NASD News

PUBLISHED BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Volume III | Philadelphia, Pa., November 1, 1942 | Number 2

SEC PRESCRIBES CAPITAL RATIO; COMMENTS ON NASD RULE

Disapproving the Association's rule establishing minimum capital requirements for members, the SEC has *adopted* for all registered brokers and dealers a rule providing that aggregate indebtedness shall not exceed 2,000 per cent of net capital. Effective date of the Commission's rule is in suspense pending conferences with NASD and other interested parties on definitions of "aggregate indebtedness" and "net capital" as well as any other matters pertaining to the rule. In any event, the Commission said, its rule would not become effective earlier than January 1, 1943.

The text of the rule (X-15C3-1) adopted by the Commission follows:

"(a) No broker or dealer shall permit his aggregate indebtedness to all other persons (exclusive of indebtedness secured by exempted securities) to exceed 2,000 per centum of his net capital (exclusive of fixed assets and value of exchange memberships).

Certain Dealers Excluded

"(b) The provisions of this rule shall not apply to any broker or dealer who (1) does not extend credit to any person to whom he sells or for whom he purchases any securities, and (2) does not carry money or securities for the account of customers or owe money or securities to customers, except as an incident to transactions with or for customers which are promptly consummated by payment or delivery; *Provided,* That credit shall not be deemed to be extended by reason of a bona fide delayed delivery of any such security against full payment of the entire purchase price thereof upon such delivery within thirty-five days after such purchase.

"(c) This rule shall not become effective until further order of the Commission and, in any event, not earlier than January 1, 1943."

The NASD has informed the Commission of its readiness to confer on matters related to the rule. Members of the Association will receive a report on such conferences as soon as appropriate.

The SEC has drafted a rule, to be known as X-17A-5, under which all registered brokers and dealers will be required to file financial statements with the Commission once a year. This rule is expected to be promulgated in the near future.

The SEC, in disapproving the Association's rule establishing minimum capital requirements, commented on certain phases of NASD policy and procedure, the more pertinent of these being as follows:

"In submitting the proposal to its membership, NASD distributed an open ballot which required a statement of the voter's firm name and the signature of its executive representative. This type of ballot was criticized by some of those who appeared before us in opposition to the rule. It has been charged that but for the open ballot the proposal would not have been approved by a majority, and it is suggested that the necessity of signing the ballot may have influenced some of the small dealers to vote in favor of the proposal or to refrain from voting at all, in order to avoid possible discrimination.

"The by-laws of NASD do not expressly require a secret ballot for this type of proposal, and the Association has in the past, in submitting amendments to its membership, used the signed, open type of ballot.

"Upon consideration of all the circumstances, it is our view that charges of unworthy motives in the selection of the type of ballot are unwarranted. However, we are constrained to add that it now seems, largely as a matter of hindsight, that the use of a secret ballot would have been preferable. . . .

"We are completely convinced that in proposing the rule and urging us and its membership to approve it, the Governors of the NASD were actuated by no improper or hidden motives; that their only purpose was to safeguard

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THANK YOU—

The Executive Committee is unable to acknowledge individually the numerous letters received from members commenting favorably upon the Association's letter and memorandum to the SEC of October 20 on the proposed "Disclosure of Market Price" Rule—X-15C1-10. The responses of members to these communications were very gratifying to the Committee. Members' original letters to the Association when the proposed rule was initially distributed in August were of material aid to the Committee in preparing its statements on the proposal and the Committee wishes again to express its appreciation for the comments sent in at that time.

Gilbreath Elected to Board; District Changes

W. S. Gilbreath, Jr., Vice-President, First of Michigan Corporation, Detroit, has been elected to the NASD Board of Governors by members of District No. 8 (Illinois, Indiana, Iowa, Michigan, Nebraska, Wisconsin) to succeed Francis F. Patton, on leave of absence from A. G. Becker & Co., Incorporated, to serve as Executive Manager of the Victory Fund Committee, Federal Reserve Bank of Chicago. Mr. Gilbreath is former Chairman of the Michigan Group of the Investment Bankers Association of America and is Vice-Chairman and a member of the Executive Committee of the Michigan Victory Fund Regional Committee.

Military and other war duties have brought a number of changes in Committees of the Association. Changes on various District Committees which have developed in recent weeks follow:

DISTRICT NO 1
(Idaho, Oregon, Washington)

Richard H. Martin, Chairman, of Ferris & Hardgrove, resigned. He was succeeded by George R. Yancey, Murphy Favre & Co., Spokane. Frank A. Bosch, Warren Bosch & Floan, Portland, also resigned. Fred M. Blankenship, Blankenship & Gould, Inc., Portland, and June S. Jones, Atkinson, Jones & Co., Portland, fill the vacancies on the Committee.

DISTRICT NO. 2
(California, Nevada)

Willis H. Durst, O'Melveny, Wagenseller & Durst, Inc., Los Angeles, elected to fill unexpired term of Donald O'Melveny, deceased.

DISTRICT NO. 4

James M. Dain, J. M. Dain & Company, Minneapolis, and William Mannheimer, Mannheimer, Caldwell, Inc., St. Paul, resigned, to be succeeded by Charles A. Fuller, Charles A. Fuller Company, Minneapolis, and Sidney H. Henderson, Henderson-Weidenborner Company, St. Paul.

DISTRICT NO. 5
(Kansas, Oklahoma, Western Missouri)

Walter I. Cole, Beecroft, Cole & Company, Topeka, and A. E. Weltner, A. E. Weltner & Co., Kansas City, elected to vacancies on the Committee.

DISTRICT NO. 6
(Texas)

Lewis Pollok, George V. Rotan Co., Houston, and John D. Williamson, Mahan, Dittmar & Company, San Antonio, elected to Committee; J. L. Mosle, Mosle and Moreland, Inc., Galveston, and Elmer A. Dittmar, of Mahan, Dittmar & Company, San Antonio, resigned.

DISTRICT NO. 7
(Arkansas, East Missouri, Kentucky)

J. Mountford Aull, Bankers Securities Company, St. Louis, elected to Committee to succeed John D. McCutcheon, John D. McCutcheon and Co., Inc., St. Louis; James R. Vinson, of J. R. Vinson and Company, Incorporated, Little Rock, resigned; vacancy to be filled by annual election.

DISTRICT NO. 8

William W. Miller, Gavin L. Payne & Company, Inc., Indianapolis, elected to the Committee to succeed G. William Raffensperger, of Raffensperger, Hughes & Co., Inc., Indianapolis, resigned; Eugene McGuire, McGuire, Welch & Company, resigned from the Committee.

DISTRICT NO. 10

Robert J. McBryde, James C. Willson & Co., Louisville, resigned from the Committee.

DISTRICT NO. 12
(Pennsylvania, Delaware)

Nathan K. Parker, Chairman, of Kay, Richards & Company, Pittsburgh, resigned. William K. Barclay, Jr., Stein Bros. & Boyce, Philadelphia, succeeds Mr. Parker as Chairman. Joseph Buffington, Jr., Young & Co., Inc., Pittsburgh, succeeds Mr. Barclay as Vice-Chairman. Willard S. Boothby, E. H. Rollins & Sons, Inc., Philadelphia, elected to succeed John C. Bogan, Jr., Sheridan, Bogan Co., Philadelphia.

$1,000 Fine, "Emphatic Criticism" in Profits Case

The Committee, in its consideration of these transactions, rejected as specifically contrary to the intent and principles of the Rules of Fair Practice of the Association, particularly Section 4 of Article III thereto, the contention that the profit charged a customer in any individual transaction can be justified on the basis of the average margin of profit earned by a member on all of its transactions.

The above is an extract from an opinion of a District Business Conduct Committee in a case involving findings that the member had charged customers unfair prices. In part, the member's defense was that the profit margins which formed the basis of the complaint were made in line with the policy of the organization to realize a certain average profit on all transactions.

A fine of $1,000 was imposed by the DBCC with which was coupled "most emphatic criticism" of the member's practice "because of the fact that its practices with respect to profits had been the subject of previous censure by the Committee."

Testimony at the hearing of this complaint disclosed that the firm, prior to the initial censure of its profit policies by the DBCC in mid-1940, effected sales of bonds to its customers as a regular practice at a fixed profit of 5 points above its cost. As a result of the Committee's criticism, this was reduced to 4¾ points. Further testimony developed that the firm's schedule of so-called "maximum" profits was a goal consistently achieved without regard for relationship of price charged to prevailing market except under the terms of the schedule described.

Oil Royalty Dealers Expelled for Charging Unfair Prices

Two members of the Association have been expelled on complaints involving charges that they sold oil royalties to investors at unfair prices in violation of Sections 1 and 4 of Article III of the Rules of Fair Practice. These are among the first disciplinary actions of the Association against members dealing in oil royalties.

Profits of from 35 to 132 per cent, representing mark-ups ranging from $115 to $1,125 per transaction were the basis for one of the complaints; profits of from 25 to 81 per cent, representing mark-ups of $126 to $722 per transaction were the basis for the other complaint. These profits were realized over and above cost of the royalty interest to the dealer and in practically all of the transactions forming the basis for the complaints, purchases and sales were effected on the same day.

The two members did not deny that the alleged profits were made. The defense of each was that the profits were fair and that each sale had been made in compliance with requirements of the Securities and Exchange Commission.

Oil royalties have been defined as "securities" and so come under the provisions of the Securities Act of 1933. The SEC requires that issues, offerings or sales of oil royalty interests, the aggregate amount of which exceeds $100,000, must be registered. Where the aggregate amount of the issue, offering, or sale is less than $100,000 it is exempted from registration provided certain other requirements are complied with. In such instances, among other things, the initial offer to sell such security must be made by means of a so-called offering sheet which discloses (1) the proposed maximum offering price of the smallest fractional interest being offered; and (2) the proposed maximum aggregate offering price, as well as other material facts.

Prices in Offering Sheet

The two members expelled claimed that the prices charged by them in no instance exceeded the maximum offering price contained in the appropriate offering sheet covering the issues sold by the members. They further asserted that they had made studies of the properties to satisfy themselves as to the merits of the royalties. In addition each of the members during hearings of the complaints argued that both the wholesale and retail dealer filed required information with the SEC including the full consideration received in payment. They argued that if such considerations were fraudulent, the SEC would have acted.

The District Business Conduct Committees which heard the cases rendered decisions expelling the members. Both appealed to the Board of Governors. The National Business Conduct Committee, for the Board, held hearings on these appeals. In its memorandum opinion recommending upholding the expulsion order against one member, the National Committee said:

"Upon study of the record, it is disclosed that this respondent used the proposed maximum offering price set forth in the schedules as the basis for its selling price to the public. When this practice is considered in relation to respondent's profits on individual transactions it is quite apparent that the District Business Conduct Committee believed that such profits might not have been realized without the use of these schedules. Therefore, it reasonably follows that the customers conceivably were misled or may well have been deceived. However, customers were not contacted and there is no evidence to substantiate this. Further, it must be borne in mind that the law requires that these oil royalty units must be sold under the appropriate schedule. Therefore, it is not the schedule itself which is wrong but a misuse of that schedule.

"We believe that to base a sales price to the public on this schedule offering price is a misuse of the schedule and the proposed maximum offering price set forth, and we further believe that such a use of the schedule was never contemplated by the Securities and Exchange Commission."

Information Not Sufficient

The contentions of the now expelled members was that in no instance had their sales prices exceeded the maximum prices prominently displayed on the appropriate offering sheet but both the District and National Business Conduct Committees concluded that the information supplied the customer as to the purpose of the offering sheet was not sufficient for him to appreciate the real import of the maximum prices listed. One of the respondents admitted he made no further disclosure to the customer in respect to the matter of computation of the sale price other than was listed on the offering sheet.

During the hearings, this respondent said:

"As to the profits concerned in oil royalties . . . in my estimation if a customer is handed a piece of paper, which is a duplicate of an effective offering sheet filed with the Securities and Exchange Commission, setting forth a maximum offering price at which that royalty may be offered—even though that price may have been put in for another purpose . . . still the fact remains that there is an implication, a definite implication, conveyed to the customer, that that is the sale price of that royalty."

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PUBLISHED PERIODICALLY BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., 1616 WALNUT STREET, PHILADELPHIA, PA.

Uniform Financial Report Approved by Various Bodies

Solution of a problem which has vexed brokers and dealers for a number of years appears near at hand. Instead of compiling as many as a dozen or more different reports of financial condition for stock exchanges, various Federal, state and other regulatory agencies, a single form has been agreed upon which, it is expected, will be acceptable to all of these parties in the future.

Final acceptance of the form has not been officially announced by the several authorities concerned but it is currently indicated that such acceptance will be forthcoming. As a result, brokers and dealers registered with the Securities and Exchange Commission, who are members of NASD, who are licensed by a state requiring financial reports and who also are members of one or more stock exchanges, will be permitted to use one financial report form to meet requirements of all or most of these.

The need for a uniform financial report has been pointed to many times in the past. Stock exchanges, many states, the Federal Reserve Board under certain circumstances, as well as other agencies, have had requirements of this kind. The SEC, when it proposed to require annual financial reports from registrants, recognized that it might add to this burden.

Development of the uniform financial report mentioned above is the outgrowth of the co-operative efforts undertaken at the behest of leaders in the securities business and the SEC, as well as appropriate members of the National Association of Securities Commissioners who are the heads of the various State Securities Commissions.

(*Continued from page 1*)

the industry and the investor—a desirable end to which the NASD has already made notable contributions. We think also that fairness to the NASD requires us to say that when the rule was first discussed the Commission was inclined to view it favorably. This, however, was a purely tentative view, and a close study of the proposal and of the problems associated with it, and careful consideration of all the facts and all the arguments which have been presented for and against the rule have forced the conclusion that the proposed rule does not conform to the statutory standards. Therefore we must disapprove it. . . .

"Further, Sections 15A (b) (1) and (2), applicable to this case, require that an association have a sufficient 'number of members' and that it be 'so organized' and 'of such a character' as to comply with the provisions and carry out the purposes of the Act. The expulsion of small firms and the limitation of the NASD to representation of larger firms is an inevitable result of the proposed rule, and the loss of so large a segment of its membership, merely because the firms are small, vitally and adversely affects the organization and character of the NASD as representative of the over-the-counter industry. No matter what state jurisdictions and exchanges may require, the legislation to which a national securities association must conform clearly intends that size shall not be a criterion of selection of membership or a basis of distinction in bringing to investors the advantage of co-operative regulation."

Members Advised to Prepare Against Air Raids

All types of securities contracts containing a time clause should be oriented to contingencies that are likely to arise in war times and the Association's National Uniform Practice Committee is currently recommending that all members make specific provisions for such unforeseeable eventualities.

Recent experiences, growing out of a practice air raid alarm during trading hours, led to consideration of ways and means of accommodating established procedures to future incidents of this kind. It was finally decided by the Uniform Practice Committee that no blanket ruling could be made that would be sufficiently automatic to meet the problem and in lieu thereof advises members of the necessity of precautionary action.

Buy-ins and other notices, deliveries, tenders for sinking funds, stock options and warrants and a number of other trading devices and processes commonly have time limits during which they are enforceable.

The possibility is foreseen that such contracts could be elapsing when business activity would be brought to an abrupt halt by a practice or actual air raid alarm. A practice alarm might last but a few minutes or an hour but an air raid might interrupt normal activities for a prolonged period.

To prevent misunderstandings and disputes, therefore, it is being recommended that members, when granting or accepting options or firm bids and offerings for the purchase or sale of securities make specific provisions for occurrences that might prevent consummation of the contract in the time allotted.

Rule on Non-Member Dealings

Members should be fully informed as to Association requirements respecting dealings with non-members. Obligations of members in this regard are set forth in the Rules of Fair Practice, Rule 25, appearing on Page C-13 of the MANUAL. In part, this Rule reads as follows:

25. (a) No member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(b) Without limiting the generality of the foregoing, no member shall

(1) in any transaction with any non-member broker or dealer, allow or grant to such non-member broker or dealer any selling concession, discount or other allowance allowed by such member to a member of a registered securities association and not allowed to a member of the general public;

(2) join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof; or

(3) sell any security to or buy any security from any non-member broker or dealer except at the same price at which at the time of such transaction such member would buy or sell such security, as the case may be, from or to a person who is a member of the general public not engaged in the investment banking or securities business.