ADDRESS PRESENTED AT THE SEMINAR ON THE MANAGEMENT FUNCTION IN THE INVESTMENT BANKING INDUSTRY, SPONSORED BY EDUCATION COMMITTEE, NEW YORK GROUP, INVESTMENT BANKERS ASSOCIATION OF AMERICA

Manuel F. Cohen
Securities and Exchange Commission

Rye, New York
October 25, 1962

I am grateful for this opportunity to address this widely representative group of investment bankers devoted to the study of the management function. No doubt many useful suggestions for more efficient and more profitable operation of your firms have been brought to your attention. I must hasten to confess, however, that I can offer you no cost-cutting or profit-making ideas. Somehow government bureaucrats have never attained a popular image of efficiency, and I make no claim to expertise in the area of business management.

However, we, who are concerned with administration of the federal securities laws, and you, as managers in the securities industry, do share a common goal--the development and maintenance of high industry standards of conduct so essential to the investor confidence upon which success of the industry depends. It is no accident that the federal securities laws have assigned to industry an important role in the development of appropriate standards of conduct. Subject to certain residual authority in the Commission, the national securities exchanges have a duty, under Sections 6 and 19 of the Securities Exchange Act, to provide rules and regulations concerning the operations of the exchange and its members. Section 15A of that Act envisions a cooperative pattern of regulation for the over-the-counter markets in which both the Commission and associations of brokers and dealers have a joint responsibility for developing practices and standards designed to achieve sound and orderly markets and to provide other adequate safeguards to the investing public.

Despite the occasional suggestion that self-regulation by the securities business is "preposterous," 1/ it has achieved considerable success. The New York Stock Exchange requirements for interim financial reports, voting rights for stockholders, proxy solicitation for all shareholder meetings, and stockholder approval for significant corporate transactions, have stimulated high standards of management responsibility throughout the business community. The assumption of regulatory responsibility over the qualifications and conduct of registered representatives by the NASD and by the Exchange is another instance in which the industry has moved to establish additional protections for the investing public.

Unfortunately, however, the need for self-examination and improvement is too frequently recognized only after the revelation of shocking abuses has shattered carefully nurtured attempts to build a public image of professionalism and trust. As you will remember, the New York Stock Exchange took effective steps to develop and require a fidelity bond covering the defalcations of partners of member firms only after the DuPont-Homsey affair publicly revealed a serious gap in the protections afforded customers. And, it was not until the Commission's staff exposed the breakdown of regulation in the American Stock Exchange that its members took steps to build an effective organization for policing the operations of that exchange.

I do not mention these events to suggest that the Commission has lost faith in the efficacy of self-regulation. On the contrary, despite serious weaknesses at the American Stock Exchange, the Commission reaffirmed its

1/ Martin Mayer, Wall Street: Men and Money (1955), p. 259.

faith in the industry by leaving primary responsibility for the rehabilitation of the Exchange in the hands of its members. Events of the past months have thus far justified that faith and have restored public trust in the integrity of its operations.

But we cannot await the needle of public indignation, or injury, before taking effective action to prevent abuse of the public confidence enjoyed by the securities industry. Despite the pressures of day-to-day problems, and an understandable hesitation to introduce change into the complex and sensitive mechanisms of the market place, both the Commission and the industry must be alert to implement existing standards and to develop, when necessary, new principles to meet the ever-changing needs of this vital industry and those who rely upon it.

All who share these responsibilities face a grave challenge in the changes wrought by the tremendous expansion of the securities markets during the last decade. The great increases in highly speculative securities of unseasoned and obscure companies, and in inexperienced and presumably unsophisticated investors, underline the need of the investing public for informed and disinterested investment guidance. Although the industry has publicly proclaimed its ability to furnish such professional guidance, its capability has frequently not kept pace with the rapid growth and broadened operations of many firms. In lieu of professionalism, we have too often encountered "hot issue" distribution techniques and high-pressure sales campaigns which preclude an informed and careful evaluation of the securities involved. In the main, these activities have emanated from newly formed and unscrupulous firms which sought only to exploit the ignorance of the investing public and to trade on the reputation of the broker-dealer community. But, it was something of a shock to learn that, in instances too numerous to ignore, customers of large and respected firms have found themselves the victims of flamboyant and high-pressure sales campaigns of the kind commonly associated with boiler rooms. I need not elaborate on the fact that these disturbing events served to encourage rather than to temper speculative excesses of recent years. Hopefully, they do not represent a permanent deterioration of standards in the securities industry and will provide the stimulus for a renewed effort by the Commission and the industry to achieve higher standards of conduct.

The Commission has reacted to this situation with vigorous enforcement efforts. Despite the intolerable strains on our limited staff created by geometric increases in the number of registration statements filed under the Securities Act and heightened regulatory duties under the Investment Company Act caused by the spectacular growth of mutual funds, our enforcement activities have reached successively higher levels over the past several years. In fiscal 1962, for example, 1844 registration statements for new issues were processed by our staff and 95 new investment companies registered under the Investment Company Act, figures which are approximately double those for the corresponding period five years ago. In the same period, the Commission filed approximately 88 injunction actions for violations of the securities laws, referred 64 cases to the Department of Justice for criminal prosecution,

instituted 121 administrative proceedings under the Securities Act and the Securities Exchange Act alone, and commenced approximately 555 investigations into possible violations of these Acts.

However, the persistence of old problems which have defied more effective solutions, and the emergence of new ones, have suggested a need for thorough inquiry into, and re-evaluation of the adequacy of, existing practices and standards, and of the regulatory pattern, under which the industry operates. As you know, the Special Study of the Securities Markets, authorized by the Congress, is engaged in an intensive examination of recruitment, training and sales practices in the industry and in a broad inquiry into important mechanisms of the securities markets and various other matters pertaining to the distribution and trading of securities. With your cooperation, we have gathered a vast body of significant data on the securities markets which our staff is now reviewing. The report--due early next year--will provide a penetrating analysis of the securities industry and thought-provoking suggestions for all concerned with the future course of the industry.

This past year has also marked the publication of the Wharton School Study of the mutual-fund industry. We hope it will stimulate thoughtful scrutiny and comment by all persons affected by or concerned with the growing importance of mutual funds in the financial community. We are analyzing the questions raised by the Study and inquiring into other areas of mutual-fund activities to determine whether and what changes in existing legislation and regulation are necessary to enable the mutual-fund industry to continue to perform its vital function of providing an important and unique investment medium in the public interest.

The solutions to many of the problems under review by our Special Study group, and those referred to in the Wharton School Report, may require fresh approaches. While receptivity to innovation and a willingness to experiment are essential to the maintenance of a dynamic industry, suggestions for change and their impact on the mechanisms of the market place will receive the careful study such proposals merit. While devoting ourselves to this effort, however, we cannot afford to delay the resolution of those problems affecting the industry which lend themselves to solution by the re-emphasis and determined application of principles of fair dealing on which the securities industry has been built and on which the federal securities laws rest. The failure to assure adherence by sellers of securities to two basic requirements of fair dealing and good business--"know your customer" and "know your merchandise"--has been at the bottom of many enforcement actions by the Commission in recent years.

The "know your merchandise" requirement is deeply embedded in the fabric of the federal securities laws. Under Section 11 of the Securities Act of 1933, an underwriter may be held liable for material omissions from, as well as false and misleading statements in, a registration statement unless he successfully establishes that, after reasonable investigation, he had reasonable ground to believe and did believe that the registration statement

contained all the required information fairly stated. The Commission has also made it clear that the failure of an underwriter, to exercise a degree of care reasonable under the circumstances to assure the substantial accuracy of representations made in the prospectus and other sales literature, is violative of the antifraud provisions of the securities acts and may be grounds for revocation of its broker-dealer registration. While the extent of the investigation required must necessarily vary with the circumstances, the Commission held almost ten years ago that blind reliance on unverified and self-serving information furnished by the issuer is not a sufficient discharge of the underwriter's duty. 2/ Recently the Commission has been faced with other cases in which the broker-dealer underwriter failed in this responsibility to his customers.

The insistence of the Commission upon adherence to this requirement is consistent with traditional practices of reputable underwriters as a prelude to a public offering. The civil liabilities imposed for omissions from, and misleading statements in, a registration statement and the careful examination accorded registration statements by the Commission's staff, have created an atmosphere of prudence and caution in the preparation of prospectuses. Perhaps less well recognized is that the duty of reasonable investigation is not confined to registered distributions, and that it also applies to unregistered and other less formal distributions.

In Securities Act Release No. 4445, released in February of this year, the Commission emphasized that a broker-dealer engaged in the distribution of a substantial block of unregistered securities of relatively obscure and unseasoned companies, in reliance upon an exemption from the registration requirements, can satisfy his burden of showing an entitlement to exemption only by making an adequate investigation into the circumstances of the transaction whereby he acquired the securities. Neither blind reliance on an opinion of counsel based upon stated facts nor unquestioning acceptance of self-serving assurances by the seller will satisfy this duty if the broker-dealer has failed to make an appropriate inquiry which, if made, would have disclosed facts or circumstances tending to negate the availability of the exemption. The Commission also noted that several of its then recent decisions had stressed that it was a breach of duty to his customers for a broker-dealer, either without information, or without disclosure of available adverse information, to make recommendations or representations concerning rising future prices or forecasts of glowing prospects of the security or its issuer.

These decisions necessarily imply that, in the distribution of a block of securities, the broker should make every reasonable effort to obtain sufficient and reliable information on the basis of which he can make an intelligent evaluation of the security, and that he will confine his representations to statements that are consistent with the facts and not inconsistent with other known or available information. While the decisions

2/ Charles E. Bailey & Co., 35 S.E.C. 33 (1953).

referred to in this release involved flagrant violations of the antifraud provisions in the context of boiler-room operations, the Commission's condemnation of unsubstantiated representations and groundless opinions applies, of course, to every broker-dealer and his salesmen engaged in a similar concerted sales effort with respect to a specific security.

Equally important to the concept of fair dealing is the requirement that a broker-dealer and his salesmen know the customer. You are familiar with the rule of the NASD that a member must have "reasonable grounds for believing that the recommendation is suitable for such customer on the basis of the facts, if any, disclosed by such customer as to his other securities holdings and as to his financial situation and needs." 3/ The New York Stock Exchange requires its members to "use due diligence to learn the essential facts relative to every customer." Before approving a new account, the member must be "personally informed as to the essential facts relative to the customer and to the nature of the proposed account." 4/ Unfortunately, we have found that many broker-dealers look upon these rules only as pointing to the desirability of obtaining sufficient information about new customers, as a protection against the risk of poor credit, and make little effort to insure that each of their registered representatives has made a reasonable effort to ascertain the peculiar financial situations and investment objectives of their customers.

The NASD indicated in a disciplinary action, which was upheld by the Commission, that its rule requires members to base recommendations with respect to purchases and sales of securities upon a judgment as to the suitability of the security for the customer, and that a failure of the broker-dealer to make inquiry as to the customer's financial needs and investment objectives may be violative of the NASD Rules of Fair Practice. 5/ It is also clear that sales techniques which ignore these criteria and are designed to operate under the pressure of breathless urgency and unwarranted and unrestrained optimism are also inconsistent with the duty of fair dealing and violative of the antifraud provisions of the securities laws. 6/

3/ NASD Rules of Fair Practice Article III, Section 2.

4/ New York Stock Exchange Rule 405.

5/ Greenberg & Leopold, Securities Exchange Act Release No. 6320 (July 21, 1960).

6/ Mac Robbins & Co., Inc., Securities Exchange Act Release No. 6846 (July 11, 1962); B. Fennekohl & Co., Securities Exchange Act Release No. 6898 (September 18, 1962); A. J. Caradean & Co., Inc., Securities Exchange Act Release No. 6903 (October 1, 1962).

Of immediate concern to all of us here is the problem of implementing these standards of conduct within each broker-dealer firm. This responsibility falls squarely on you as managers in the securities business, not only because the law places it there but because good business requires that you assume it. The failure to provide adequate and effective supervision has, of course, led to sanctions not only against salesmen guilty of misconduct but also against the firm and its officers who were derelict in their management responsibilities. 7/ Beyond this, it has resulted in serious loss of reputation and financial embarrassment.

The rapid expansion of many firms during recent years has made more urgent the necessity for proper supervision. Pressing needs for additional personnel too frequently have been satisfied at a sacrifice of experience, training and integrity. The establishment or acquisition of numerous and scattered branch offices has made the problems of adequate supervision increasingly more complex and difficult.

Broadened public participation in the markets and the spread of population centers point to the continuing importance of branch-office operations. It has been suggested, despite some recent contraction, that the main office of the future will be largely devoted to syndication, trading, research and centralized back-office operations with actual servicing of customers left to numerous small branch offices. To the extent that branch offices provide investors with opportunities for increased contact with their brokers, they can serve to encourage high standards of responsibility in the relationships of broker-dealers and their customers. But if experience is any teacher, branch-office operations can also present great potential for abuse. In almost every case in which customers of large and reputable firms have been abused, the activity took place in a branch office. Isolated from the standards of responsibility embedded in the operations of the main office, the branch manager is left, without adequate assistance, to handle recruitment, training, and certain minimal back-office operations, all in the face of an increasing volume of business. And, when the branch manager is also lacking in a proper concern for standards of responsibility, an appalling breakdown in standards can occur with greater potential injury to the investing public than from an unscrupulous boiler-room operation.

7/ Reynolds & Co., et al., 39 S.E.C. 902 (1960); R. H. Johnson & Co., 36 S.E.C. 467 (1955); Merrill Lynch, Pierce, Fenner & Beane, 31 S.E.C. 494 (1950); Kidder, Peabody & Co., 18 S.E.C. 559 (1945); E. H. Rollins & Sons, Inc., 18 S.E.C. 347 (1945); Bond and Goodwin, Inc., 15 S.E.C. 584 (1944).

For a description of one type of management program adopted by a broker-dealer to provide supervision, see E. H. Rollins & Sons, Inc., supra, at pp. 394-395.

A case decided by the Commission not too long ago provides a dramatic illustration of the need for vigorous supervision of branch-office activities and for prompt and thorough investigation by those in high authority when the slightest indication of irregularity appears. The Commission found that employees in two branch offices of a large and long-established firm had conducted, for a period of over one year, an intensive, high-pressure sales campaign to induce the sale of a large quantity of certain low-priced speculative stocks. Numerous false and misleading statements were made to customers and a widespread fraudulent publicity campaign was instigated. Customer orders were deliberately withheld until the market price had increased as a result of higher bids caused by employees. Orders were funneled to one particular market despite the availability of other lower-priced sources. As a result of these activities, one of the employees personally realized a trading profit of about $100,000.

Despite a stated firm policy against encouraging customer investment in speculative securities, neither the branch managers, the partner in charge of regional operations, nor the supervisory personnel in the main office made any reasonably adequate effort to inquire into the circumstances of the unusual and localized spurt of activity in these securities, even when some of the serious irregularities were forcibly brought to their attention. The failure of supervision was no isolated accident in this case. During the same period, other serious abuses, including churning of discretionary accounts, unauthorized transactions effected through forgery of customers' signatures and violations of Regulation T appeared in three other branch offices. In each instance, the personnel directly responsible for the supervision of these offices were oblivious to the necessity for effective supervision and thorough inquiry into persistent irregularities. Despite the breakdown of the system of internal control, indications of irregularities did, in fact, reach those in higher authority. However, their efforts were confined merely to obtaining self-serving explanations from the employees involved.

This and other disturbing instances of ineffective supervision make clear that branch-office management must never resemble chain-store supervision. The securities industry does not merchandise standardized products which lend themselves to impulse buying by customers who may be presumed to know its suitability to their tastes and needs. Its merchandise is sold along with the service of investment advice which requires a relationship of trust and confidence between the broker-dealer and the customer. The creation and maintenance of this relationship requires that any conflict between effective supervision and the efficiencies and economies offered by certain systems of management must be resolved in favor of rigorous implementation of the elements of fair dealing throughout every level of internal organization.

In my view, this conflict is neither inevitable nor insoluble. In recent years the industry, through intelligent application of modern systems and the increased use of automation, has made considerable progress in

solving many of the technical problems involved in back-office operation caused by the scattering and increased volume of activities. A similar intensive effort and willingness to experiment with new management techniques can also solve the problem of adequate supervision of branch-office operations. Many of you, I understand, have already adopted new and improved training programs for registered representatives. Some firms have sought to assure adherence to the "know your customer" requirement by insisting that registered representatives obtain and record relevant information regarding the financial situation and investment needs and objectives of each customer or to state the reasons why it was not obtained. Other firms have re-examined their practices of recommending securities and have not only limited principal transactions to those securities in which the firms' research people have compiled current and adequate information for an informed evaluation of the securities but have taken steps to insure that this information is disseminated to all members of the staff engaged in dealing with the public. Still other efforts have been directed to the improvement of systems of internal control so that unusual activities in particular securities or portfolios are quickly detected and pursued through thorough investigation by specially trained personnel from the main office.

These are a few examples of management programs to develop adequate supervision of broadened operations which have come to my attention. At the outset of my remarks I disclaimed any expertise in business management. Nevertheless, I shall venture the opinion that time and effort expended in developing your own program will be well rewarded.

Apart from improvement of internal controls, our common interest in the welfare of the security industry calls for a continuing effort by the Commission, the NASD and the national securities exchanges to rid the financial community of those who have demonstrated indifference to the basic elements of fair dealing. For the longer term, it also requires that we consider the feasibility of establishing minimum entrance requirements, as to personal qualification and financial responsibility, for those who deal with the public and thus undertake the responsibilities imposed by the traditions of the industry and our system of cooperative regulation.

While the Commission, the NASD and the national securities exchanges have the principal statutory responsibilities, and all of you make a contribution to their efforts, we should not overlook the suggestion that other representative organizations in the securities industry, such as the Investment Bankers Association, can play more significant roles in the common task of developing and implementing principles of fair dealing. Beginning efforts in this direction have already been made. An example is this conference, by which good management practices are made more widely known. These small but encouraging steps suggest that useful and meaningful criteria can be achieved when responsible segments of industry work together, in an atmosphere of enlightened self-interest, to define, to articulate and to encourage standards of business and public responsibility. Much more can be done and it is to be hoped that these and similar conferences may serve as springboards for continuing effort on the part of the Association and other groups to develop and publicize principles important to the maintenance of a healthy securities industry. Only in this way can the public be persuaded that claims to professionalism and integrity are more than mere advertising copy.