

"OVER-THE-COUNTER BROKERS AND DEALERS"

ADDRESS

OF

WILLIAM T. LESH

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Congress has provided that over-the-counter brokers and dealers register with the Commission. This is required by Section 15 (a) of the Securities Exchange Act of 1934. Section 15 (b) describes the method for registration. Section 15 (c) (1) authorizes the Commission to adopt rules against deceptive practices of brokers and dealers in over-the-counter markets, and some rules are now in effect under this section.

The compound word "Over-the-Counter" means other than on an exchange, so that an over-the-counter sale of a security is a sale that does not occur upon a national securities exchange, an over-the-counter dealer is a dealer who effects transactions other than on an exchange, and the over-the-counter market is the market made by brokers and dealers who effect transactions other than upon exchanges. An over-the-counter dealer may also be a member of an exchange and effect exchange transactions, but if he has any over-the-counter business, registration normally is necessary.

The words "broker" and "dealer" appear together so often that the important distinction the Securities Exchange Act makes between the words should be noted. I have always felt that members of the investing public very frequently are unaware of the distinction between the word "broker" and the word "dealer" that sometimes exists.

In law, "broker" means "agent". Thus, if you desire to sell securities and deal with a firm acting as your broker, it is acting as agent for you to sell your securities. The broker does not get title to the securities, nor make a profit in the transactions, but normally is paid a commission for his services by the person he represents. The broker owes this person a fiduciary duty to effect the transaction at the best possible price.

If you desire to sell securities and the firm you are dealing with acts as dealer, the firm buys the securities from you for itself at whatever price you both will agree to. Later the firm sells the securities, retaining the difference between what it sold them for and what it paid you, as its profit; or if it sells for less than it paid you, then it suffers a loss. Often a firm, particularly a small firm, will ascertain the amount it can obtain from another firm for your security before purchasing the security from you so that there may be very little risk of loss.

Although this is the meaning usually attributed the word "dealer" by those in the securities business and by the definition in the Securities Exchange Act, it seems to me that in a larger sense the word dealer also includes anyone who deals in or handles securities. In this sense a broker *dealing* with his customers as agent is within the purview of the word "dealer" as well as the word "broker", since the broker is engaged in a course of dealing and since he frequently handles securities of his customers which physically are in his possession. As authority for the view that "dealer" sometimes includes "broker" I refer you to the Securities Act of 1933 which defines dealer as any person who engages as agent, broker, or principal in buying or selling securities. When you add to this, the fact that a securities firm can one moment act as agent and the next moment act as dealer, it is not difficult to believe that the customer may be confused as to whether the firm is acting as his agent trying to get him the best possible price, or whether the firm is buying from him for itself and advising him to sell his security at a low price in order for the firm to obtain the greatest possible profit.

This is sufficient background to introduce to you some of the more serious over-the-counter market problems. Let me use as illustration a case that is now under investigation by the New York Regional Office at the direction of the over-the-counter section. It involves a New York securities firm and a small bank in Clermont, Iowa. In response to a circular letter from the New York firm the Bank sent a list of securities it wanted to sell, including a certificate of deposit for bonds of the Universal Gypsum and Lime Co. having a face value of \$2000.00. The New York firm telephoned long distance offering a price of 90, or \$900, for a \$1000 certificate of deposit. The Bank said it did not desire to split up the certificate but would sell it all at 92, or \$1840.00, and this offer would remain open for one hour. The New York firm telegraphed acceptance of the offer and paid the Iowa Bank \$1840.00 for this security. Actually the security was worth over \$5000.00 and the New York firm made a profit of \$3300, nearly twice as much as the Bank obtained for its security.

Another illustration: One of the members of the staff of the Trading Division reported to us that an acquaintance of his asked an over-the-counter firm to act as broker to sell for him 1000 shares of stock having a limited over-the-counter market. The firm indicated the market price for this security was 55 and acting as dealer purchased from the customer at 55. Later the firm resold the security for 65, a profit of ten dollars a share for one thousand shares, a total profit of ten thousand dollars.

There you have the problem of what constitutes an unreasonable profit in the over-the-counter markets.

Another problem: If you seek to sell an over-the-counter security, how can you ascertain what is the fair market value. There are no published reports to which you can refer to find prices at which actual sales of this security have occurred, as there are reports of stock exchange transactions. Some of the large metropolitan papers publish a list of quotations for a limited number of over-the-counter securities, but these are bids and offerings of over-the-counter dealers, that is, estimates of prices at which they may be able to do business rather than reports of actual sales prices. The National Quotation Service publishes a list of bids and offerings for dealers but this is confidential in nature and is not available to members of the public. What protection have you against an over-the-counter dealer who buys your security at a price that, unknown to you, gives him an exorbitant profit. Suppose you obtained prices from a number of dealers for comparison, and all of them included unreasonable profits? The protection from employment of an over-the-counter firm as broker instead of as dealer may be more theoretical than real, since the head of one firm has estimated that his firm acted as a dealer 95% of the time and as broker 5%. There you have the problem of inadequacy of information available to a member of the public as to the market value of his over-the-counter security. The two problems are complementary since if there were adequate information available to the public it would tend to preclude a dealer from exacting unreasonable profits, and if dealers did not exact unreasonable profits upon occasion there would be much less need for information available to the public as to the market value of over-the-counter securities.

I do not wish to minimize the legal problem before the Commission. If a department store sells you a pair of shoes, or a real estate company sells you a house the selling price may include a very considerable profit for the seller, and the law asks no questions about the extent of that profit. But some people incline to the belief that the sale of securities may be differentiated from the sale of shoes, bananas, or houses and that different standards may appropriately be applied. At one time the public had much less protection against the sale of new issues of worthless securities, but now the blue sky laws of most of the states and the federal Securities Act afford such protection. At one time the public was not entitled to know the profit of an underwriter or the profit of a dealer engaged in the distribution of a new issue of securities, but now the Securities Act includes provisions making such information available. So we hope that within the framework of existing law or within the framework of law and of regulation to be evolved by the Commission, the public may be afforded protection against those over-the-counter dealers who sometimes overreach, to realize a profit that is unreasonable.

The management and method of operation of the over-the-counter section may be described as follows. Miss Steig is in charge of this section, which handles registration of brokers and dealers, and in conjunction with the General Counsel's Office supervises revocation of the registration of those brokers and dealers whose conduct has subjected them to this penalty. Mr. Hopkins is immediately in charge of registration, which is accomplished by a broker or dealer filing Form 3-M with the Commission. This registration becomes effective at the end of 30 days unless the Commission has discovered grounds for instituting proceedings to deny registration. In the meantime the Commission makes a careful search of its records including the indexes of the Securities Violation section and the Complaint section to discover if any reason exists for denial of registration.

An application for registration may be denied, or an effective registration may be revoked if the broker or dealer or any individual partner, officer, director or branch manager, one, has wilfully made a false statement in the application for registration, two, has been convicted within ten years preceding the filing of the application for registration of any crime involving the sale of a security, three, is permanently or temporarily enjoined from any conduct in connection with the sale of a security, or four, has violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, or any rule or regulation adopted by the Commission under those Acts. If any of these grounds are thought to exist the Commission issues an order notifying the registrant of a hearing on the question of revocation of his registration. The hearing is usually conducted by an attorney of the Regional Office where the hearing is held. After the usual procedure prescribed for hearings in the Commission's Rules of Practice has been followed, from the evidence that has been obtained the Commission issues an opinion and order determining that registration should, or should not, be revoked.

There are at the present time six thousand seven hundred fifty-nine over-the-counter brokers and dealers registered with the Commission.