ADDRESS

OF

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SECURITIES AND EXCHANGE COMMISSION

Before the

MAINE INVESTMENT DEALERS ASSOCIATION

PORTLAND, MAINE

October 27, 1937.

It would be less than gracious on my part to refrain from acknowledging the compliment implied in the invitation to address your organization. I must confess that my acceptance was not without some trepidation, in view of the all but unique position of the State of Maine in the 1936 election columns.

Upon reflection, however, it was clear that I assumed no real risk. There are no longer any frontiers in the securities business. It appears to be a far cry from Portland, Oregon to Portland, Maine, with a vast continent lying between; yet, the problems of the Maine Investment Dealers Association are, in their broad outlines, the same as those of the Bond Traders Club of Portland, Oregon. Whatever influences materially affect the business in Los Angeles, in Seattle, in Denver or in Chicago will be felt in Atlanta, in New York, in Boston and in Maine. The enormous advances made in our time in the development of the facilities of communication and transportation have had profound and enduring consequences upon our civilization. Not the least of these has been the virtual destruction of sectional and political boundaries where commerce and industry are concerned. Your business, like many others, has come to assume national characteristics and, by the same token, national responsibilities.

Hence it is, that I feel myself on familiar and friendly ground in discussing with you some aspects of federal regulation which relate to the business as a whole. These matters concern you as closely as they concern the dealers in any other section of the country. In this respect, if I may transpose a well-known slogan--as the nation goes, so goes Maine.

Among the measures adopted by the Commission of current interest to you are the over-the-counter rules which became effective on October 1. Recurrent in these rules is the principle that in his relations with a broker or dealer, the investor is entitled to truthful and candid information which may help him to arrive at sound conclusions.

Thus, the rules prohibit a broker or dealer from bringing about the purchase or sale of a security by fraud, misrepresentation or concealment. A specific prohibition is directed against representing that the registration of a broker or dealer indicates that the Commission has passed upon his financial standing, business or conduct, or has approved the merits of any security in which he is interested. The undesirable effect of any such representation upon the mind of the investor is obvious.

Certain affirmative disclosures are also prescribed by the rules. A broker-dealer is required to notify a customer whether his capacity in the transaction is that of broker for the customer, dealer for his own account, broker for some other person, or broker for both parties. It needs little argument to demonstrate that a customer should be aware of the exact nature of the relationship between himself and his broker-dealer. Obviously, the impact of advice or sales effort upon a customer's judgment may vary according to whether it emanates from a broker who bears a fiduciary relation to him, or from a dealer who does not. It may also be important for him to realize that a broker who undertakes to act as his agent is also acting as agent for another in the same transaction.

Certain features of the rule embodying this requirement deserve brief mention. In order that the attention of the customer may be sharply focussed upon this question of capacity, the rule requires that disclosure be made in each transaction. Hence, a general or "blanket" disclosure with respect to future transactions will not suffice. Moreover, if the rule is to be effective, the language of the disclosure should be clear, unequivocal and easy of comprehension by the average customer. The time fixed for the disclosure is "at or before the completion of the transaction"; but sound practice would seem to dictate that the customer be supplied with the information at the earliest possible moment.

The rules further require that a broker-dealer controlling, controlled by or under common control with an issuer disclose to his customer the existence of such control. Here, again, it seems clear that knowledge of the connection between the broker-dealer and the issuer may enable the customer more accurately to size up the situation. This disclosure must precede the making of a contract with or on behalf of the customer. It may be oral provided that a written notification is sent to the customer before he parts with value.

If a broker is participating or otherwise financially interested in the distribution of a security he must reveal that fact to a customer. This provision is likewise applicable to a dealer who is being paid by the customer for investment advice. In either case the customer, in considering the advisability of entering into the transaction, is entitled to be informed that his agent or investment counsel is interested in the distribution of the security. It is, perhaps, pertinent to observe that a distinction may exist between a financial interest in a security and a financial interest in its distribution. It is only under the latter circumstance that the disclosure is prescribed.

Where a broker or dealer is financially interested in the distribution of an unlisted security he may not represent to a customer that the security is being offered "at the market" unless he knows there is a market other than that made or controlled by the distributors. The customer ought to know, if it be the fact, that the price is controlled by the broker-dealer or his associates. Moreover, the question of marketability is a material one in the calculations of the average customer and he ought not to be led into believing that a broader market exists than is actually the case.

A broker-dealer who is vested with discretion over his customer's account is precluded from effecting transactions which are excessive in size or frequency in view of the financial resources and character of the account. Thus, where a customer assigns his judgment to the keeping of another, the law imposes a limit upon the activity in the account. A further safeguard is provided for the customer against the unscrupulous broker-dealer and for the broker-dealer against the unscrupulous customer by a requirement that immediately following each discretionary transaction a record be made of the name of the customer, the name, amount and price of the security and the date and time when the transaction occurs. This record, it is anticipated, should obviate disputes over the allocation of transactions to discretionary accounts.

Finally, a participant in the distribution of a security is prohibited from paying any other person for soliciting purchases on an exchange of that or any other security of the same issuer, or from paying another person for effecting purchases of any such security on an exchange, except for the account of the participant himself. If any such payment is made in connection with a distribution, subsequent sales or deliveries of the security by the participant are prohibited. This rule, it is expected, will go far toward purging the market of the practice of "painting a picture on the tape" by the subsidization of customers' men and others.

I have endeavored in this brief summary of the new over-the-counter rules to indicate how they fit into the pattern of regulation and advance its underlying purposes. I would like now to turn to another motif in the pattern in which your organization has heretofore manifested an active interest -- the subject of unlisted exchange trading.

As I have indicated, one of the basic concepts of the laws administered by the Commission is that adequate information should be made available to investors with respect to securities which are the subject of public trading.

Concerning a multitude of securities traded exclusively over the counter little authentic information was formerly procurable. The 1933 Act dealt with this situation by requiring registration as a condition precedent to a public offering of any security. By an amendment to the 1934 Act and the rules promulgated thereunder, any issuer of substantial size, when seeking new capital, is required to keep current its registration statement filed under the 1933 Act. But until an issuer comes to the public for financing, registration is not required and, hence, even now comparatively little is known about many over-the-counter issues. The organized exchanges, on the other hand, have long recognized that a security ought not to be admitted to exchange trading upon application of the issuer, unless the latter agrees to furnish adequate information. This principle was codified in the 1934 Act.

When Congress came to consider the question of unlisted exchange trading, however, it was confronted with an anomalous situation. Since securities were admitted to unlisted trading privileges without any action on the part of their issuers, appropriate information concerning many securities in this category was not available. Here, then, was a type of exchange trading which was in direct conflict with one of the fundamental principles of the 1934 Act. Because of the magnitude and importance of the questions involved, Congress made no final disposition of the problem for a two-year period and directed the Commission in the interim to make a study and recommend the course which should be taken with respect to this kind of trading.

The Commission made a study of the situation and submitted its report to Congress on January 3, 1936. It was found, among other things, that of the 23 national securities exchanges, 16 had unlisted departments. Leaving out of account the New York Stock Exchange on which there is no unlisted

trading, as of December 15, 1935, 1,370 issues of stock involving a total of 1,875,291,931 shares and 564 issues of bonds with a face value of $6,882,396,436 enjoyed unlisted status on exchanges, as against 1,735 issues of stock involving a total of 1,326,777,428 shares and 513 issues of bonds with a face value of $6,207,092,920 having a listed market.

The Commission was faced with two alternatives. It could either recommend that this great volume of unlisted stocks and bonds be stricken from the exchanges or that unlisted trading privileges be permitted to continue subject to appropriate safeguards. The wholesale dumping of these securities into the over-the-counter market might well have resulted in considerable dislocation of the market machinery and serious impairment of security values. Accordingly, the Commission recommended the second course and, as a result, the Congress adopted certain amendments to Section 12(f) of the 1934 Act.

Under the amendments, three types of unlisted exchange trading are permitted. In the first category are those securities which were admitted to unlisted trading privileges on exchanges prior to March 1, 1934. It is with respect to these securities that adequate information may not be available and, therefore, the Congress determined that there should be no expansion in this category. It was believed that if this type of trading were prevented from expanding, it would be graduálly diminished through the liquidation or reorganization of issuers, the retirement or redemption of securities, and the transition of securities to a fully listed or fully unlisted status.

The trend in this direction is indicated by the following figures. On October 1, 1934, 3,918 issues were admitted to unlisted trading on national securities exchanges. To this figure may be added 55 issues which were so admitted on the Chicago Curb Exchange and the Standard Stock Exchange of Spokane when those exchanges became registered in the latter part of 1935,

making a total of 3,973 issues formerly enjoying unlisted trading privileges. As of September 30, 1937, there were 2,212 issues in this category. Thus, during the last three years, the number of issues admitted to unlisted privileges has been decreased by 1,761 or about 44% of the former total. It is reasonable to assume that some of these securities passed into the over-the-counter market while others became fully registered on exchanges.

The second category of securities to which an exchange is permitted under the 1936 amendment to extend unlisted privileges, includes those which are already listed and registered on some other national securities exchange. A distinguishing fact here is that comprehensive information is available with respect to the issuer by virtue of the registration of the security on the other exchange. However, the availability of information does not alone satisfy the requirements of the Act. In addition, it must be established to the satisfaction of the Commission that there exists in the vicinity of the exchange sufficiently widespread public distribution and sufficient public trading activity in the security to render the admittance thereof necessary or appropriate in the public interest or for the protection of investors. Finally, even if these conditions are satisfied, the Commission is required to deny the application unless it finds that such admittance would in all other respects be in the public interest.

To date, under this provision, applications have been filed by seven exchanges requesting unlisted trading in 71 securities. The applications cover 65 stocks and 6 bonds. Of those relating to stocks, 7 were granted in round lots and odd lots, 25 were granted in odd lots only, 11 were

denied, 3 were withdrawn, decision was reserved with respect to 2 and recent applications covering 17 are now pending before the Commission. Of the 6 bond applications, 1 was granted, 4 were denied and 1 is pending.

Securities eligible for unlisted trading under the third category are those in respect of which there is available from registration statements, periodic reports and other data filed with the Commission, information substantially equivalent to that available with regard to a security listed and registered on a national securities exchange. Here, also, the standards of distribution, trading activity, and public interest, which I have mentioned, must be satisfied.

Thus far the New York Curb is the only exchange which has sought to admit securities in this class. It has filed applications covering 22 bond issues which are presently traded in the over-the-counter market. Of these, 4 were withdrawn, leaving 18 applications awaiting disposition. A hearing was held in this matter on June 15, 1937, at which Mr. Chase appeared on behalf of your association. Other associations were also represented as were several over-the-counter dealers.

In order to indicate the complexity of the problem, it may be of interest to review various of the arguments advanced in opposition to and in support of the applications. Mr. Chase suggested that a system of security distribution should be developed which would bring home to investors the responsibilities of ownership. In this way, he contended, securities would cease to be "poker chips" passing from hand to hand in the interests of activity and speculation and would be held for more or less permanent investment. He made the further point that it is the distributor rather than the exchange broker who maintains a continuing interest in his customers and

provides them from time to time with complete information concerning the issues he has sold to them. He emphasized that the admission of these securities to exchange trading would tend to destroy the responsibility of the underwriter and his associates to furnish information to their customers and to protect the market for their securities.

On behalf of other over-the-counter representatives it was contended that by reason of the greater activity over-the-counter, a more stable market is maintained and the customer receives a better execution; that once a security is admitted to exchange trading, the efforts of over-the-counter dealers in making a market must be terminated; that if all the better grade over-the-counter securities were to be transferred to the unlisted departments of the exchanges, the business of over-the-counter dealers would be confined to inferior securities; that the exchange market for these bonds would be essentially parasitical and the specialists would make such markets as would enable them to even out their transactions in the over-the-counter market at a profit directly chargeable to their customers; that because of the thinness of the exchange market in bonds of this type, any quantity of buying or selling would cause wide price fluctuations and the quotations and transactions on the exchange would be misleading and spurious; and that the "print" on the exchange would facilitate high pressure distributions off the exchange.

On the other hand, in support of the applications it was argued that the investor who entrusts an order to a member has the benefit of two markets and his broker will execute the order in the more favorable of the two; that bonds admitted to unlisted trading are more readily accepted as collateral for loans; that as competitors the specialists are closely

restricted by exchange rules whereas the outside dealers are under no similar restrictions; that transactions on the exchange are given wide publicity and, hence, investors can more readily check the price movements of their securities; and, finally, that transactions in securities admitted to exchange trading are subject to the anti-manipulative provisions of the 1934 Act.

From this resume it is apparent that there are many factors which have a bearing on the issue in these cases. It would not, of course, be appropriate for me to comment on the pending applications. My purpose is merely to indicate that there is no short answer to this problem of unlisted trading.

Under the Act, the Commission is placed in the position of impartial arbiter. Some securities should be traded in the over-the-counter market, others on exchanges, and still others may be appropriate for trading in both markets. The approach to this problem may best be described as an endeavor to create a fair field of competition between exchanges as a group and the over-the-counter markets as a group and to allow each type of market to develop in accordance with its natural genius insofar as this development is not inconsistent with the public interest.

During the last three years, a great deal of progress has been made by the Commission in the solution of those problems which touch you most closely. Many questions of vital import still remain to be settled. We have, from the beginning, considered the active cooperation and support of such organizations as yours to be essential to the formulation of a sound and workable program of regulation. May I, in closing, express the sincere hope that in the tasks which lie ahead, we may continue to count upon your aid.

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