

"ENFORCEMENT WORK OF THE TRADING
AND EXCHANGE DIVISION."

ADDRESS

of

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The Securities Exchange Act of 1934 outlawed manipulation. Section 9 of that statute is the section dealing specifically with that subject, although, as I shall point out, Section 9 is reinforced both by other provisions of law and by rules adopted by the Commission pursuant to the powers conferred upon it. Sections 9 (a) (1) and 9 (a) (2) are the heart of the provisions against manipulation. Roughly 9 (a) (1) prohibits wash sales and matched orders for the purpose of creating a false or misleading appearance of active trading or a false or misleading appearance with respect to the market for a security. "Wash sales" is a familiar phrase. It means selling to oneself. Matched orders refer to the entering of orders on one side of the market at a time when you know that orders have been or will be placed on the other side. You will notice that wash sales or matched orders are prohibited only for the purposes I have mentioned. The reasons for coupling the prohibition against matched orders with a purpose requiring a showing of an intent to mislead are obvious, when one considers the mechanism of the market. Matched orders are entered every day. A large wire house will constantly have orders on both sides of the market for their various customers. To prohibit flatly the entry of such orders would prevent a broker from acting as agent for a buyer of U. S. Steel at 50 if, at the same time, he held for another customer an unexecuted order to sell U. S. Steel at the same price. Under such a circumstance, it would be a hardship on the broker to require him to turn away the buying order. The transaction is a legitimate one and both sides of it represent bona fide customers' orders. Moreover, in the case of the New York Stock Exchange (and, so far as I know, most of the other exchanges) rules have been adopted to prevent the broker from favoring one customer over another and to insure the best possible execution of each customer's order.

Wash sales are but infrequently encountered in trading investigations. Matched orders, however, are more common. To cite an instance: In February of this year the Commission obtained an injunction against a well-known operator prohibiting further violations of Section 9 of the Securities Exchange Act. This man's technique of manipulation depended largely upon the employment of matched orders for purposes prohibited by the statute. At one time or another he had guaranteed almost 100 different accounts at the offices of certain members of the New York Stock Exchange. These accounts were not his, but in all of them he had discretionary power to trade and it was his custom to enter orders for the purchase and sale of the same security in different guaranteed accounts. By buying in one account the stock which he was selling through another and constantly repeating the process through the use of still other accounts, he was able to create activity in the market, to raise the price of the stock, and to attract the public into the market, which permitted him to unload his own stock at higher prices. This, of course, involved a violation not only of Section 9 (a) (1) but also of Section 9 (a) (2).

Section 9 (a) (2) prohibits the effecting of a series of transactions in any security registered on a national securities exchange, creating actual or apparent active trading in such security or raising or depressing the price of such security for the purpose of inducing the purchase or sale of such security by others. Again, as in the case of Section 9 (a) (1), the purpose is the determining factor. Any series of purchases or sales, especially in inactive stocks, is bound to be reflected in the market. A series such as I have described, however, becomes illegal only when for the prohibited purpose; that is, for the

purpose of inducing the purchase or sale by others. Let me illustrate: Last spring we noticed that a comparatively inactive stock suddenly came to life. In one day almost 25,000 shares were traded and the market price almost doubled. Even before the market closed that day, we began to inquire into the reasons for such unusual behavior. We found that a young man just out of college and armed with the fortune of his father, recently deceased, had founded a small company. Not finding sufficient opportunity for the exercise of all of his talents, he decided that he should merge his modest business with that of the largest company in the field. That company was not interested in such a union. Thinking that his overtures would meet with a warmer response if he became a large stockholder in his competitor, he entered an order with his broker for the purchase of 25,000 shares of that stock at the market. The reaction of the market I have described. Because the prohibited purpose was lacking--that it, the purpose of inducing the purchase of this stock by others--no violation of Section 9 (a) (2) was found.

Other cases have not proven so simple. The usual situation is this: A person who is manipulation-minded will obtain an option on a large block of stock, usually at prices above the market and frequently at prices on a scale upward. Obviously, if the option is to be worth anything, the price must rise. To effect this desired result, the manipulator will proceed substantially as follows: If he is a crude sort of manipulator, he will begin buying the stock on the exchange for his own account to increase its price and to attract the attention of tape readers to the security. If he is more subtle, he will enlist the services of others. He will bribe customers' men to put their clients into the stock, he will pay market touts to recommend it to their friends. He will compensate persons conducting tipster sheets to describe the stock in glowing language. He will offer to share the profits of the enterprise with those who can command a market following or who will themselves become purchasers in the market. As the effect of this stimulated buying begins to show itself, he will begin slowly to feed out the stock which he has under option, increasing the tempo of his sales as the price rises and the public begins to come in. Ultimately the distribution of the stock under option will be completed; the efforts to advertise the stock will cease; the plug will be pulled and the market, either slowly or precipitately, will sink back to its earlier level of inactivity.

Sections 9 (a) (1) and 9 (a) (2) are strengthened by other provisions of the statute. Other sub-sections prohibit the inducing of the purchase or sale of a security registered on a national securities exchange by making false or misleading statements and by spreading rumors to the effect that a market operation is being conducted to raise or lower the price of a security. Rules of the Commission prohibit such devices as the bribing of customers' men and others to recommend a security and require brokers acting for customers, and dealers who for a fee undertake to give market advice, to disclose any interest which they may have in a primary or secondary distribution of any security recommended. Then again the fraud section of the Securities Act reaches many manipulative schemes.

How do we detect manipulation? Information is received from many sources. Sometimes a complaint from a member of the public will call the matter to our attention or the thieves themselves will fall out and one of them carry the story to us.

Complaints are not always a trustworthy source of information. Frequently they are the product of misinformation and occasionally of corrupt motives. For example, in one case we found that the complaining person had sold short a particular security and had then tried to persuade us that a manipulation was in progress, hoping thereby to cause us to take such action as would adversely affect the market for the security involved so that he could cover his short position at a profit. He was disappointed when the investigation turned on him.

Then again the stock exchanges occasionally report suspicious transactions to us. We do not, however, rely primarily upon tips or complaints. Both in the New York and Washington Offices, the Commission has tickers. The men who watch the tape are trained to be on the lookout for unusual market action. Sometimes we anticipate that there will be a manipulation and instruct these men to pay particular attention to the security under suspicion. There is also maintained at the Washington Office a section of the Trading Division known as the Security Information Analysis Section. The men in that section are assigned lists of securities which they must watch. Daily they tabulate the volume and price range of every security traded on a national securities exchange--there are over 3,000 of them. They know from their study of registration statements and from other sources, the securities that are subject to options (always a red flag) and those whose holdings are concentrated in few hands. They know from their experience the normal volume of each security in relation to the general market and can judge pretty accurately the normal range of price during a day's trading. Unfortunately, they cannot tell whether the market is going up or down.

How efficient that section can be was demonstrated last fall. A young man who believed himself possessed of a certain talent for finance undertook to manipulate five securities. The Security Information Analysis Section picked out four of the five for investigation and missed the fifth only because the young genius had not been able to affect appreciably the market price of that security.

Other recent cases come to my mind where the vigilance of the Security Information Analysis Section has resulted in an investigation. Thus their observation of the market action of the common stock of Callahan Zinc Lead Company on the New York Stock Exchange began a chain of inquiries which has resulted in the institution of formal proceedings. A similar result followed their recommendation that the trading in the common stock of Reiter Foster Oil Company on the New York Curb Exchange be investigated. They first brought to our attention the trading in the Philippine Railway Bonds on the New York Stock Exchange, which I shall mention later. I recall also a manipulation in the common stock of Weisbaum Brothers--Brower traded on the New York Curb Exchange last August. The Security Information Analysis Section caught that jiggle only a few days after an option had been granted. As a result, we were able to block that distribution to the public and to place under injunction those responsible for a manipulation which was just beginning when we appeared on the scene.

When one of the members of the Security Information Analysis Section notes that a security has become unusually active and that its price trend is against the general market or the average for its own group, an attempt is made to find a reason for the activity. Sometimes that is found in a

press release indicating increased earnings, extra dividends, the booking of unusually large orders or other favorable corporate news. Frequently no explanation can be found. Then it is that a field investigation may begin. If begun, its scope will vary. If we know, for example, that the security is held in scattered hands, except for one large block owned by one person, we may seek that person out and inquire whether he is selling stock, has given an option, or plans to do so. Depending upon the character of the person interviewed, we are frequently satisfied if we receive a negative answer to those questions. In such cases we may conclude that the market action was not due to manipulation. On the other hand, if we know that a large stockholder or optionholder is desirous of distributing a block of stock, we will frequently examine the trading for the purpose of determining who were the buyers and sellers and through what brokers they traded. This may be a task of considerable magnitude. Let us take as our example a security traded on the New York Stock Exchange. Most securities thereon are "cleared" through the Stock Clearing Corporation, a stock exchange affiliate. By consulting the records of that corporation, we determine the names of the brokers, both on the buy and sell side of the market. Our next step will probably be to visit the offices of the most active brokers to learn the names of these brokers' customers. Sometimes such an examination discloses that the broker has executed most of his orders for the account of one customer. In that event, that customer will be interviewed. Frequently we find that many customers of a single house have been in the market for the security, in which event it is likely that the activity is due to recommendations made either by a customer's man or by a partner. If such be the fact, those whose recommendations have created the interest in the security are interviewed. Inquiries are made in other sources to determine whether or not anyone has an option covering the security under investigation. If we find no evidence of manipulation, the case is closed. On the other hand, if manipulation appears to be present, a much more detailed examination of the trading is made. As a first step, we will probably write to all of the clearing members of the exchange, asking for the names and addresses of all their customers buying and selling the security during the period under investigation. Since some orders may go through the hands of three or even four brokers, it may be necessary to write to each of them before we determine the name of the ultimate customer. To assemble all of these replies is a monumental task. The information received will include not only the names and addresses of customers, but also the date of the trade, the number of shares represented by each order, the price at which the order was executed, the time when the order was entered, and if possible, the time when it was executed. Brokers are given a period of at least two weeks to answer our questionnaires. Up until last fall their replies would be sent to the field office conducting the investigation. Now in those cases where the volume of trading during the period under investigation was heavy, the replies are sent in duplicate directly to the Washington Office by the brokers. There the names of customers are checked against the Commission's securities violations files and the "Who's Who" maintained by the Trading and Exchange Division to determine whether any of them have appeared as parties to previous manipulations or other violations of law. After this check one copy of the broker's reply is sent to the field office conducting the investigation, together with a resume of information pertinent to the customers whose names appear thereon. The other copy is sent to the Machine Tabulating Unit, where the information thereon is punched onto International Business Machine cards. When all replies

have been received, the cards completed therefrom are run through a sorting machine, thence into a printing machine, and there finally emerges a complete transcript of trading for the period under investigation.

We now have reconstructed the market for all trades in their chronological sequence and can tell at a glance who bought from whom, when, at what price, through what broker, and how many shares. A second running of the cards through the machine gives us another list of all trades made by each customer, arranged alphabetically by customers' names. If between January 1 and March 1 you bought 1,000 shares of the security under investigation on eight trading days, and sold 500 shares on three trading days, we know that at a glance and know the brokers you employed and the prices at which you bought and sold. If we know that a market tout has been active in a state—say in Connecticut—another running of the cards through the machine will give a separate list of all persons in that area who bought or sold. By interviewing them, we can trace the activity attributable to that market tout.

The main schedule of trading we have christened "Form 10." This form is studied by the investigators and attorneys working on the case. They look for wash sales and evidence of matched orders. They examine the form to determine the volume of buying power put into the market by manipulators and to see how, at what times, and at what prices they unloaded their own stock. All manipulations are not consummated by sales of the security on the exchange. Frequently the stock is unloaded on the public in the over-the-counter market at prices determined by the last sale price on the exchange. Such over-the-counter sales do not appear on the Form 10 and are traced separately.

In examining the operation of trading on the exchange, we look for purchases at new high prices, orders entered to support the market, transactions executed at the opening or the close of the market, and other indicia of manipulation. Since many potential purchasers of stock closely follow the quoted prices as they appear in the newspapers, it is always desirable to have the stock close "up" for the day. If the market price has remained static or even declined during the day, it is frequent to find that just before the close of the market the manipulator will enter a series of orders to buy which when executed will advance the price of the stock above the preceding day's close. The manipulator also deems it desirable to have the market open strong in the morning. To accomplish this he will frequently put in orders at the opening which will have the effect of opening the day's trading at an advance over the previous night's close.

Having all of this material before them, the investigators are now ready for the real work. Usually at this point we have pretty clear evidence that a manipulation has taken place and the Commission has adopted a formal order designating officers who may administer oaths and interrogate witnesses. As the investigation proceeds, persons are examined, brokers' and bank records are checked, copies of material telegrams are obtained, and the data concerning all long distance telephone calls between the parties to the manipulation are gathered from the telephone companies. All of this takes weeks and even months; it may involve work in different states, and may even require an investigation nation-wide in scope. In fact, investigations international in scope

are not uncommon. Recently the Commission suspended a member of the New York Stock Exchange and other exchanges for a period of ten days. That investigation embraced transactions originating in England. In another case involving the Philippine Railway bonds, much of the intrigue took place in the Philippines. Many cases take our investigators into Canada.

At this point I hear some of you asking, "What action do we take against those responsible for manipulation?" We have many strings to our bow. Under the Securities Exchange Act we can seek an injunction; refer the matter to the Department of Justice for criminal prosecution; in the case of a member of a national securities exchange, begin proceedings to suspend or expel from the exchange; and in the case of a registered broker-dealer institute proceedings to revoke that registration. Other indirect sanctions can be applied. Thus we have frequently used information obtained in trading investigations as a basis for stop order proceedings under the Securities Act, as we did recently in the Callahan Zinc Lead case, the Reiter-Foster Oil case, and the Austin Silver Mines case. Under certain circumstances we can begin proceedings to delist the stock from an exchange, as we did in the Callahan Zinc Lead case where the existence of a pool was not disclosed in the registration statement.

In the conduct of our investigation we are alert to discover violations of the registration provisions of both the Securities Act and the Securities Exchange Act. We look for non-compliance with Section 16 of the Securities Exchange Act, which requires insiders to report their transactions in the security and for violations of laws relating to short sales. We have frequently encountered violations of the fraud section of the Securities Act, and from time to time have uncovered brokers' insolvency. I can recall one case where we discovered that a broker in Philadelphia was washing stock on the New York Stock Exchange. His explanation of his dealings led us to suspect his financial condition and a full examination of his books disclosed not only insolvency, but also misuse of customers' money and securities. These disclosures resulted in the withdrawal of his broker-dealer registration and in criminal prosecution and conviction. Only last month we discovered the same kind of a situation in exactly the same way involving a St. Louis broker. Here the broker killed himself before he was apprehended. Then again we sometimes find that the manipulation is but part of a more grandiose scheme and we sometimes swing over to the mail fraud statute as our best means of attack. We took that line in a recent case involving manipulation of the Philippine Railway Bonds on the New York Stock Exchange in the early months of 1938 and assisted the Department of Justice in obtaining indictments. That case, involving as it did international intrigue, romances with movie stars, an airplane load of chorus girls, and an early morning arrest by our officials who boarded the Queen Mary as it came into quarantine in the New York harbor, caught the headlines.

Sometimes our investigations reveal evidence of violations of the rules of the various national securities exchanges which permit those exchanges to deal directly with their own members on the basis of the information which we furnish them. Examples of this are the cases involving the manipulation of the stock of Backstay Welt Company by Mills and Company, members of the Chicago Stock Exchange; and a manipulation of the stock of Lakey Foundry and Machine Company by Dart and Company, members of both the Detroit and the Chicago Stock Exchanges. In both of these cases the exchanges cleaned their own houses and expelled those guilty of manipulation from membership.

By our vigilance we are frequently able to forestall manipulation. Last summer we learned that a company whose common stock was traded on a national securities exchange had liquidated its business and distributed all of its assets to its stockholders. It had not, however, forfeited its charter. A group of promoters bought the charter, renamed the company, amended its articles so as to permit it to engage in a totally different business; in fact, so changed it that nothing of value of the old company was left except its exchange listing. All of the stock in the renamed company came into the hands of five individuals. They were getting ready to sell the stock to the public, and in the process, to make "prints" on the tape to attract the public into the market when we informed the exchange of the situation. As a result, the exchange delisted the stock.

The foregoing represent but a small part of the work of the Commission in its effort to keep the markets free from manipulation. I need not remind you of the action taken by the Commission against Michael J. Meehan; Charles Wright; White, Weld and Company; nor of the results of other proceedings which have appeared in official press releases.

As a result of the small part which I play in enforcing the anti-manipulative provisions of the statute, I have come to the conclusion that the Commission protects the public best when it acts quickly to ascertain the causes of market gyrations. The Commission, of course, is extremely cautious in its approach to an investigation and never, unless formal proceedings are commenced, divulges to the public the names of those securities or persons under investigation. This policy is adopted for obvious reasons. In its early attempts to enforce the statute, the Commission waited until it was pretty sure that a manipulation was taking place before it began an investigation. This was because it was felt that the mere fact that we were conducting an investigation would cause the market for the particular security to react unfavorably as the word spread among the brokers that the Commission was interested in certain trading. We felt that if we were wrong in our suspicions, nevertheless the fact that we were investigating would adversely affect the issuer, as well as other parties interested in the trading in the security.

I don't think that this is true today. My observation has taught me that in cases where there is no manipulation the fact that the Commission is asking some questions about the trading has little effect upon the market. I think that this is due to the fact that the Street is now accustomed to the S.E.C. On the other hand, if there is a manipulation in progress, once we begin to investigate, it usually, although not always, ceases. I can recall one case last fall where the manipulators had been able to sell only two lots of fifty shares each before we were in on them and the jig was up.

Because the Street has come to accept our investigations as a matter of routine, we now resolve our doubts in favor of the public and begin to investigate as soon as we notice suspicious activity without waiting for the confirmation of further facts. It is my conviction that by this method we not only afford greater protection to the public, but also save the time and money of the brokers and the Commission. By the time our suspicions could be confirmed, if we waited for complaints or to convince ourselves from a study of the pattern of the day to day trading as it appeared on the tape that manipulation was probable, months might have gone

by and hundreds of thousands of shares traded and, of course, large sums of money invested by unsuspecting persons in the purchase of the particular security. By being quick to inquire, we think that we save the public's money. We reduce the period of time for which the market must be reconstructed and find ourselves concerned with a much more limited volume. Instead of asking the brokers for all their trades covering a period of months, we can confine our inquiries to weeks or even days. I confess that this policy has increased the number of "flying quizzes", as we term the early stages of an investigation, but they involve little inconvenience or burden to the public or the brokers when compared with the salutary results which I believe follow from our program. I have reviewed the flying quizzes closed since July 1, 1938, and I find that we have closed 35 of them involving securities traded on the New York Stock Exchange without finding any serious violations of the law. In the conduct of these quizzes, we have interviewed 145 persons or an average of about four interviews per case, of which, I dare say, 50% constituted interviews of brokers or specialists and a good proportion of the remainder interviews with individuals or corporations owning large blocks of the security dealt in. In a number of the cases closed, while we found no serious violation of law, we did find evidence of infractions of exchange rules which were referred to the exchange for disciplinary action. It is rare that a case goes beyond the "flying quiz" stage unless there is some serious violation of law involved.

I would not want to conclude without saying this: An integral part of the enforcement work of the Division are the field investigators of the Commission. Behind every case is a record of their painstaking and exacting efforts. Although their names rarely make the headlines it is they who do the spade-work and uncover the facts without which no case could be successful. They are the shock troops in our war on fraud and manipulation, and like good soldiers, dedicate themselves to the task at hand with a singleness of purpose. They perform their work with tact, loyalty and skill. Without them there would be no story to relate of the enforcement work of the Commission.

/s/ James A. Treanor, Jr.