

THE CURRENT MARKET AND ENFORCEMENT ACTIVITIES

Address of

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It is a great pleasure to visit for the first time the floor of the Midwest Stock Exchange and it is an honor to be asked to address the membership of the Stock Brokers' Associates of Chicago here. Since your daily work is directly affected by the administration of the Federal securities laws by the Securities and Exchange Commission, I warmly welcome this opportunity to discuss with you our enforcement activities and certain of the objectives, policies and programs of the Commission as they relate to the current market. I hope that this meeting will contribute to a better understanding of the respective responsibilities of the Commission, the securities industry and the investor.

We have lately been experiencing a renewed surge of interest and activity in the securities markets which has brought the prices of many securities on both the over-the-counter and national exchange markets to levels unparalleled in our history, even in the days of the great bull market of the late nineteen twenties. This spectacular rise in trading activity and in values has, unfortunately, been accompanied by side-effects which have been of serious concern not only to the Securities and Exchange Commission but also to responsible leaders of the financial community.

Under the statutes we administer, we have no authority to control general market price levels, the fluctuation of share prices or the volume of securities traded on exchanges and the over-the-counter markets. Although Congress delegated to the SEC the duty of enforcing the rules relating to margin requirements, it gave to the Board of Governors of the Federal Reserve System the duty of prescribing these rules for the purpose of preventing excessive use of credit in the purchase or carrying of securities. However, the Acts contain specific prohibitions against certain types of activities which might endanger or impair the free and open character of our security markets. The Commission must try to enforce these provisions and must be very much concerned with any conditions which might directly or indirectly have such an effect.

Except for these limitations on credit, the Federal securities acts do not provide any administrative power or procedures designed to control or prevent speculation as such, and leave to the individual free choice as

to whether or not he should go into the market. Perhaps I should also emphasize what is doubtless quite clear to this audience that the Commission does not have any power to pass on the quality or investment merits of a security. The investor or the speculator must make his own decisions. One of the primary purposes of these statutes and of the state Blue-Sky laws is to make available to the public generally reliable information to assist in the making of these decisions.

We have recently expressed some concern in public pronouncements and before the Congress over the extent to which the prices of some securities have fluctuated without visible economic reason, apparently as the result of baseless tips and rumors and often with the apparent participation of a considerable body of public investors. These conditions by their very nature cause us to be concerned whether what in fact occurs is the manipulation of securities prices by the unscrupulous, to the eventual detriment of the naive and unwary. Our concern is not directly with whether prices of securities go up or go down or go sidewise, but is rather whether price movements result from the judgment of buyers and sellers trading in fair, honest and orderly markets free from manipulation and fraud, based upon their evaluation of economic and other factors.

Let me give you a concrete example of the peculiar psychology which I am afraid may be an aspect of the present bull market and which is responsible for much of our concern. Several weeks ago, we had an anonymous tip that a certain security issue was oversold, though the registration statement had not even been filed as yet. We investigated, and found that there was a certain element of truth in the accusation. The syndicate manager, a perfectly reputable New York Stock Exchange house, had actually received so-called "indications of interest" for more shares than were to be offered by an electronics manufacturer. He insisted, and we found ample corroborative evidence, that he had not lifted a finger to sell the stock nor breathed a word of the issue. When we interviewed the brokers who had communicated their interest, we found that most of them had done so because of orders received from their customers. So, we interviewed the customers. One of them had overheard a conversation at a filling station, where he was pumping gas, told his father, who told his uncle, who put in an order for five hundred shares. A second had run out of the lunch counter where he was cashier with change left by mistake by a customer. The customer gratefully gave him a hot tip, and the order went in to the broker. Another customer overheard a couple of strangers discussing the issue in a board room, and at once placed his order. Mind

you, the prospectus was not even in print, let alone filed, and it turns out that the company is a new venture with no earnings record and rather dubious prospects. I have no doubt at all but that the stock will be oversubscribed as soon as the preliminary prospectus is available. We have been completely unable to discover where the rumor started, or who started it. It will probably be a spectacularly successful offering, but I would be foolhardy to forecast what the end result will be to the purchasers.

This psychology is no doubt a factor in the bullish action which has dominated the market price of many issues during the past few years. Many of these situations and the enforcement problems involved are of continuing and vital interest and importance to the Commission, which I represent. It should be of equal importance to each and every broker and dealer that the integrity of the securities markets be preserved. I am convinced that the willingness of the American people to participate in private corporate investment, which has served in very large measure to make possible the tremendous capital expansion of the last few years, is based in substantial measure on the sense of security engendered by the public belief that the present market is honest, just and fair.

An interesting collateral conjecture relates to the possible relationship between the confidence reestablished by the disclosure provisions of the securities laws since the early 1930's when the Securities and Exchange Commission was established by Congress and the increased investor gullibility reflected in the resurgence of the "boiler-room" technique. I am happy to be able to say that most of the large boiler rooms have been driven out of business as a result of the Commission's enforcement efforts. There has developed, however, a more elusive type of activity in which small organizations open for business, sell an issue or two and disappear, often to reappear again in another location and often under another name. Not infrequently, the long distance telephone salesmen work out of hotel rooms, apartments and alleged business offices.

Our main effort, of course, is to stop the boiler room operators. We have been including numerous salesmen in the injunctive actions instituted to halt these operations, but, as a practical matter, it is sometimes difficult to obtain criminal convictions against salesmen, and it is not too easy to reach them even in civil actions. The result is that these individuals float from one boiler room to another as we close down their places of business. In a way, this is rather helpful to us, since we can get some idea of the nature of the business of a new broker-dealer by looking at the list of its salesmen.

But not all the securities transactions which result in serious losses to investors are effected through boiler rooms. We find the most reputable houses at times and, I think, in perfect innocence, mixed up in the most peculiar transactions. Let me cite you another example. In the course of our investigations into Alexander Guterma's dazzling legerdemain, we discovered that a very substantial block of F. L. Jacobs stock had been distributed through a highly reputable broker on foreclosure of one of Guterma's loans. The broker had sold it to some 600 of his customers at about \$7. Since trading in the stock had been suspended by the New York Stock Exchange, and since the source of the stock would seem to have warranted grave suspicion as to the soundness of Mr. Guterma's empire, we asked the broker, out of sheer curiosity, what in the world ever persuaded him to get into this situation. It turned out that one of his office help had gotten into a conversation with an attendant at an industrial exhibit of General Electric, and had been informed that Symphonic Electric, which was in process of acquisition by Jacobs, had a fine future. Upon the assurances of Jacobs' executives that the suspension was only a flea bite and that the company expected a great year, without any up-to-date financial data, without inquiry of any disinterested source, the broker took delivery of the stock and peddled it to its customers. As you know, Jacobs is now in Chapter X, and the position of its stockholders is something less than enviable.

This situation, as well as the incident I described a minute ago present one aspect of a problem that must, it seems to me, give some pause to persons such as you who have their eyes fixed on goals involving something more substantial than the "fast buck." Just what is the duty of a broker? Is it to accept his customer's order for what the broker knows, or should know, is a "dog," without protest and with the attitude of an indifferent seller of merchandise? Or does he owe it to his customer to investigate carefully, and, even though his customer does not ask for advice, to tell him exactly what he is planning to buy? I am willing to go so far as to say that a substantial contributing factor to the speculative hysteria which appears to have attended the activity in some issues has been the failure of many brokers to insist that their registered representatives be customers' men in the true sense of that term, that is, that they be something more than salesmen, and that they be willing to sacrifice a few dollars in commissions in order to protect their customers. The NASD Rules of Fair Practice go at least part way in describing what I conceive as the duty of a broker toward his customer when they say that:

"In recommending to a customer the purchase, sale or exchange of any security, a member shall 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 other security holdings and as to his financial situation and needs."

The Commission has repeatedly and, to my view, very correctly held that the relationship of a securities dealer to his client is not that of an ordinary merchant to his customer and that, inherent in the dealer-customer relationship is the implied representation that the customer will be dealt with honestly and fairly and in accordance with the established standards of the profession. However, I would go further than this, and suggest that these established standards might, perhaps, be reexamined and extended, and that the salesman be charged an affirmative duty to inquire, so far as he can do so discreetly, as to the financial position of his putative customer, and to point out the speculative or other negative aspects of the proposed transaction, if there are any.

The Commission is not solely concerned with fraudulent representations in the offer and sale of securities, such as those broadcast through the boiler rooms. It is also deeply interested by the sudden and unreasonable fluctuation in the price of securities, accompanied by unprecedented activity in them. While we must necessarily rely to a considerable extent upon the cooperation and self-regulation of the exchanges, we find that these gyrations sometimes occur, apparently without arousing any particular inquiries by the floor officials of the exchanges.

The statutory powers of the Commission over manipulative activities are extensive. It is unlawful for any person to create an appearance of active trading in a security or so to act as to raise or depress the price for the purpose of inducing the purchase or sale of a security by others. It is specifically illegal to wash sales or to match orders for the purpose of creating a false or misleading appearance of active trading in any security. It is similarly unlawful to indulge in any deceptive device, such as the dissemination of rumors by persons buying or selling securities to the effect that the price of any security is likely to fall or rise because of market operations conducted for that purpose.

In addition, it may be noted that the Commission is given rule-making power in many important areas in order that it may promote orderly

markets. For example, the Commission, after studying the effects of short selling in the rapidly declining market of 1937, adopted a rule covering the prices at which short sales may be effected on an exchange. This rule effectively prevents short sales in a declining market, thus discouraging "bear raiding." As recently as last month, we filed an action to enjoin violation of this rule in a case where the defendant had represented to his broker that he was "long" several thousand shares which he ordered sold, whereas in fact he owned no stock. His object was to drive the market price down by suddenly throwing a large number of shares on the market and then to buy shares at the reduced market level to cover his previous sales. Since he was selling short and since his sales were not being made on the "up-tick" as provided by Rule X-10A-1, he became subject to civil and criminal sanctions.

Another example of our anti-manipulative rules is the prohibition against payment by persons engaged in the distribution of a security to other persons in consideration of the solicitation of purchases of securities of the same issues on an exchange except under specified conditions. The Commission has also adopted rules governing the stabilization of prices to facilitate a distribution. These requirements, like the general anti-manipulative standards of the statute, operate to prevent brokers engaged in distributing a security from creating an illusion of active trading and from raising the price artificially in order to facilitate the retailing of the stock. The Rules of the Commission establish requirements of disclosure and other controls which operate to prevent deceptive or unfair advantage being taken of the buying public.

We have an active force assigned to detect and prevent manipulation on the exchanges. As you know, each registered exchange is required to furnish a large amount of information to the Commission, including the volume and price of transactions, and, in the case of the New York exchanges, the activities of various classes of persons such as floor traders and information with respect to, among other things, margin trading, short selling and odd-lot transactions. All of this information is currently reviewed by our staff. We have a "market surveillance unit" which watches the recorded transactions on the ticker tapes of the New York and American Stock Exchanges. This unit also observes transactions on the other exchanges and checks the quotations in the over-the-counter market as they are published in the daily National Quotation Sheets, for the same purpose of detecting any unusual activity or price movement in any security which

might indicate the presence of manipulation. This surveillance covers some 20,000 issues. Whenever a question concerning market activity and price level arises with respect to a particular security, a preliminary inquiry is commenced in which the identities and activities of purchasers and sellers are ascertained and reviewed. The regional offices also investigate complaints received from the brokerage fraternity or the public concerning suspected manipulative activity. The very existence of this surveillance has unquestionably, like a cop on the beat, served as a deterrent to illegal tactics.

I mentioned a moment ago the reports filed with us regarding floor traders. I do not know whether floor trading constitutes a problem in the Midwest Exchange. Analyses which we have made of their activities on other registered exchanges have indicated that they tend quite noticeably to exaggerate the swings of the market, particularly where there is a relatively small floating supply of a security. In 1945, the staff of the Commission proposed to outlaw all such activity on the New York exchanges. This move was compromised by the adoption of certain restrictive rules by both of the New York exchanges. In the early 1950's, these rules were rescinded. It may be that they ought not to have been so dropped. In any event, we are currently suggesting to the exchanges that more vigorous floor trading rules be placed in effect upon those exchanges, and, if floor trading constitutes a similar problem on the Midwest Exchange, it is possible that your own organization might find it expedient to suggest similar rules.

There are substantial grounds for belief, indeed, that many of the current gyrations of market prices may be linked up with a thin floating supply of stock. Out of the \$276.7 billion aggregate value of equity securities, listed as of January 1, 1959 on the New York Stock Exchange, about \$45 billion were reported as held by institutional investors, the activities of many of whom are, in the main, acquisitive and who sell from their portfolios relatively seldom. The average turnover of the portfolios of open-end investment companies in 1958 was reported at only about 18 per cent. The investments in equities by these purchasers have grown tremendously in recent years, and they are tending constantly to increase as more institutions are turning from debt securities to equities in order to protect their market position. It is only necessary to point out as an example that there is a noticeable tendency for pension funds to turn to equity investments, and that it has been estimated that such funds may total

as much as \$80 billion within a relatively few years. I have never seen any statistics as to what percentage of equity securities is tied up due to the influence of the capital gains tax and the sometimes peculiar application of the Internal Revenue Service of the tax laws to securities transactions, but it is unquestionably a very sizeable amount. Also, there have always been other substantial blocks of stock which are off the market since they are held for purposes of control. When all of these influences come up against an apparently insatiable public interest, the result is, very naturally, to create a far greater demand than can be satisfied by the supply at hand. It requires no Ricardo or, even a Keynes, to see that prices would tend to rise sharply in such a situation.

If the present market activity continues and prices generally continue to rise, and if these phenomena are accompanied, as I am certain they will be in many issues, by erratic moves in the market, we will continue to be faced with situations in which the problem will arise as to whether manipulative activities are present. However, since it is always easier to manipulate in the general direction of the market, it is difficult to distinguish innocent buying from artificial and unlawful activities. In order to cope with this situation now and in the future, the staff and the Commission are considering new techniques to supplement those already in use in our market surveillance and anti-manipulation programs.

The topics I have discussed with you this afternoon are only a few of the maze of problems which face us under the Securities Acts. This legislation is twenty-five years old last July, and while I have no personal knowledge of what problems there were a quarter of a century ago, I am very certain that they were no more perplexing than those we face today. There is no branch of our organization which is not handling far more work today than it was even a year ago. Let me give you a few statistics on which you might chew. During the fiscal year beginning July 1, 1958, up to April 23, 1959, there were 953 registration statements filed with us, covering securities having an aggregate value of \$14.5 billion. During the same period ending April, 1958, there were 742 issues filed having a value of \$13.7 billion. I might point out that, for workload purposes, the important figure is the number of issues, which represents about a 25 per cent increase in one year. After detailed review in our office, we have referred 34 cases of various types in the nine months since last July for criminal action. This is exactly the number we referred during the two-year period ending last July. You know from personal experience how active the

market has been, and how many transactions must be watched by our staff. The number of disciplinary proceedings we have been required to institute against brokers has hit a new high. Everywhere I turn, I find the same tendency.

I am not trying deliberately to court your sympathy by citing these figures. I merely ask you to take them into consideration if you encounter delay or error in your dealings with our organization. Perhaps they may also convince you that the Securities and Exchange Commission is far from being a moribund bureaucracy, and that it must stay dynamic and strong if it is properly to carry out the duties assigned to it by law. The securities industry can be of very great help to us in this endeavor. The stock exchanges are, as I can testify from personal knowledge, eager to be of help to us. In fact, were it otherwise, I am very sure that our machinery would break down completely. So, also, the member firms of the exchanges can be equally helpful.

The statistics I have quoted, which I could enlarge on practically endlessly, furnish a very good reason for this appeal for your cooperation. We have all too few personnel to handle the routine work of our organization. I do not think it is asking too much that we be permitted to assume that the responsible element of the securities industry will continue, as is contemplated by the Securities Exchange Act of 1934, to a large extent to police itself and thus free our staff to concentrate on the less reputable group. In these difficult days, I can do little but remind you of this fact and ask you soberly to review your policies and your activities to make sure that they are consistent with the highest ethical standards. As a result of this reappraisal, perhaps we can reaffirm our mutual dedication to the work we have in common, the preservation, no less, of that free and honest capital market which is essential to our national economic welfare.