonstrating specific practices or problems. The five companies and their principal markets were Avnet Electronics Corporation (NYSE), BarChris Construction Corporation (ASE), Chemtree Corporation (OTC), General Development Corporation (ASE) and Technical Animations, Inc. (OTC). The Report observes that the companies studied "are by no means a typical group of publicly owned issuers," and that it is difficult to estimate how widespread are the practices described, but it notes evidence that a considerable number of companies and financial publicists have engaged in them. It adds, however, that many companies and their publicity agents conduct their activities "with restraint and propriety."

According to the Special Study, the corporate publicity examined by it "ran the gamut from straight-forward reporting of corporate affairs to what can only be described as deliberate attempts to falsify a company's financial position and prospects." Much of the misleading publicity observed consisted of "optimistic sales and earnings projections which seem to be based primarily on wishful thinking, glowing descriptions of new products which are still in the experimental stage, and announcements of mergers or acquisitions which are only vague possibilities."

The varied techniques of financial publicists, the Report indicates, are often designed to create a snowballing effect, with the well planned story gaining momentum and scope as it travels from management to publicist to analyst to financial writer to adviser to salesman to investor. Techniques include "the placement of articles favorable to the client in the columns of the financial press, the use of 'contacts' and personal influence with persons with brokerage firms and investment advisory services, and the entertainment of financial writers and security analysts." Such practices, the Study comments, "not only may . . . seriously mislead stockholders and potential investors; they also tend to corrupt the media of communications upon which the investing public must rely for its information."

The powerful effect that corporate publicity can have on the prices of a security, the Special Study notes, is hardly open to question. In fact, according to its Report, the literature of financial public relations men aimed at prospective clients emphasizes that their purpose is to increase stock prices. In discussing instances found by the Special Study in which corporate publicity appeared to have a direct effect on securities prices, the Report comments that various motives may underly public relations activities, including the desire to increase the company's sales, prestige in the financial community, or the price of its stock for a future financing or merger. "The essential point," adds the Report, "is that the investor who relies on publicity that is over-enthusiastic or incorrect may be injured, regardless of the purpose of those who are responsible for it." A related problem of which the Report gives examples is the sale of stock by insiders at approximately the time of an intensive public relations effort. The Report also describes trading by public relations men in the securities of their clients, acquired by option or otherwise, "not to imply manipulative or any other improper intent" but to demonstrate the conflicts of interest that can arise. "Since the publicists are under no obligation to disclose their financial interests in issuers," the Special Study observes, "neither the press, the financial community, nor the public may be aware that corporate information which they receive comes from interested sources."

In its conclusions, the Special Study notes that "undoubtedly the most effective restraint on irresponsible publicity is the regular reporting and wide dissemination of reliable data." To some extent, it suggests, abuses call for control by direct prohibition and penalties, and it recommends that consideration be given to enactment of a statute providing criminal sanctions and civil liability for intentional or reckless dissemination of false and misleading statements, including forecasts unwarranted by existing circumstances. Its Report also calls for changes in Commission rules to require disclosure of compensation of public relations firms, including options and warrants in stock of the company.

The Special Study concludes, however, that "there are limits to what can and should be accomplished by direct regulation in this area." Its Report calls on the self-regulatory groups, official and unofficial, the business and financial communities, and the press itself, to exercise their powers and responsibilities. It also suggests that the exchanges and the NASD are in a position to impose needed restraints on companies whose stock they trade or publicly quote as well as on their own members, and that public relations associations can be of value by regulating their members and raising professional standards. It further urges news media and press and public relations associations to impose "standards designed to separate corporate propaganda from news, and to control conflicts of interest on the part of writers of financial news."

(NOTE: Copies of the five chapters of the Report are not available for distribution by the Commission. A further announcement will be made when printed copies are available for sale by the Government Printing Office.)

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