Remarks of

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I am told that you gentlemen have just weathered one of the most intensive training programs on the Street. Given this background, I doubt that it is particularly important at this point that I describe in detail what I might conceive to be your economic functions and ethical responsibilities. On the other hand, in justice to my own peculiar situation, I may be excused for giving you some highlights on this topic as we in Washington see them. As you know, the securities business has expanded sensationally in the last ten years, bringing into play certain pressures on industry standards which it seems to me we might profitably discuss together.

Ten years ago, in 1950, NASD member firms employed some 29,824 registered representatives operating out of 4,131 offices. The latest figures, for the end of November 1960, show 92,878 registered representatives and 8,626 offices, three times as many men and twice as many offices. The statistics regarding member firms alone are equally impressive. Ten years ago, New York Stock Exchange members operated 1,661 offices throughout the country and employed 11,409 registered representatives. By the end of November 1960, the number of offices had increased to 3,154 and the number of registered representatives to 27,578. Some of the bigger Wall Street firms have engineered dramatic increases in their staff activities. I note, for example, that Bache & Co. had 39 branch offices in 1950 and 73 in July of this year. In several instances, where there were originally a smaller number of branches, the increase has been as much as six-fold.

There is some indication that the impulse behind this expansion has not been exhausted. Mr. Keith Funston has referred glowingly to a "body of potential shareowners which stretches the imagination." A recent stock exchange survey suggests that "new frontiers" in the brokerage business may even be delimited geographically. For instance, taking households with $7,000 or more annual income, it appears that in New York, Brooklyn and Newark there were 130 such households per New York Stock Exchange registered representative. There were 200 households per representative in Miami, 280 in San Francisco, 380 in Phoenix and 400 in New Haven and Waterbury. On the other hand, there were 1,770 such households per representative in Augusta, Georgia and Sioux City, Iowa, 3,480 in Billings, Montana and 4,200 in El Paso, Texas. This rather eccentric distribution would seem to indicate some substantial room for industry expansion over a wide area.

This process of expansion has brought with it some problems of defining and maintaining standards of proper behavior and some serious difficulties in assuring adequate supervision of inexperienced or over-zealous staffs. In the first place, a branch office is not only physically separated from the main office but is also normally physically separated from the firm's concentration of supervisory personnel. The manager of such an office is in many cases not a partner or an officer of the firm. Furthermore, in establishing new branch offices I would assume that not infrequently it is unavoidable that there be assigned men who are relatively inexperienced in the securities business. It is also true that, in some non-member firms, the demanding task of supervision may be complicated by the presence of part-time employees, particularly in the mutual fund field, who may solicit their neighbors from door to door or from their own homes. Finally, sharp competition for experienced personnel may result in a rapid turnover in the sales force. All of these conditions may explain, though they cannot excuse the failure to maintain and enforce adequate standards of supervision. No firm should expand its sales facilities more rapidly than it can expand its supervisory force. As the Commission stated in a recent case: "The duty of supervision cannot be avoided by pointing to the difficulties involved where facilities are expanding or by placing the blame on inexperienced personnel or by citing the pressures inherent in competition for new business. These factors only increase the necessity for vigorous effort."

We can no doubt look forward not only to an increasing public appetite for securities but also to an increasing competition in meeting such demand. This competition plus the expense attendant upon expansion of service might be expected to increase pressures tending toward rather flamboyant and otherwise undesirable sales activities. The process of establishing a branch office normally involves a long-term lease, some capital investment in furniture and equipment and, perhaps, enlargement of research and statistical staff and similar facilities. Many of these costs are quite inflexible and tend to increase the vulnerability of the firm to fluctuations in trading volume. This vulnerability will tend to encourage the use of techniques designed to create and sustain a high volume of business.

Expansion and competitive pressures of this kind have a subtle tendency to change the way in which people in the securities business think about themselves. The standards and ethics of the industry are logically premised on the idea that investment banking is by way of being a profession, whose members do not sell goods but rather provide a highly skilled service to clients. From this concept, many things flow. You are subject to professional discipline through the Exchange and the NASD. You must demonstrate competence which requires training such as you have just completed. In your Exchange business you do not sell anything to anybody, but rather you buy for the customer as his broker, owing to him the obligation of undivided loyalty which the common law and common honesty impose on an agent, and these obligations do not evaporate when your firm happens to act as principal. You are not called a "salesman." Rather you are called a "registered representative" or a "customer's man." Your job is to serve your client, not to sell him.

I know that your instructors have emphasized that a registered representative has a fundamental, primary duty fully to inform his customer of the facts and investment factors surrounding any security he may recommend and that he must base his recommendations upon his judgment as to the suitability of this particular security for purchase in the light of the customer's peculiar financial situation and investment objectives. This requires a careful and unhurried consultation which is completely inconsistent with the atmosphere of breathless urgency.

When I speak of sales techniques, I am not necessarily speaking of the use of positive misrepresentations which has become familiar in boiler-room operations or even of a failure completely to disclose the less desirable or speculative aspects of an investment. I refer just as much to sales methods designed to persuade a customer to purchase without adequate consideration of the desirability for him of the prospective investment. Such merchandising techniques may actually fall far short of actual fraud and may still be far from consistent with present-day industry standards. They are not only grossly unfair to the customer but are unfair to the industry. As Mr. Funston recently pointed out: "A customer who feels high-pressured, oversold, underinformed will not stop to consider whether the investment he was persuaded to make might not have been a sound one. He will feel that he has been 'had' - and he is likely to take out his resentment, not just on a particular individual or firm, but on the whole securities industry."

An approach such as I have described requires that a registered representative have a relationship with his customer which is highly personal and confidential. Without such relationship, it is difficult to see how he can fully execute his duties as they have been delineated by the rules of the NASD and the Exchanges. As you have been told, under the NASD rules, before recommending to a customer the purchase or sale of a security, a member must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his security holdings and as to his financial situation and needs." The New York Stock Exchange goes even further and requires that every member must "use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account" and before approving the opening of an account members must "be personally informed as to the essential facts relative to the customer and to the nature of the proposed account."

I think it is important for you, as fledgling registered representatives, to understand that these are no empty phrases reflecting a sanctimonious hope which you are expected to ignore in practice. They represent a reaction from the selling techniques which were a part of the securities market of the twenties and were designed to help prevent a revival of the rejected philosophy of that period. If you cannot sell securities without keeping well inside these limits, you ought not to attempt to sell securities. Neither is this a place for the operation of a callow cynicism. The public creates the securities market, in the last analysis, that public to safeguard which the Securities Acts were adopted and whom the SEC is bound to protect. The industry can no longer afford to permit any sophisticated person to sneer with valid reason at the morals of this particular market place.

No attempt to develop a market for securities by chain store merchandising methods is conducive to establishing the type of personal relationship which I have discussed. I am informed, however, that it is by no means unusual even among established and reputable houses for registered representatives to solicit securities orders of persons with whom they have no previous acquaintance. I know of no rule which forbids such solicitation, and it may even be to some extent inevitable. None the less, I suggest that the practice is open to some question. While the securities business has not, perhaps, in all respects reached the status of a profession to which it has sometimes seemed to aspire, there is only a difference of degree between the position on the one hand of the banker, the trustee or the attorney and the position on the other of one who lives up implicitly to the rules I have quoted. I am sure that solicitation by a lawyer, or even a banker, from a prospect list would be inconceivable even to the most insensitive critic.

It has been asserted that the Commission, the NASD and the Exchange are flitting about like so many elves in a fairyland world, and that to insist upon such a personal relationship between registered representative and customer does not comport with the realities of the industry. I am here asserting what this relationship should be and I am not necessarily trying to make an empirical observation. My agency does not feel impelled to adapt moral standards to recalcitrant facts. It may well be that competition compels the use of something less than professional scruples in initiating contacts, but it most certainly does not justify anything less than the most scrupulous conduct in the subsequent negotiations with the customer and in the business of giving investment advice.

In a way, the principal philosophical justification for the enactment by Congress of the Investment Advisers Act of 1940, was to bring within the jurisdiction of the Commission investment advisers who were not theretofore subject to the Securities Exchange Act of 1934. In a real sense, a registered representative is, or certainly should be, an investment adviser. Congress has recently instructed our agency, among other things, to define proper rules of conduct governing persons performing this function. While no such regulations have as yet been promulgated, due principally to the pressure of other work and the complexity of the problem, there is little doubt but that the ethics embodied in the Exchange and NASD rules governing registered representatives will be reflected in the rules we will ultimately propose for the guidance of investment advisers. There seems to be but one answer to which an analysis of your future economic function can lead. Your work will involve a large element of individual trust and confidence and, as in the case of any such relationship, you will be held to correspondingly high moral standards.

There are certain unforgivable crimes; there is no excuse for stealing from your customers, for lying to them, for taking advantage of them to your personal gain. But mere observance of an obvious negative code of this sort is not enough. A sin of omission is, in this context, if not quite so black, still certainly adequately reprehensible. Your training and the skills which you will acquire with study and experience are not for your benefit, but for that of your clientele to whom you will owe an affirmative duty of positive leadership and advice. Your customers must not only be able to say "I trust him": it is equally important that they be able to say "He is my trusted financial guide."

One ironic aspect of the reluctance of some of the Street to give more than lip service to these rather exacting standards has been a proliferation of what might be called "man bites dog" cases. These are situations in which a registered representative has fallen victim to the wiles of the customer rather than vice versa. In one scheme which seems on its face pretty obvious, but which is surprisingly frequent, the customer places orders for the purchase of a fairly large number of securities through several brokerage firms. The orders are accepted without adequate knowledge of the responsibility of the customer and are duly executed. If the price of the security declines or remains static, the customer proves not to live at that address or to be judgment-proof, settlement is not made and the broker-dealers sell out and take their loss. On the other hand, where the price rises, the customer begs, borrows or steals the purchase price, appears, gleefully places his sell order and demands his profit.

In other cases, a purported customer has telephoned several brokerage houses under an assumed name and has placed fairly massive sell orders. We have reason to suspect that, in some cases, these orders were part of an effort to drive down the price of the stock in a weak market and thus to allow the person placing the calls to buy in through other brokers and cover his short position.

A more elaborate scheme was recently devised by one Stanley Younger, who has now quit Wall Street for the more fitting environment of a Federal jail. Younger represented to a New York firm that he owned substantial amounts of certain listed securities, placed sell orders for these stocks and directed that the proceeds be used to buy securities in something called National Photocopy. At the same time, Mr. Younger's confederate appeared in Salt Lake City proferring shares in this same mysterious and, as it proved, non-existent company, and two Salt Lake City firms obligingly entered the sheets. The New York firm was supposed to forward payment to Salt Lake City, where it could be received by Younger's friend in return for the worthless stock against which no delivery of the listed securities would be made. Fortunately, the New York firm finally became suspicious, the sale and purchase transaction was never consummated and Mr. Younger's only reward was to be indicted and convicted.

While incidents of this type may seem more amusing than upsetting since they have placed us in the peculiar position of bringing action to protect the brokers against being taken by their customers, the apparent ease with which this fraud is committed places the industry in a somewhat embarrassing position. They could, of course, be obviated by elemental recourse to the adage: "Know Your Customer." In any event, I sincerely hope that we will not see any of this graduating class listed on a staff memorandum as the dupe of a securities con-man.

To a very substantial measure, my remarks have not been intended as personal injunctions to you. I am sure that you have had my humble adjurations already dinned repeatedly into your ears in the course of your training by persons far more learned and experienced than I. The most that I can really accomplish here is to emphasize to you that the tradition of careful and personal treatment of the public customer which has been established in your industry is now, and will continue to be, subject to severe pressure. This pressure you must be big enough and strong enough to resist. There is no substitute for unyielding integrity, and nothing short of that standard, uniformly applied by the securities industry, will support these fine traditions in the economic stresses and strains to which the market will always, from its very nature, be subject.

Gentlemen, I congratulate you upon the successful conclusion of your training. You are about to join a large fraternity of alert, intelligent and able colleagues. I commend you to their fellowship. It should be amusing; I hope it will be profitable; and I know it will be challenging and interesting.