CHAPTER III

BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS—ACTIVITIES AND RESPONSIBILITIES

SUMMARY TABLE OF CONTENTS

DETAILED TABLE OF CONTENTS

A. INTRODUCTION

B. SELLING PRACTICES

C. RESEARCH AND INVESTMENT ADVICE

D. PROTECTION OF CUSTOMERS' FUNDS AND SECURITIES

E. DELIVERY OF SECURITIES

F. THE BROKER-DEALER AS CORPORATE DIRECTOR

TABLES

APPENDIXES

CHAPTER III

BROKER-DEALERS, INVESTMENT ADVISERS AND THEIR CUSTOMERS—ACTIVITIES AND RESPONSIBILITIES

A. Introduction

The firms and individuals who assist the public in its selection, purchase, and sale of securities are engaged in a business, and a large and important one. It is also an unusual business in that, complex as it is and involving as it does intricate merchandise and the handling of other people's funds and securities, and the existence of relationships often based on trust and confidence, it has come to be surrounded by more legal restraints, and has imposed on itself more ethical standards than most other businesses. Yet it remains, for most of its segments, essentially a business of merchandising securities.

Broker-dealers and investment advisers perform a wide variety of functions, but those which concern chapter III involve the activities and responsibilities most directly affecting public customers. Most prominent are the methods by which broker-dealers and their salesmen induce customers to purchase and sell securities: the practices involved, the legal rules and ethical standards which should govern their conduct while selling, and the controls by which these rules and standards are enforced (pt. B). Important too are the nature and manner of preparation of the vast amount of investment advisory materials supplied to the public, the obligations of the broker-dealer and investment adviser firms which disseminate it to the persons who receive and often rely on it, and the agencies by which it is controlled (pt. C). The manner in which the broker-dealer community provides protection for its customers' funds and securities is another matter of public concern (pt. D), as is the subject of the delivery of securities (pt. E). Finally the chapter considers the potential impact on the public of the role played by members of the securities industry as directors of publicly held companies (pt. F).

1. LEGAL AND ETHICAL OBLIGATIONS OF THE INDUSTRY TO THE PUBLIC

The legal restraints and ethical standards surrounding the securities industry are frequently and rather loosely covered by the umbrella phrase of "fiduciary and quasi-fiduciary obligations." The phrase is perhaps overused, and may obscure significant distinctions between actual legal obligations and ethical ideals. Nevertheless, its use does correctly indicate that brokers, dealers, investment advisers, and their employees have special obligations to deal fairly with the members of the public, whether they be called customers or clients, and that these obligations are above and beyond the ordinary obligations imposed on sellers of other types of merchandise. These obligations are imposed both by Federal and State laws relating to the sale of securities, and by the rules, regulations, and practices of the national securities exchanges and the National Association of Securities Dealers, Inc. A brief review of the most significant legal and ethical obligations affecting the industry is necessary to an understanding of the material which follows.

The obligations of broker-dealers and their salesmen to the purchasers of securities recommended by them may well be the area in which the legal and ethical obligations have been most frequently defined and least effectively achieved. In the often reiterated words of the Commission, the representation that the purchaser "will be dealt with fairly in accordance with the standards of the profession" is basic to the relationship between a broker-dealer and his customer.[1] An obligation of fair dealing, based upon the general antifraud provisions of the Federal securities laws,[2] rests upon the theory that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public. While the Commission has prescribed no general "standards of the profession," it has used the "shingle" theory in various decisions to develop certain specific standards. The prices of securities sold by any broker-dealer must be reasonably related to the market price,[3] he may only execute transactions authorized by his customers,[4] he must be solvent and financially able to perform his contracts,[5] his recommendations to his customers must have an adequate basis,[6] and a market letter distributed to arouse customer interest in a security must provide an accurate presentation of the status and prospects of the company.[7] Recent boiler room cases have also suggested that the lack of suitability of a security recommended for purchase by a customer, in the light of his particular financial situation and investment objectives, is a factor to be considered in determining whether a broker-dealer has fulfilled his legal obligation to treat customers fairly.[8] In another line of cases, the Commission has held that where a relationship of trust and confidence has been developed between a broker-dealer and his customer so that the customer relies on his advice, a fiduciary relationship exists, imposing a particular duty to act in the customer's best interests and to disclose any interest the broker-dealer may have in transactions he effects for his customer.[9]

Whatever the extent of a broker-dealer's legal obligation to recommend securities which are not unsuitable to the particular customer, his ethical duty to do so is clear under the express language of article III, section 2, of the Rules of Fair Practice of the NASD:

> In recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation

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[1] *Duker & Duker*, 6 S.E.C. 386 (1939).

[2] Sec. 17(a) of the Securities Act and secs. 10(b) and 15(c)(1) of the Exchange Act. See also rule 10b–5 promulgated under sec. 10(b) of the Exchange Act.

[3] *Charles Hughes & Company, Inc.* v. *S.E.C.*, 139 F. 2d 434 (2d Cir. 1943), certiorari denied, 321 U.S. 736.

[4] *First Anchorage Corp.*, 34 S.E.C. 299 (1952).

[5] *S.E.C.* v. *C. H. Abraham & Co., Inc.*, 186 F. Supp. 19 (S.D.N.Y. 1960); *Batkin & Co.*, 38 S.E.C. 436 (1958).

[6] *Best Securities, Inc.*, 39 S.E.C. 931 (1960); *Barnett & Co., Inc.*, Securities Exchange Act release No. 6310 (1960); also see Securities Exchange Act release No. 6721 (1960).

[7] *Heft, Kahn & Infante, Inc.*, Securities Exchange Act release No. 34–7020 (Feb. 12, 1963).

[8] *Best Securities, Inc.*, Securities Exchange Act release No. 6282 (June 3, 1960); *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962).

[9] *J. Logan & Co.*, Securities Exchange Act release No. 6848 (July 7, 1962); *May & Phinney*, 27 S.E.C. 814 (1948); *Arleen W. Duches*, 27 S.E.C. 629 (1948), aff'd sub. nom.; *Hughes* v. *S.E.C.* 174 F. 2d 969 (D.C. Cir. 1949); *Allender & Co.*, 9 S.E.C. 1043 (1941).

is suitable for such customer on 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.

Both the NASD and the Commission have rejected the contention that under the language of the rule, when a customer does not volunteer his financial condition and holdings, the broker-dealer and his salesman have no duty to obtain such information.[10] The rule has been applied to recommendations of excessive trading of securities as well as recommendations of unsuitable types of securities.[11]

The New York Stock Exchange, which enjoins its members and their salesmen "to maintain high standards of commercial honor and integrity"[12] and "just and equitable principles of trade and business,"[13] also imposes ethical criteria on the relationship between broker-dealers, their salesmen, and customers in the purchase and sale of recommended securities. The exchange's most important general rule in this area is the so-called "know your customer" rule, which requires general partners and officers of member organizations to "use due diligence to learn the essential facts relative to every customer * * *"[14] While there is some doubt as to the extent to which the exchange regards this rule as a protection to customers as well as to members organization,[15] it is nevertheless clear that the exchange regards "inappropriate recommendations" and "churning" as a basis for discipline of registered representatives.[16]

Ideally the legal and ethical obligations of the broker-dealer to his customer should not inhibit his successful operation of his business. There is at least a theoretical identity of interest between the customer who wants to purchase securities and the broker-dealer who wants to sell them. Nevertheless, the merchandising emphasis of the securities business in general, and its system of compensation in particular, frequently impose a severe strain on the legal and ethical restraints. The most common evidences of this strain are misrepresentations, omissions, and failure to learn facts about securities recommended, overtrading discretionary accounts and the accounts of trusting customers, and the recommendation of securities unsuitable for the purchaser. A detailed discussion of the causes and effects of these phenomena appears in chapter III.B.

The legal and ethical duties of those engaged in the dissemination of written investment advice are also generally defined by the Commission, the NASD, and the New York Stock Exchange, although the standards have not been spelled out quite as fully. From the point of view of the Commission, the legal restraints arise again out of the general Federal antifraud statutes, both for broker-dealers[17] and for registered investment advisers.[18] The Commission counts as conduct

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[10] *Greenberg & Leopold,* Securities Exchange Act release No. 6320 (July 21, 1960).
[11] *First Securities Corporation,* Securities Exchange Act release No. 6497.
[12] NYSE constitution, art. I, sec. 2, NYSE guide, par. 1002.
[13] Ibid.
[14] NYSE rule 405, NYSE guide, par. 2405.
[15] During the study's public hearings, G. Keith Funston, president of the exchange, expressed the opinion that this rule was primarily designed to protect firms against financially irresponsible customers.
[16] NYSE, "Ethical Conduct: A Study Guide for Registered Representative Trainees of New York Stock Exchange Member Firms," p. 25.
[17] Sec. 17(a) of the Securities Act and secs. 10(b) and 15(c)(1) of the Securities Exchange Act; see rules 10b-5 and 15c1-7 (a) and (b) adopted under the Securities Exchange Act.
[18] Sec. 206 of the Investment Advisers Act; see rule 206(4)-1 relating to investment adviser advertising.

which may be considered to violate the obligation of fair dealing the distribution of market letters or other sales promotional material which makes exaggerated and unsupported predictions of prices or earnings [19] or omits material information,[20] or implies the existence of a nonexistent research staff,[21] as well as the practice of trading against investment advice.[22] While no self-regulatory organization has power to prescribe ethical codes for registered investment advisers, broker-dealers which are members of the NASD and the New York Stock Exchange are subject to the ethical restraints imposed in this area by these bodies, each of which, quite properly treating written investment advice of broker-dealers as sales promotion material, has established general standards which should be met. These legal and ethical restraints, and the strains to which they are subject, are detailed in part C.

In the variety of functions performed by broker-dealers and investment advisers, some involve obligations to their customers and clients, while some involve obligations to others, particularly in the activity of serving on the boards of directors of publicly traded companies. For the most part the obligations to customers, clients, and companies are reasonably clear and compatible, and can be satisfied without difficulty. Inevitably, however, the world of business creates situations where the fulfillment of one set of obligations may be inconsistent with the fulfillment of another. In these situations of conflicting obligations there is least agreement among legal and self-regulatory authorities, and in the business community itself, as to the proper priority of obligations. These problems of conflicts are the subject of the final part of this chapter.

2. "PROFESSIONALISM" AND THE INDUSTRY

The words "profession" and "professional" are frequently associated with the securities industry, sometimes by way of description or aspiration, sometimes as an exhortation, and sometimes as an indication of self-esteem. Partly the use of the word reflects a desire to encourage the development of those ethical concepts which ideally should be associated with the practices of the business, as when the Commission refers to "the standards of the profession," [23] or when the New York Stock Exchange, in a study guide for member firm trainees, says:

> The goal is to achieve a standard of conduct befitting a profession. This means that the registered representative himself must be a professional.[24]

On the other hand, the frequent use of the terms also reflects motives which may be less lofty. To a considerable extent the words become a tool of merchandising, when used to advertise "professional guidance," or "professional financial planning." In recruiting they become a symbol of prestige and status, as when advertisements for mutual fund

[19] *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962).
[20] *Investment Service Co.*, Securities Exchange Act release No. 6884 (1962).
[21] *Anna Caseley Robin d/b/a The Profitmaker*, Investment Advisers Act release No. 127 (1962).
[22] *S.E.C. v. Capital Gains Research Bureau, Inc.*, 300 F. 2d 745, 306 F. 2d 606 (en banc) (2d Cir. 1962), certiorari granted, 31 U.S.L. Week 3233.
[23] See, e.g., *Best Securities, Inc.*, Securities Exchange Act release No. 6282 (June 3, 1960).
[24] "Ethical Conduct: A Study Guide for Registered Representative Trainees of New York Stock Exchange Member Firms," p. 1.

salesmen extol the advantages of "becoming a member of a profession."

A matter of concern to the Special Study has been the confusion generated by the use of the words "profession" and "professional." They are words of many meanings and shades of meaning in many different contexts. The professional baseball player is distinguished from the amateur athlete, the professional soldier from the civilian in the ranks, and members of the "learned" professions—doctors, lawyers, and clergymen—create a still different image.

The confusion within the securities industry stems from a lack of agreement both as to the meaning of the words themselves and as to the extent to which they are used to describe an existing state of facts or an ethical ideal. To one person "profession" may principally connote a calling characterized by specialized knowledge and intensive preparation; another may give more emphasis to high standards of ethical conduct. An executive of one large firm described a "professional" within the securities industry as—

> a dedicated man, a well-trained man, a man of highest intellect, a man of highest caliber, morally—then the man who puts the customer's interest first.

The managing partner of another large firm, describing what a firm should stand for, separately enumerated "integrity, and then professional competence." The head of a smaller firm which extensively advertised its "professional" services, agreed that a professional was an individual who puts the well-being of his clients above that of himself in terms of his professional relationship with them, "within the context of earning a living in a capitalistic society." The president of one mutual fund distributor defined a professional mutual fund salesman in the following language:

> Someone that knows everything necessary about the product that he is representing, has a firm conviction in the soundness of the product, and the need for it, and considers the prospect more important than himself in trying to service individuals.

The president of another mutual fund organization had this to say on his understanding of the term "professional" in relation to the securities business:

> A. I would like to think it is an attitude of services to the client, seeing that he reaches his objectives, he understands fully the product, that it meets the objectives of the customers' needs.
>
> Q. Are you more interested in a salesman who has this attitude than in one who sells?
>
> A. I think this is the best way to sell. Ours is a repeat business. Unless a salesman does have this attitude he is not going to get the repeat sales and he will fail.[35]

Given the wide diversity of views as to the nature of professionalism, it is hardly surprising to find a diversity of views on the extent to which it exists within the industry at present. Few broker-dealers would seriously claim that the industry as a whole has achieved a status of true professionalism; some, on the other hand, claim that status for people in their own organizations, like the mutual fund distributor president quoted above, who claimed that "all of our full-time men are very much so professional." A different appraisal of

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[35] Questioned later about how certain prospecting techniques were consistent with professionalism he stated, "I think the way one prospects is unimportant in the professionalism [sic]."

the industry as a whole was given by the executive director of the NASD at the study's public hearings:

> I cannot see at the present time an element of true professional competency or true professional standards entering into the sale of most securities. I just don't see that coming about for a long time, if ever.

It was not necessary for the study precisely to define or measure "professionalism" in the securities industry in order to conclude that an image of professionalism has been actively promoted which, as to much of the industry, does not in fact exist. To say this is being neither critical nor cynical; essentially it is being realistic. Professionalism involving both elements of technical competence and high standards of conduct is a highly desirable goal or ideal which the industry has set for itself. Some persons and firms in the industry even now operate on a level of skill, specialized knowledge, and integrity which may justify the application of the term to them, and many more recognize and, for the most part, achieve, a level of ethical practice considerably higher than that of many other businesses.

Nevertheless, the primary emphasis of the securities business still is, as it historically has been, on selling securities. Although the exchanges and the NASD have made advances toward the establishment of ethical standards in the industry, there is still much room for implementing these standards. The conclusion that segments of the securities business have not attained the ultimate ideals of a profession does not mean that its selling activities are necessarily unethical, nor does it mean that the industry is incapable of change or reform, but it would be a disservice to the investing public to engender the belief that professionalism has actually been attained on a wide scale in the securities business today.

B. Selling Practices

1. SCOPE OF THE PART

This part of the report examines those activities of broker-dealers and their salesmen which are most directly related to the public's participation in the securities markets: their selling practices. It reviews the methods and techniques used by firms and salesmen to attract new customers and to sustain the interest of old ones. It discusses the manner in which the compensation of salesmen and specialization in some types of securities may place a strain on the primary duty of the broker-dealer and the salesman to deal fairly with the public investor. It notes special problems peculiar to larger firms with numerous branch offices and staffs totaling hundreds of salesmen. Finally, it evaluates the internal and external controls over selling practices which are exercised respectively by the firms and the governmental and industry regulatory bodies.

A study of this kind by its nature and purpose, although surveying the entire scene, must necessarily focus upon problem areas, including specific abuses that appear to represent more than isolated cases. For this reason this part gives more attention to improper practices than to ethical ones, although it does also cite instances in which firms or individuals or segments of the industry have demonstrated an awareness of problems and have instituted techniques to raise standards and to assure fair dealing, in its highest sense. This concentration upon specific improper practices in areas where the need for reforms is indicated, however, is not intended to reflect a quantitative measurement of the extent of these practices. Nor is there any intention to convey the impression that an individual situation characterizes all or even a major part of the activities of a particular segment of the industry, or, in some cases, of the particular firm.

Many selling practices discussed in this part require positive action by the industry and the regulatory organizations in order to narrow the existing gap between the industry's stated goal of high standards, and the existing conditions in the marketplace. Some of these practices may have less significance in the event of the adoption of the recommendations set forth in chapter II, relating to adequate character and competence requirements for those who sell securities to the public. Fortunately a growing awareness of the need for higher standards is reflected in the increasing emphasis on training and supervision by some of the exchanges and some of their member firms and by the NASD and some of its members. Nevertheless, serious abuses have occurred, and problems exist which unless corrected could cause grave damage to the industry as well as to the public investor.

In focusing on selling, the discussion in this section excludes those activities carried on by brokers which do not involve direct contact with the public, and deals principally with the techniques used in connection with the selling of corporate equity stock to public investors. Practices relating to the sale of mutual funds are discussed in chapter XI of this report. It is evident that except for mutual fund selling organizations, only a small number of broker-dealer firms do not fall within the scope of this part,[26] since corporate stock is sold to the public by almost every segment of the industry from the large NYSE "wire houses" to the one-man nonexchange firm.[27] Between the two ends of the spectrum are small- and medium-sized NYSE firms, firms which are members of other exchanges, NASD member firms without stock exchange affiliations, broker-dealers registered with the Commission who are neither members of the NASD nor of any exchange, and those firms who sell securities to the public but are exempt from Federal regulation.[28] The customers to whom securities are sold range from banks, pension funds, mutual funds, insurance companies, and other financial institutions, to individual investors of all degrees of sophistication and amounts of capital. Within the range of capital are included the wealthy, the middle-income group, and, to an increasing extent, individuals whose income is relatively low. In terms of occupation, individual public investors include the wage earner, the pensioner, the salesman, the small entrepreneur, the large corporate executive, the trustees, the farmer, the housewife, and the professional and others.

The methods of study followed in accumulating the data and materials upon which chapter II was based [29] were also followed for this part. Interviews were held with various firms; private testimony was taken; the files of the Commission, the NASD, the NYSE, and of

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[26] Odd-lot houses, specialists, floor traders, and pure wholesale dealers, among others.
[27] See table I–10 in ch. I.
[28] Securities Exchange Act, sec. 15(a).
[29] See ch. II.A.3.

brokerage firms were examined; correspondence with interested persons from within and without the industry was studied and investigated in a number of instances, as time permitted; decisions of the Commission, the courts, and the self-regulatory agencies were analyzed, as was relevant historical background material; and public hearings were held. In addition, material received in response to questionnaires STS-1 and STS-2, described in chapter II.A.3. above, was extensively relied upon in the preparation of this section.

2. THE MERCHANDISING EFFORTS OF THE SECURITIES INDUSTRY

An important and obvious feature of the securities industry which brings it closer to the world of business than of the professions is that most of its members who deal with public customers normally and regularly engage in merchandising activities. The merchandising efforts of the securities industry are addressed to three basic objectives: first, to attract the funds of a potential investor to securities rather than to other forms of investment; next, to persuade the investor to execute his securities transactions through the facilities of a particular market or firms; and, finally, to induce him to purchase particular securities. To accomplish these objectives, the industry engages in various methods of merchandising, including advertising, sales promotion, and point-of-contact selling. While the techniques and services employed in these different methods are separately discussed below, their essential interrelationships must be borne in mind. Although advertising and sales promotion may at times be difficult to distinguish from each other, both are essentially and ultimately aimed toward accomplishing sales.

a. Advertising

The securities industry makes extensive use of all of the principal media of advertising—newspapers and magazines, radio and television programs and direct mail solicitations all play a part. Publications in which retail brokers advertise include daily newspapers, trade journals, weekly and monthly news magazines, literary magazines, and women's magazines. Newspaper advertisements, which are largely confined to the financial pages, aim principally at a public already interested in the world of business, while magazine advertising in business publications may be directed to a similar audience. But the extensive use of mass circulation magazines reaches a wider group. In recent years, as public interest in the securities markets has grown, retail brokerage firms have turned increasingly to the airwaves to advertise their names and services. In many metropolitan centers at least one radio station broadcasts a daily summary of market activity sponsored by a brokerage firm, and in some areas market averges are broadcast hourly throughout the day. In addition to advertising the names and services of sponsoring firms, such programs serve as continual reminders of securities as an investment medium, reaching the broadcast segment of the public. Sponsored television programs, too, carry the message to a vast audience.

A more selective type of advertising can be accomplished through direct mail solicitation based on specialized lists. The New York

Stock Exchange specifically recommends this technique to its members in a 15-page brochure, issued in 1957 and again in 1960,[30] which suggests the compilation of lists from such sources as trade and professional directories obtained from local libraries, private clubs, chambers of commerce, credit rating books, property valuation and street lists, and local news items about promotions and job changes.[31] The exchange also recommends purchase of lists through list brokers, many of whom offer selective lists,[32] and this source of potential customers has been used by large and small firms.

Whatever the medium, broker-dealer advertising has the basic purpose of obtaining new customers for the firm. While a few larger firms are content to do this by impressing the public with their name and a description of their services, much broker-dealer advertising is, at least in its broadest sense, "come-on" or "bait" advertising,[33] in that the advertiser offers to supply something "free" or "without obligation." What is offered free is, most often, "sales literature," as that term is defined by the New York Stock Exchange, i.e., printed reports covering individual companies or industries, leaflets or booklets interpreting the facilities of the firm, and generalized discussions of the place of investment in securities in an individual's financial planning.[34] One major NYSE member firm, for example, used a full-page New Yorker magazine advertisement to offer the firm's "comprehensive new booklet" which "tells why they recommend investment in major international oil stocks and describes in detail the three they favor at this time." Another member firm more dramatically invited the reader of its advertisement to call or write for the firm's publication recommending "six securities which we believe should be able to double over the next few months." [35] The member firm sponsoring one radio program offered its listeners a booklet called "A 10-Year Investment Forecast," of which the announcer said:

> [F]ully illustrated with charts and photographs, this new booklet tells you why the economic outlook for the 1960's appears so bright * * * tells you how fast business and industry is expected to grow * * * and tells you what yardsticks an investor should use when choosing stocks in the coming decade.

Another common feature in advertisements in all media, by NYSE member firms and nonmember firms alike, is the offer of free portfolio analysis. One such advertisement of a large exchange wirehouse offers the reader "investment help tailormade for you," and contains a coupon with blanks for personal information and a list of present holdings, to be filled in and sent to the firm for analysis by the firm's portfolio analysis department. Occasionally portfolio analysis offers are made by firms without facilities for providing that service; the proprietor of one small New York City nonmember firm admitted to the Study that his firm used direct mail solicitation of portfolios for analysis as a device to obtain the names of potential customers, al-

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[30] NYSE, "How You Can Use Direct Mail To Enlarge Your Securities Market."

[31] Id., at 8–9.

[32] Approximately 250 firms offer special lists. Wall Street Journal, Jan. 7, 1963, p. 1.

[33] Under a NASD interpretation of sec. 1, art. III of its Rules of Fair Practice, "come-on" techniques in any form of advertising are "deemed conduct inconsistent with just and equitable principles of trade." NASD Manual, G–19 (1961). The NASD apparently does not consider free offers of special reports, portfolio analysis, or market letters to be "come-ons."

[34] See NYSE Guide, par. 2472.10 (1962). For a detailed discussion of broker-dealer sales literature, its contents and the manner of its preparation, see ch. III–C below.

[35] When this advertisement was submitted for approval to the exchange a second time is was rejected.

though no person connected with the firm was trained to make such analysis and no analyses were ever made.

Financial planning and estate planning are other free services offered by broker-dealer advertisements. A Wall Street Journal advertisement of a firm which for the year ending October 31, 1961, sold over $1 million in mutual funds urged readers to "Leave your children a managed estate" and invited them to call the nearest office of the firm and ask to speak to an "estate planner."

Many firms also advertise at regular intervals a list of recommended securities, available at no cost to any applicant. Although most broker-dealer market letters are distributed without charge as a sales promotional device, at least one firm uses advertisements offering market letters normally available only on a subscription basis.

The reader, listener, or viewer who responds to the offer of free material or free services will receive the material and, usually, the services he requested, and will also become a "prospect" for the firm, and may expect a direct approach from one of the firm's registered representatives.

While broker-dealer advertising reveals a basic uniformity of purpose, it also displays a wide range of style, emphasis, and approach. Advertising copy ranges from the low key "institutional" to the flamboyant, depending on the nature of the advertising medium, the audience aimed at, the taste and standards of the particular firm, and the public image which it wishes to convey.

Certain firms aim principally at giving an impression of conservatism and competence. For example, one NYSE firm with a large number of branch offices used an advertisement headed: "We Have No Branches." The text of the advertisement soberly explained that every office of the firm contains "main office facilities" and "main office staff," and emphasized the training and background of the firm's staff and the dependable investment guidance available at any of the firm's offices, without any offer of free sales literature or services. Similarly, the radio commercial for one NYSE member firm pointed out:

> [The firm] has no magic formula that can guarantee a success in the stock market. What they do have is a half-century of experience with investment problems of every sort * * *.

The commercial offered no booklet, but merely stated that the firm would be happy to make an appointment at the listener's convenience.

A major portion of the more conservative advertising lays heavy stress on the high quality of research underlying the firm's advice. An advertisement of a large NYSE member firm warned of the difficulties of investing and concluded, "However, if you are looking for advice based on sound research and mature experience, why not try us?" Another member firm advertised:

> THOROUGH INVESTMENT RESEARCH is the guiding principle of this experienced research organization. We place primary emphasis on professional research. * * *

A considerable portion of the advertising material used by exchange member firms is in the form of "tie-ins" with the exchange's own advertising campaign, which is designed to encourage capital investment in securities—"Own your share of American business"—and until 1960, distributed the names of persons responding to its own advertisements among member firms for follow-up as potential customers.[36] Material relating to the exchange advertising program is sent to member firms in advance, and member firms are free to run under their own name their own tie-in advertisements or those prepared by the exchange. One advertising series prepared by the exchange staff was directed at the potential woman investor, with slogans such as "Who Said Investing Is a Man's World?" and "Why Is a Smart Shopper Like a Good Investor?" Both the exchange advertisements and the tie-ins prepared by its staff typically encourage the customer to investigate before investing, and to invest only surplus funds. The promotional element of the advertisements is evidenced principally by an overt emphasis on investing only through NYSE member firms, and the underlying emphasis on the competence and integrity of the members and employees of such firms. The tie-in program appears to be quite successful; 136,906 lines of tie-in advertisements, amounting to 57 full pages of a standard-sized newspaper, were run by member firms in the spring of 1962, an increase of 53 percent over the 1961 fall program.

While many conservative and established firms use conservative advertising, the mere use of that approach is by no means a reliable criterion for an investor's choice of a brokerage firm. A conservative or even protective approach is available to any broker-dealer who wants to use it. It was appropriated, for example, by a nonexchange member firm which has been an underwriter of low-priced highly speculative securities, specializing in glamor issues with glamor names but often without any earnings history. This firm ran a prominent advertisement in New York newspapers in 1962, warning investors of the dangers involved in purchasing securities of unseasoned companies in glamor industries. The advertisement set out a list of investor "do's" and "don't's," such as:

> Appraise the fundamentals, i.e., the risks involved, success and integrity of management, product, profit margin, industry competition, years in business, growth potential, and past rate of growth, if any.
>
> Emphasize earnings per share. * * *
>
> Ask yourself: "Does the company show special promise of some kind?"
>
> Don't buy on tips and rumors. * * *
>
> Don't buy just because of a scientific sounding name. * * *
>
> Don't buy on the basis of profit promises. * * *

The advertisement concluded with an offer to send a brochure on the firm's formula for purchasing new issues. This advertisement contrasts with another by the same firm in 1961, captioned "Our First Year," and featuring a table showing 11 of the underwritings in which the firm had participated. The table contained the name of the issuer, the date of the offering, the offering price, the high bid, and the current market price. In each instance the current market price was higher than the offering price, and in all but two cases it had more than doubled. Particular issues showed increases from \$3.125 to \$60 per share, from \$1 to \$17.50 per share, and from \$2 to 10.50 per share. Two other issues labeled "Special Situation Letter Recommendations," appearing below the table in the same format, were shown to have doubled in price since first offered.

[36] A detailed discussion of the NYSE's advertising program appears in ch. XII.

Another nonexchange member firm carried on a direct mail campaign by mailing 5,000 copies of a report headed:

> MAN'S FAVORITE INVESTMENTS—*LAND* and *GOLD*—combined in a single seasoned security.

The report, divided into four main headings captioned "The Attraction of Gold," "Golden Values in Land," "Home Development," and "Attractive Value," evaluated the recommended security in the following terms:

> Because it afford such attractive values in well-located land and ageless gold; because it provides a two-way hedge against either inflation or deflation; and because it is available at the moment at the amazingly low price of 1¼, we regard [the company's] common as a seasoned security capable of producing *rewarding* market gains. [Emphasis in original.]

The unrestrained appeal to speculative impulses represented by such advertisements of firms which are not members of any exchange has been used by many broker-dealers, including NYSE member firms. One member firm advertised copies of its current market letter which "reviews a farm equipment maker whose 1961 earnings should double and an agricultural chemical company with the promise of a later earnings 'explosion.'" Another compared a small, little-known plastics company with the giants of the industry—Du Pont, Dow, and Monsanto—noting its price rise from $4 to $8 per share and inviting the reader to receive the complete story of the company's "success and bright future by mailing the coupon below." An NYSE member firm radio commercial tantalized listeners with the questions:

> Which international electronic company has increased in price over 340 percent in the last 2 years? Why should this dynamic company maintain this excellent growth record in the years ahead? The answer to these and many other important questions are in [the firm's] booklet available free. * * *

Regardless of the advertising tone, however, broker-dealer advertising, other than announcements of public offerings and public service messages, generally carries one of two themes, or a combination of both. One is the theme of profits to be made from securities; the other is the theme of reliance and trust in the experience and judgment of the firm, its registered representatives and, often most particularly, its research department. Reliance on these themes is hardly surprising. The advertising merchant generally must advertise his merchandise, his services, or his prices. Since, for exchange member firms at least, advertising of a price advantage is precluded by minimum commission rate schedules, the broker-dealer must advertise the advantages of his merchandise, which lie principally in its potential appreciation, or the advantages of his services, of which the one with broadest public appeal is its research. Each theme can be, and often is, carried out unobjectionably, and yet each has its dangers. The first lends itself to the unrestrained appeal to gambling instincts, and can fan the flames of such speculation as existed in 1961. The second may create an atmosphere of trust and confidence, encouraging full reliance on broker-dealers and their registered representatives as professional advisers in situations where such reliance is not merited, and obscuring the merchandising aspects of the retail securities business.

b. Sales promotion

Brokerage firms with a sizable following of retail customers generally supplement their advertising with sales promotion activities of varying sorts. The most common form of promotional activity is the preparation and dissemination of sales literature, such as market letters and special reports, described in part C below. As noted above, a large amount of broker-dealer advertising offers such sales literature in order to obtain names and addresses of potential customers. The extensive circulation of such material to existing customers also serves as a constant stimulant to the firm's business.

The promotional value of conducting lectures and investment courses is also recognized by a great many firms of all kinds and sizes. The NYSE, consistent with its objectives to educate the public and spread the awareness of investment to an ever-broadening segment of the public, considers this technique an excellent means of communication and education, and has prepared an outline for a nine-lecture adult program to be given by its members.[37]

The courses are well advertised, are geared for all segments of the population, and are held throughout the country. One large NYSE member firm offered investment courses for women through its Brooklyn office by means of an advertisement titled "Dividends Are a Girl's Best Friend." This firm offered "Fundamentals of Investing" to the public in the Buffalo area; in Chicago, a "Practical Course for Investors and Traders"; in Milwaukee, an investment seminar entitled "Which Stock Should You Buy?"; and a series of six lectures for the "Sophisticated Investor," through the firm's Syracuse office. The course for the "Sophisticated Investor" covered such subjects as taxes in relation to securities, margin accounts and their uses, services and facilities of a brokerage firm, and trading vehicles and techniques.

The curriculum for the more basic courses includes these subjects: "Should I Invest," "Literature and Services Available," and "Mutual Funds." Other firms have offered courses advertised in local newspapers under headings such as "Learn How To Invest From Professionals," "What You Don't Know Can Hurt You," and "Why the Break? * * * The Key to the Future Is a Critical Evaluation of the Recent Break."

Some firms charge registration fees for a series of lectures extending for as long as 9 weeks. Other lectures and courses are open to the public at no charge. Free tickets are available to any member of the public who inserts his name and address on a coupon and sends it to the sponsoring firms.

When properly presented, these courses perform a valuable public service. They are also a merchandising technique in that they stimulate potential customers to consider channeling their capital into the securities market and direct attention to the particular firm conducting the course. The courses are also capable of direct abuse, as is illustrated by a firm which, while giving lectures on the securities markets

[37] NYSE, Securities and Investing (undated pamphlet). The introduction points out that "Adult courses on personal finance have become increasingly popular throughout the country."

to students at a university, recommended highly speculative issues to students and, during and immediately after the lectures, took orders for securities from those in attendance.

An unusual promotional device in the securities industry was a "Be an Investor" contest. An NYSE member firm, in conjunction with Invest in America Week, invited the reader to "Try your hand at selecting investments in dividend-yielding stocks without spending a penny—and win a 5-day all-expense trip to New York and also see the New York Stock Exchange in operation." Under the rules of the contest the entrant had to select six stocks which would "do the best" in the next 6 months. The contestant mailed the firm his list, together with his name and address, and was then credited in his "contest account" with an imaginary investment of $5,000 in each stock chosen. The winner would be determined as of the closing market prices on a date 6 months after the contest began. This contest was approved by the NYSE after minor editorial changes in the advertisements were made.

The use of a promotional device such as this investor contest serves the usual purposes of sales promotion by obtaining the names of prospects and stimulating public interest in securities generally and the sponsoring firm in particular. It also emphasizes the gambling aspects of the securities business. Any participant enjoying imaginary profits may, as a result, be drawn into the securities market under the false assumption that it provides an easy avenue to wealth. On the other hand, the "losers" may be impressed with the need to rely on the experienced broker.

c. *The salesman's efforts*

Advertising and promotional techniques are directed toward establishing personal contact with the individual investor. Ultimately, however, it is the salesman whose activity is critical. As one firm, commenting upon the limitations of one of its promotional market letters, advised its salesmen:

> It can be used for long-range prospecting; as a mailing piece to casual customers; as a means of digging out new cash from present clients; but not as a sales document. Sales are made as a result of a person-to-person meeting of minds between you, as a sales representative, and the client, customer or prospect. [Emphasis in original.]

The efforts of the salesman, in the securities business as in others, embrace two distinct activities: Locating potential new customers, generally referred to as "prospecting," and servicing or selling to new customers and old ones.

The salesman in most firms is expected to seek out or "prospect" for new customers on his own, whether or not the firm engages in promotional activities of the types discussed above. Some firms use little or no advertising, and rely heavily on the energy and ingenuity of the salesman or the selling partner for additional customer accounts. The Investment Bankers Association of America (IBA), an organization representing some of the largest and most highly reputed firms in the industry,[38] in one of its publications summarizes several of the prospecting techniques presently used in the industry, but not before emphasizing to the salesman the wisdom of dealing fairly with his

[38] According to a survey performed by James O. Rice Associates, Inc., in November 1960, the average member firm of the IBA is 46 years old; the median number of employees for its corporate firms is 90, for partnerships, 250. The most important activity for the majority of its members was found to be NYSE brokerage.

customer. For example, under a heading "Salesmen's Profits—Measured by Services Rendered" the salesman is advised to select—

with adequate assistance—the right securities for the right people, regardless of the personal influence of large or small profit credits.[39]

The salesman is also told that—

Decisions on matters concerning client *welfare* are always being made. Despite profits which might be made, every firm periodically rejects or "passes" available issues which are not up to its overall standard. Similarly, each salesman who administers the standards of his clients' lists must decide primarily on qualifications of the issues, with the profit motive being in the background.[40] [Emphasis in original.]

The IBA manual, under the heading "Building a Clientele," recommends that the salesman prepare lists of prospective clients as a first step in building a customer following. The publication then proceeds to discuss 11 different "prospect sources." The first of these is called a "cat and dog" list, composed of the names of those persons who at one time did business with the firm but whose patronage failed to continue for a variety of reasons. Another suggested source is "friends, relatives, and acquaintances." Still another prospect source suggested in the manual is the "cold turkey" call; this technique requires that the salesman merely walk into an establishment and introduce himself to the prospective customer. The manual suggests that—

Names and titles on doors, or information obtained from company truck-drivers in front of the establishment or on the shipping docks, offer leads for introductory calls.

The salesman is also advised—

to "case" the block and to determine from the exteriors of the business houses those organizations which comprise industries generally known to be doing a substantial volume of business

"Cold turkey" calls are recommended to the salesman as a method for the "sharpening of his wits" and "agility for coming around to his point of entry." The manual goes on to state:

Men who are accustomed to making "cold turkey" calls find that their efforts build up in a definite crescendo as the day proceeds. They generate enthusiasm and are thrilled with their effectiveness and their ability to think, speak, and gain approval for their recommendations.[41]

The IBA does not suggest that salesmen engage in the practice of making "cold turkey" telephone calls to sell specific securities to unknown customers, a practice which characterizes high pressure or "boiler room" organizations.[42] In its direct mail brochure the NYSE describes "an effective procedure" used by many member firm salesmen which combines telephone and direct mail contact. The brochure states:

As one top producer puts it, "If there is real interest, the mailing may be followed by a telephone call—during which you and the prospect can get down to specific cases or arrange a personal meeting."

Another man, however, states: "In that phone conversation, I am only selling the idea of a *discussion* to plan the customer's program." [Emphasis in original.][43]

The IBA manual also suggests use of the mails to attract prospects. The manual suggests that mailing pieces include the firm's market let-

[39] IBA, "Manual on Securities Salesmanship," p. 8 (1961).
[40] Id., p. 9.
[41] IBA Manual, pp. 18 and 19.
[42] For a description of "boiler rooms," see sec. 4.b, below.
[43] NYSE, "How You Can Use Direct Mail To Enlarge Your Securities Market," p. 12.

ter or some pieces of economic literature to which the firm subscribes. These mailing pieces, it is said, should be specifically marked in red or blue pencil to attract the attention of the prospect:

> The psychology of this method of prospect approach is that people will seldom throw into the waste basket subject matter which is specifically marked.[44]

Since the basic enclosures are usually the sales promotional material supplied by the firm, the type of mailing material varies with the policies of the firm.

Although the "leads" or lists of prospects which respond to the published advertising, the radio commercials, the direct mail campaigns, the contests, etc., constitute an important source of potential customers for the salesman, some new customers, of course, come to brokerage offices of their own volition. While some are undoubtedly attracted by the firm's promotional activities, others select their broker on the basis of the attractive establishment it maintains, the general reputation of the firm as expressed by friends, business associates and others, or a personal relationship with some of its principals or employees.

Regardless of the means by which a potential customer and a salesman may meet, the relationship which develops between the two determines the functions which the salesman will perform. Some investors demonstrate reliance on the salesman by giving him complete discretion to buy and sell securities, usually up to a specified dollar limit. Others, including the growing number of unsophisticated investors with little or no knowledge of securities or the mechanics of the securities markets, while not formally authorizing discretionary accounts, place great reliance on the salesman's advice. Often the customer's only contact with the securities industry is through his salesman. Even the more sophisticated customers, devoting full time to their own jobs, may rely heavily on the advice of the securities salesman.

Some investors, on the other hand, do not depend on the salesman for advice. Such individuals often do business with more than one firm, and may use a particular broker for a particular purpose or specialty. Typically, one who considers himself a knowledgeable investor may have an account with a NYSE member firm and with one or more other firms who specialize in new issues and are expected to allot shares of potential "hot issues." There is also the investor who makes his own investment decisions based on his own analysis—merely using the salesman as an order-taker. The salesman's role as an order-taker has been described in a NYSE publication as follows:

> * * * some customers do not see investment advice. They simply want the registered representative to see that they get good service in executing their orders, that their purchased stock is registered properly and stock sold is paid for promptly. The registered representative gives good service to clients (particularly those who are not experienced investors) by voluntarily advising against the purchase of the stock of a little known company or of a company whose price action has been extremely volatile where risks of failure appear to him to be far greater than the chances of success. If, however, the customer still insists on such a purchase the decision is his.[45]

Where the relationship between the customer and broker is such that the former relies in whole or in part on the advice and recommendations of the latter, the salesman is, in effect, an investment adviser, and some of the aspects of a fiduciary relationship arise be-

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[44] IBA Manual, p. 25.

[45] NYSE Department of Member Firms, "Supervision and Management of Registered Representatives and Customer Accounts," p. 7 (1962).

tween the two parties. However, regardless of the nature of the relationship with the customer, where the salesman recommends a security to a customer, such recommendation must be consistent with the salesman's duty to deal fairly, and it should rest on considerations of the customer's investment goals, financial circumstances, and a careful analysis of the security by qualified persons. The NYSE has stated:

> * * * a great majority of clients are dependent upon a registered representative and his firm for investment information and advice ranging from complete dependence to the casual question, "What do you think of XYZ at these levels?"
>
> Because the great majority of his customers are going to want investment information and advice of one sort or another, it is essential that the registered representative serve his customers in an informed and intelligent manner. To advise an investor properly he obviously needs to know his client's investment objective. At the extreme where an investor wants advice on fitting investment into his personal financial plan, the representative will need to help his customer define his investment objective through consideration of (*a*) financial resources and obligations, (*b*) background and knowledge, (*c*) other investments held in his portfolio, (*d*) cash resources, and (*e*) other major assets such as real estate and insurance. On the other hand, an investor who approaches the representative with the objective of buying shares in a particular industry may want only the representative's opinion on the most promising companies in that industry. Only with the investment objective clearly understood will a representative be able to give a satisfactory opinion on a security held by a client or make a proper recommendation for his portfolio. Like a doctor or a lawyer, the representative should determine pertinent facts concerning his client's situation prior to giving advice. Furthermore, the advice given must be based on good faith and upon informed judgment of investment facts, not on rumor.[46]

In fact, considerations other than the welfare of his customer operate to motivate the salesman; these include the salesman's own compensation (as discussed in the following section) and sometimes the limitation to the particular types of securities offered by his firm (as discussed in sec. 4, below).

3. COMPENSATION OF SALESMEN

a. Dominance of commission compensation

Salesmen being human, the financial incentives offered them can be expected, in large measure, to affect the manner in which they do their job. While the fee structure of the industry itself is subject to certain disclosure requirements and regulatory controls by the exchanges,[47] the NASD [48] and to some extent by the Commission,[49] compensation of salesmen is, with certain exceptions,[50] undisclosed and unregulated. Firms are relatively free to choose the method and rate

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[46] Ibid.

[47] The policies, rules, and regulations relating to commissions and charges for transactions in securities listed on the NYSE and other exchanges are discussed in ch. VI; see NYSE constitution, art. XV.

[48] NASD, "Rules of Fair Practice," art. III, sec. 3, requires that charges for services performed be "reasonable and not unfairly discriminatory between customers." Sec. 4 requires that a member buy and sell securities to and from customers at fair prices and when acting as agent for a customer "he shall not charge his customer more than a fair commission or service charge * * *." In addition, the NASD has promulgated an interpretation under art. III, sec. 4, and has set forth the factors for determining the fairness of the markup charged by a member, NASD Manual, G–1. This subject is discussed in detail in ch. VII.

[49] Securities Exchange Act, sec. 15A(b)(7). Under this section the act requires that the rules of the NASD "provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges," and prohibits any rules designed "to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges." Under sec. 19(b)(9), the Commission also has jurisdiction over exchange rates and charges. Pursuant to form S–1 promulgated under the Securities Act, the Commission requires disclosure of underwhiter's compensation and dealer commissions and discounts in connection with a public offering of securities. See rule 15c1–4, concerning disclosure in confirmations of source and amount of commissions.

[50] Securities Exchange Act, sec. 10(b), rule 10b–2; NYSE rule 347; NASD Manual, G–52.

of compensation for their salesmen, but absence of regulation has not stimulated any considerable diversity in form. Such variations as exist are either in the level of rates or reflect one or more of such factors as a firm's exchange membership or nonmembership, whether or not the security is listed on an exchange, and the nature and form of the transaction.

Securities salesmen employed by exchange member firms and nonmember firms are, with few exceptions, paid exclusively on the basis of straight commissions or draw against commissions. The latter method differs from the former in that it assures the salesman a minimum fixed income each month, thereby serving to reduce the immediate economic pressure to produce business.

A major exception to the general rule is Merrill Lynch, the industry's largest retail brokerage firm. Its compensation system was described at the study's public hearings as follows:

> Our salesmen are paid on a salary basis. Twice a year we give them adjusted compensation if their performance is surpassing what we normally expected when we set their salary. You might say, Is this a bonus, is this a commission arrangement? No, because the adjusted compensation that we give them, we take many factors into consideration.
>
> First of all, how well the customer is doing. Secondly, how many errors have they had. Third, what is the quality of their work. Fourth, have they been any trouble to the manager, and the like, before we determine what they should be paid from then on.

Nevertheless, Merrill Lynch keeps the customary record of commissions produced by each salesman, giving varying "production credits" according to the type of business done; e.g., exchange transactions, transactions on a principal basis and on an agency basis, underwritings and other types of distributions, and adjusts salaries to reflect production. However, its system does recognize factors other than production, and the salesman's compensation does not depend exclusively upon the amount of commissions he has generated.

The general rule of commission compensation for sales efforts creates two problems: The salesman is economically motivated to persuade customers to enter into as many transactions as possible, thereby creating the danger of excessive trading or churning; he also benefits most from sales of those securities for which the rate of commission is highest, and is thus motivated to recommend purchases of securities without sufficient regard for their merit or suitability for a particular customer. An experienced executive for a large NYSE member firm commented on these two problems during the course of the study:

> It has become very clear in the recent past that some salesmen, notwithstanding the rules and admonitions of their firms to the contrary, have on occasion presumably under the motivation of commission income advised clients to purchase securities which might be regarded as unsuitable to their investment objectives. In fact, it can be said as a general observation that salesmen are all too frequently in their advice motivated by the "commission motive." This is not a motive that is entirely foreign to other businesses or even professions, but nevertheless it cannot be condoned.

Despite these dangers, most retail firms, including the one with which the author of the above statement is associated, use a salesmen's compensation system which is based on production alone.

The almost universal pattern of commission selling has not always existed. Until 1949 members of the NYSE were subject to rule 436, which provided:

No employee shall be paid other than a fixed salary not varying with the business, without the consent of the exchange.

However, long before 1949, the exchange and its members decided that a salesman's salary could justifiably be predicated substantially upon the business he introduced and the resulting profits accruing to the firm. Although rule 436 remained in effect, for many years the exchange imposed few restrictions on the frequency or amounts of salary changes for salesmen, and compensation was generally geared to production. After the 1929 market crash, the exchange had taken steps to restrict the compensation policies of its members in an effort to raise the caliber of salesmen. During the early 1930's, when there was little activity in the securities markets, the exchange for a time fixed minimum salaries according to geographical zones, and also required contracts of employment for stated periods. However, by 1943 the exchange's position had been modified at the insistence of the member firms and salary changes were permitted to be effected monthly, although with the understanding in all cases that the dollar salary for a given month or other pay period must have been set in advance. Although rule 436 made no distinction between transactions in listed securities on the exchange and transactions in the over-the-counter market, members were permitted to pay commissions to salesmen in connection with business in unlisted securities, subscriptions to investment management or investment advisory services, listed bonds owned by the firm, public offerings of listed securities and other special situations.[51]

In 1943, a Commission survey of the compensation practices of NYSE member firms concluded that a substantial number of "customers' men" were in fact being paid on what amounted to a straight commission basis, contrary to the exchange's rule. The Commission's survey was undertaken after the president of the NYSE submitted a proposal to amend rule 436 in order to permit firms to pay salesmen on a commission basis. Earlier proposals had been opposed by the Commission staff on the ground that the customers' interests were better protected by a fixed salary rule. In the course of the survey, a number of firms expressed the fear that abandoning the fixed salary rule would greatly increase the danger of salesmen's churning of accounts. Nevertheless, 6 years later, in 1949, rule 436 was amended by the board of governors to permit compensation on straight commission basis, thus conforming to the practices of the majority of the exchange members.[52] No safeguards were imposed to prevent the potential abuses which concerned those firms that had opposed revision of the rule in 1943. The Commission did not object to the amendment.[53]

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[51] NYSE, Supplementary Material, E–287.

[52] NYSE, Notice to Members, C–7449 (Aug. 19, 1949). Under a 1957 revision, rule 436 became the present rule 347.

[53] Although the Commission staff did not formally object to the proposed amendment of rule 436, it made the following comment on the matter:

"Although a salary basis appears to be better for the public since it helps to dissuade churning and excess trading in customers' accounts, the Division [of Trading and Exchanges] is aware that for all practical purposes the salary bases used are so frequently changed as to be tantamount to commission payments for business done by representatives. Therefore, although we feel the exchange will harm itself in the long run, we do not object to the proposal."

b. Variable factors

(1) *Exchange memberships and markets*

A dominant consideration in most compensation is the minimum commission rate schedule in effect on all exchanges. Such schedules for the most part prohibit member firms from splitting commissions with nonmembers.[54] Thus, firms which are not NYSE members must pay full exchange minimum commissions on all orders executed on that exchange. This places nonmember firms at a competitive disadvantage vis-a-vis member firms in transactions in listed securities, as is reflected in the relatively low percentage of gross income from exchange transactions reported by nonmember firms.[55] In turn, since salesmen's compensation is generally directly related to their firm's commissions or profits, the impact is reflected in the salesman's share.

The effect of minimum commission rate schedules is eroded to some extent by reciprocal business,[56] by the fact that some nonmembers charge commissions over and above the exchange commission, and by the practice of some nonmembers who purchase listed securities from over-the-counter dealers at prices slightly better than those available through an exchange member.[57] Nevertheless certain industrywide patterns are clear. A salesman whose firm is a member of the NYSE and several regional exchanges will receive full compensation for a transaction executed on any member exchange and for an over-the-counter transaction. A salesman whose firm is a member of only one exchange will receive full compensation for transactions on that exchange or over-the-counter transactions, but will be paid on a reduced scale, or paid nothing at all, for transactions on exchanges of which his firm is not a member. A salesman for an exclusively over-the-counter firm is likely to receive compensation only for over-the-counter transactions. The potential influence of this structure on the recommendations of salesmen is obvious.

Apart from the impact of the minimum commission rate structure, salesmen generally receive highest compensation from over-the-counter transactions than exchange transactions, regardless of whether the firm is a member of one or more exchanges, except where orders are executed on an agency basis.[58] This higher compensation is a combination of two factors: First, salesmen generally receive a higher percentage of the firm's gross profit on over-the-counter transactions than of the firm's commission on listed securities; and, second, the firms themselves frequently make a greater gross profit on transactions in the over-the-counter market. Thus while commissions to large NYSE member firm salesmen on their exchange business generally average one-third of the member firm's gross on such business, and the percentage drops off or disappears where the firm is not a member of the exchange on which the transactions are executed, a salesman's commissions on his over-the-counter business generally range from 40 to 50 percent of the firm's mark-up. As would be expected, the difference between compensation for exchange and over-the-counter busi-

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[54] The rules of the Pacific coast, Detroit, and Cincinnati stock exchanges permit splitting of commissions with NASD members and other specified entities under certain conditions. The subject is discussed in detail in ch. VI.

[55] See ch. I, table I–12.

[56] See chs. VI and XI.

[57] See tables in ch. VII and discussion in ch. VIII.

[58] For a discussion of principal and agency transactions in the over-the-counter markets, see ch. VII.

ness is least where the firm is an exchange member, and at least two member firms reported paying salesmen commissions at the same rate on all business. Most large member firms handle regular over-the-counter business on both a principal and an agency basis. In agency transactions they usually charge a commission approximately equivalent to the NYSE minimum commission, and salesmen receive the same percentage of the firm's gross as on listed business. Over 50 percent of the dollar volume of all shares purchased for public customers in the over-the-counter market, excluding registered and unregistered distributions, is on an agency basis.[59]

The study's review of salesmen's compensation practices, through questionnaires STS–1 and STS–2,[60] demonstrates the general patterns described above and the variations in those patterns. The STS–1 and STS–2 responses reflect the compensation advantage to salesmen, even among exchange member firms, in sales of over-the-counter securities. One firm with 17 branch offices reported that it paid 40 to 50 percent for over-the-counter transactions and 30 percent on NYSE orders. A smaller firm employing only 7 salesmen reported a 5-percent differential between exchange and over-the-counter business, while a firm with 2 branch offices and 40 salesmen, and memberships on 4 exchanges, reported differentials of between 5 and 15 percent.

Among exchange member firms, compensation to salesmen for business executed on their respective exchanges varies within fairly narrow limits, with smaller firms tending to pay higher commissions. Variations according to geographical location and the volume of business produced by the individual employee are common. For example, 1 large firm with 49 branch offices nationwide pays 25 percent to salesmen in its western offices, 30 percent to its midwestern salesmen and 33⅓ percent to its eastern salesmen, but western and midwestern salesmen who produce gross commissions exceeding $3,000 in a given month are rewarded by being raissed to the 33⅓-percent level for that month. Another large firm compensates its salesmen for listed business as follows: salesmen in eastern and midwestern offices receive 33⅓ percent of the gross commissions they produce; salesmen in western and southern offices receive 25 percent of the gross and those in southwestern offices receive 30 percent. Another firm with 65 branch offices, which varies the rate of compensation according to monthly production, makes only one geographical distinction among salesmen; all those in New York City offices are paid a minimum of 36 percent of their gross commissions with a sliding scale upward to a maximum of 41.4 percent as the individual's gross monthly production increases from $2,000 to $5,000 per month. The scale for this firm's other salesmen varies from 32 to 36.8 percent.

A representative example of a large NYSE member firm's commission schedule for salesmen, showing the complexity of the commission pattern and considerations involved, is set forth below:

> (*a*) On agency transactions in listed and unlisted securities 25 to 40 percent, depending upon location of office and the amount of the production of the individual registered representative;

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[59] See ch. VII. If distributions are included, the total percentage of the dollar volume of shares purchased for public customers on an agency basis would be lower since most distributions are done on a principal basis.

[60] See ch. II.A.3.

(*b*) Forty percent of the concession received by the firm in the "selling group" of new issues or secondary offerings (the firm does not take underwriting commitments);

(*c*) Fifty percent of the concession received by the firm on sales of mutual funds shares; and

(*d*) Twenty-five to fifty percent of the profit in a "net" transaction in over-the-counter securities depending upon the location of the office. (The firm takes no positions nor does it make any markets in such securities.) The majority of the firm's transactions in unlisted securities are on an agency basis upon which it charges the regular New York Stock Exchange commission rate. When it acts as a principal in such transactions, the profit generally is related to a regular commission or depends upon the type of security, work involved, and competitive situation with a maximum of 3 percent of the money involved.

Among the category of firms which are members of regional exchanges but not members of the two major exchanges, one small firm with six salesmen, a member of the Philadelphia-Baltimore-Washington Stock Exchange, pays its salesmen 15 percent of the NYSE member's commission for orders executed on that exchange although the firm receives no direct financial benefit from such transactions, and 30 percent of the commissions received for orders executed on the Philadelphia-Baltimore-Washington Stock Exchange. A medium-sized member of the Midwest Stock Exchange with 6 branch offices and 11 salesmen, pays them 33⅓ percent of its commission for an order executed on the Midwest Stock Exchange, and only 20 percent of the minimum allowed commission for an order executed on the NYSE, of which it is not a member. On the Pacific Coast Stock Exchange, one member allows its salesmen 40 percent of commissions for orders executed on that exchange, and only 20 percent for those executed on the NYSE and Amex, while another, which also gives 40 percent of commissions for orders executed on the PCSE, provides no compensation for orders executed on other exchanges. Firms which are members of regional exchanges but not members of the NYSE and nevertheless compensate their salesmen for transactions executed on the NYSE indicate that they follow the practice so that the salesmen will not turn away such business.

As for broker-dealers with no exchange affiliations, STS-1 and STS-2 responses generally show them paying lower commissions or no commissions for orders executed on exchanges, and, as would be expected, this category of firms derives little or no gross income from transactions in securities listed on exchanges.[61] There are, however, exceptions among over-the-counter firms, such as one retail broker which reported a gross income of $17,000 from customer transactions in stocks traded on exchanges and pays a 25-percent commission to salesmen on listed stocks as compared with a 40-percent commission on sales of over-the-counter securities. Most nonmember firms compensate their salesmen at the rate of 40 to 50 percent of the gross profit made on each over-the-counter transaction, although one firm reported giving its best producers as much as 70 percent of the gross profit on such business.

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[61] In the case of nonmember firms which show income from transactions on exchanges, the firms either charge customers an additional fee over and above the NYSE minimum commission, or purchase the securities over the counter through one of the dealers who specialize in this type of business. See ch. VIII.

(2) *Influence of nature of transaction*

(*a*) *Sales of over-the-counter securities on behalf of public customers.*—In exchange member and nonmember firms alike, because of the minimum commission schedules of the exchanges, salesmen receive the same compensation whether the exchange transaction is a purchase or a sale. However, while a salesman usually receives more compensation for the execution of customers' purchase orders in over-the-counter transactions than in exchange transactions, he customarily receives less for the execution of a sell order in unlisted securities. In over-the-counter transactions, one large firm credits a salesman with 50 percent of its gross profit on retail sales made to his customers and only 25 percent of its gross on sales made by his customers. The lower salesmen's compensation on customers' sales is, in turn, a reflection of reduced income to broker-dealers for the execution of retail sell orders.[62] Spokesmen for the NASD explained the reason for this practice as follows:

(Donald Burns, an NASD staff member:) "I have my own opinion. I think this is a merchandising business, and the profit comes in on the sale of your merchandise to the customer. All you are doing in liquidating other securities is, for the purpose of obtaining proceeds, for the sale of a customer."

(Glenn Anderson, former chairman of the board of governors:) "I would give the same view. As a matter of fact, most firms that I know of in the retail business, whereas they will pay a commission to a salesman on a retail sale, give no consideration at all on a liquidation, and take just enough to handle the transaction, or nothing at all. And do not shoot for any profit. And this is not uniformly so."

It seems clear that under this policy, a salesman's main financial incentive to recommend that his customer sell a particular unlisted security lies in a corollary recommendation to purchase other securities with the proceeds. On the other hand, the reason for lower compensation on customers' sales was explained by Merrill Cohen, the present chairman of the NASD, as follows:

Question. Would not the salesman devote just as much time in evaluating whether a customer should purchase as whether a customer should sell?

Answer. Well, let me give you a practical example. When a salesman goes out to sell something, he has no list of people who may be reasonably certain to buy it, so he is out prospecting for these people.

When a salesman has a selling recommendation, he has a list of customers of his who own that security, who, presumably, respect his judgment, and those salesmen, when we make a sales recommendation, will come much faster than the merchandising of an issue on the other side.

There are other factors, but I think this would be one that would be considered.

(*b*) *Distributions.*—The effectiveness of compensation as a stimulus to sales effort is best demonstrated when a block of securities is distributed to the public by one or more broker-dealers. Such distributions include registered and unregistered underwritten offerings in the over-the-counter market, special offerings and exchange distribution plans using the facilities of the exchanges, and sales of an accumulation of shares of a particular issue by a broker-dealer for his own account in the over-the-counter market.[63] Customarily an issuer or a holder of a substantial block of a particular issue must provide a selling broker with a financial incentive beyond the usual

[62] This matter is discussed further in ch. VII.

[63] Registered distributions of new issues and unregistered distributions are discussed in pts. B and C of ch. IV.

commissions or markup, in order to assure that the block will be sold in a short time and at reasonable prices. In an underwriting, this takes the form of a discount from the price at which the securities are to be offered to the public. Where the securities are offered by the issuing corporation or by controlling persons, the underwriting discount generally ranges from about 6 to 15 percent of the offering price, depending on the type and size of the issue. This compares with the median fee of approximately 4 percent charged by broker-dealers on their principal "riskless" transactions with public purchasers in the over-the-counter markets,[64] and even smaller fees on agency transactions. When a seasoned security listed on the NYSE is distributed either through the registration process or by means of an unregistered secondary distribution, concessions or discounts to broker-dealers are also substantially higher than the commission earned for executing orders for the same securities on the exchange.[65] Since a salesman's compensation is generally geared to firm profits in the particular type of business, he receives substantially higher than normal commissions for securities sold in any such distribution.

A recent distribution of one listed security demonstrates the striking effect of the incentive of extra compensation. In August 1962 a mutual fund sold 116,500 shares of common stock of American News Co., an NYSE listed stock, by means of an unregistered secondary distribution. The shares were sold to the public at 27½ through a selling group of broker-dealers who were allowed a discount of $1 per share, approximately three times the commission which would be charged per share if the order had been executed in the regular way over the exchange by a member firm. In less than 24 hours the entire $3.2 million block had been successfully distributed to the public. Salesmen for firms participating in the distribution earned at least three times their normal commission for selling that security. Unquestionably the rapid distribution desired by the selling broker-dealer in this type of situation is made possible only through an organized selling effort including extra compensation for salesmen.

A different kind of example of the impact of extra compensation involved the disposition by Blyth & Co. of an inventory of approximately 13,000 shares of Grosset & Dunlap, Inc., which had been reacquired in the after-market following a registered public offering managed by the firm. This incident is described and discussed in further detail in chapter VII. When the firm's inventory accumulation became large, it offered a larger than normal profit to its salesmen for selling the stock to public customers, whereupon 1,500 shares were sold to 31 customers in 1 day, in contrast to the previous 5 weeks in which none of the firm's customers had purchased any of the shares. After the firm had disposed of its long inventory position and had developed a short position it withdrew the extra compensation for salesmen, and purchases by its customers stopped.

c. Salesman's compensation and merchandising

The patterns of salesmen's compensation and their variations, both among firms and within firms, reflect the use of compensation in the securities industry as a strong merchandising stimulus. This system

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[64] See ch. IV.B.2.c(2) and ch. VII.

[65] Firms which are not members of the exchange may participate in distributions of listed securities when they occur in the over-the-counter market.

tends to make personal economic considerations a factor in the salesman's selection of securities which he recommends to his customers. Since he usually earns more money on over-the-counter transactions than on exchange transactions of comparable size, the salesman has an economic incentive to emphasize the former type of security in his recommendations. Since he earns little or no commission on customers' sales of securities in the over-the-counter market, he has an economic incentive to advise a customer to sell only if the proceeds are needed or likely to be used for the purchase of other securities. Since the salesman's rate of compensation is highest when he sells securities being distributed by the firm, he has an incentive to recommend such securities above all others. Even within the category of listed securities, because of the structure of the commission rate schedule he has an incentive to recommend that any sum be invested in lower priced rather than higher priced securities.[66] In addition to the financial pressure on the salesman to prefer particular categories of securities, the practice in some firms of stepping up his rate of compensation for each transaction in a given month, if the dollar volume of all his commission business during that month exceeds a fixed level, provides an inducement to exert extra effort to generate enough business in the month to qualify for the higher rate. In his zeal to reach the desired level there is danger that the salesman may stimulate customer orders without regard to the customer's needs.

4. THE TYPE OF MERCHANDISE—SPECIALIZATION

In view of the vast variety of securities available for purchase in the public market, it is hardly surprising to find that a considerable degree of specialization has grown up among retailers. A large number of firms sell only mutual funds or derive their income primarily from that source. Smaller groups restrict their activities to the sale of participations in real estate syndications, bank stocks, insurance company stocks, puts and calls, municipal and other government bonds, and oil and gas participations. Other broker-dealers concentrate on primary or secondary distributions of securities, and some of these further specialize according to type and quality of issues.

Specialization by itself is not only inevitable but in many respects desirable. There is a danger, however, that the specialist may not hold himself out to the public as such, but may project an image of equal willingness to sell, and equal knowledge about, securities other than those within his specialty. In such instances, specialization strains the broker's obligation to deal fairly with his customer, and strains it even further where a relationship of trust and confidence has been developed.

An example of this practice appeared in the study's public hearings. The brokerage firm of Hodgdon & Co., Inc., which employs over 50 salesmen in 3 offices, advertises itself extensively, both in newspapers and on the radio, as "specialists in financial planning," emphasizing in its advertisements its special ability to devise an investment program tailored to the individual needs of each customer. In fact the firm's salesmen are instructed, in making recommendations to customers who avail themselves of the firm's offer of financial planning,

[66] For a discussion of the relation between commission rates and round-lot value, see ch. VI.

to follow a fairly rigid investment formula under which the customer will divide the major part of his capital between mutual funds and real estate syndications, the latter described by the firm as "blue chips." Approximately one-third of the real estate issues purchased by customers were in enterprises promoted by the firm, and one-half of the mutual fund shares sold were of a fund in which the proprietor of the firm had an interest through the fund's management company. Extra compensation is paid on sales of this fund and on real estate syndications promoted by the firm. The emphasis on real estate participations and mutual funds is reflected in the fact that in the firm's 8-year history, less than 20 issues of industrial companies have been recommended to customers and of these, 8 were underwritten by the firm.

a. Specialists in speculation

Another group of specialists are those who do not purport to be financial planners but who concentrate on the sale to the public of stock of promotional or unseasoned companies. The merchandise they offer and the selling methods they use preclude concern on their part for the interests of their individual customers. Despite the intricate and specialized nature of their merchandise, they apply to the sale of securities the merchandising methods more suitable for selling vacuum cleaners or used cars.

The operations of one firm specializing in sales to the public of low-priced speculative securities were described during the course of testimony given the study by John F. Dailey, Jr., the operating head of Albion Securities Co., Inc. (Albion), of New York City, a member of the NASD with no exchange affiliations. Dailey's lack of previous experience in the business and the boilerroom backgrounds of his managers and salesmen are described in the previous chapter.[67] Albion was formed in September 1958 for the sole purpose of making a regulation A offering to the public of the stock of Heliogen Products, Inc., a company in which Dailey and his family had substantial interests.[68] The Heliogen offering was unsuccessful, but Dailey decided nevertheless to continue in the securities business after making arrangements to undewrite another regulation A public offering of the stock of Scaico Controls, Inc. Albion distributed 12,000 shares at the $1.25 offering price before the unsold portion of the issue was withdrawn.[69] Finding other unseasoned highly speculative securities for its salesmen to sell, Albion remained in the business. It does not appear that Dailey ever contemplated that Albion's business would consist of anything other than the merchandising of one or two speculative issues at a time.

Whenever Albion is engaged in the distribution of an issue, its salesmen push that particular security and are given incentives in the form of extra compensation or push money. Securities issues in which Albion acts as underwriter or as a selling group participant or which the firm trades for its own account are posted on a blackboard in the firm's offices and comprise the current list of merchandise which

[67] Ch. II.B.1.a(4).
[68] Dailey was vice president and treasurer and his brother was a "heavy" investor.
[69] At present there is no quoted market for the stock and its last price was below $0.50 per share.

salesmen are encouraged to offer their customers. Dailey himself evaluated the risks of the merchandise sold by Albion when he said:

> It's the type of thing that may go up or down, and if it goes up it may go up in a very fantastic fashion or go down and be worth nothing but you go into a gambling hall and you shake the dice and if you win you win, or if you want to play roulette you play the 36-to-1 odds and win big and lose a little.

Despite the totally speculative quality of the securities offered, the prospecting and selling techniques of Albion's salesmen are directed at all types of investors and potential investors, including small investors for whom such issues are clearly unsuitable. The firm also offers services which tend to blur the distinction between Albion and firms offering a wide variety of more substantial merchandise. When Albion plans to engage in an "aggressive selling campaign," a list of up to 25,000 names of potential new customers, including special categories of investors such as doctors and heads of small businesses in towns and villages, is purchased from a list broker. The list is the basis of a mailing campaign in which market letters and offers of portfolio analysis are circulated to potential investors, with return post cards enclosed. The returned cards are then distributed to salesmen who, without the firm's having performed any portfolio analysis, proceed to recommend the merchandise in which Albion specializes. The following colloquy provides insight into the purpose of this technique:

> Question. Mr. Dailey, I will show you a card which is entitled "Another Free Service by Albion Securities Co., Inc. For Confidential Survey of Your Investments Use This Form. The Form Which You Give Us Will Be Held in Strict Confidence." It says, "Portfolio Analysis." And it gives the recipient an opportunity to list the number of shares, common stocks held, date of purchase, and cost per share. What was the object in sending this out to members of the public?
> Answer. Well, the idea was to get a mailing list so that you could get customers out of the mailing list.
> Question. Have you any idea how many of those were mailed out, Mr. Dailey?
> Answer. No, sir.
> Question. In the thousands? Hundreds?
> Answer. I would think in the thousands. When I say in the thousands, maybe 2,500 or 5,000. I am just guessing.
> Question. To your knowledge, no such confidential survey of investments was ever made for any of your customers?
> Answer. No, sir.
> Question. This was simply a selling technique?
> Answer. That is right.

As another means of obtaining names of potential customers, Albion at one time employed a young man to make telephone calls to persons whose names he selected from a telephone directory. Described by Dailey in the boilerroom phrase of a "lead opener," his sole function was to accumulate names of prospects, to whom market letters would be sent by the firm. He was not a registered representative and apparently did not attempt to sell securities during his brief telephone conversations, which were described by Dailey as follows:

> In other words, he would call up people and say, "This is the Albion Securities Co. Would you be interested in having information." "Would you like to be put on our mailing list so that we will send you out all this information?" And if they said "No," that was the end of it. If they said "Yes," he would take their names down and go to the next one.[70]

[70] The importance of the telephone to Albion's operation is demonstrated by the fact that one of its major capital requirements has been its deposits with the New York Telephone Co., which have amounted to as much as $2,700.

Dailey, himself, candidly conceded the importance of telephone selling to unknown customers, in the following colloquy from the public hearings:

Question. Was it contemplated, and has it been the practice of Albion Securities, to sell securities over the telephone?
Answer. Yes, sir.
Question. Is there much in the way of personal contact between your salesmen and the customers of the firm?
Answer. No, sir; there is not.
Question. It has been the contemplation and it is the practice for there to be the sale of low-priced securities on the telephone?
Answer. That is right.

He also recognized that the securities sold by his salesmen were unsuitable for the small investor who could not afford to risk his capital on a "1 out of 10" chance of success, nevertheless admitting that a good number of his customers were in this category.

Dailey was candid in disclosing the nature of the firm's operations at the Study's public headings, but it is doubtful that many of his customers understand the risks involved in buying securities recommended by Albion salesmen. The firm holds itself out as a general broker-dealer and does not distinguish among the persons whose business it solicits. There is no warning to the unsophisticated investor that the firm specializes in speculation. One of the firm's salesmen, asked how he selected the securities recommended to customers, replied:

Whatever they come in, like a grocery store. Now we got beans and now we got bread. Whatever they had.

As a specialist in speculative issues Albion is not unique in the securities industry. During the period of frenzied buying of new issues, which reached its peak in the spring of 1961, a number of broker-dealer firms concentrated their efforts on sale to the general public of these low-priced, high-risk issues.[71] The attitude of one such firm to the merchandise it sold is suggested by the fact that it sent out market letters prepared by a printer who composed the copy as part of his printing service. The market letters were widely distributed to rented lists of names, and recipients were then solicited by telephone to buy the mentioned stocks. The suitability of the merchandise apparently was of no concern to the firm's proprietor, who testified as follows:

Question. Do you think that any deal that you go into * * * is suitable for any customer of yours?
Answer. I think so.
Question. Did you ever run into a situation where a customer of yours is unable to take the risk involved in a particular issue that you brought out?
Answer. To be honest with you, I wouldn't know.
Question. What do you know about your customers? Do you know how much money they have? What securities they hold? What their investment objectives are? Are you making any inquiry as to that?
Answer. No, I don't.

* * * * * * *

Question. Were you aware of the rule in the code of fair practice of the NASD which talks about the suitability of investments for or securities for customers?
Answer. Well, I think that any underwriting is a suitable investment, however speculative it might be.

Another broker-dealer employed as many as 28 salesmen to distribute 27 new, highly speculative and low-priced securities between April

[71] See ch. IV, below, for a discussion of the new-issue phenomenon.

1960 and April 1962. Unseasoned new issues were the only type of securities ever sold by the firm, which was the primary underwriter for 13 of these offerings, 9 of which it financed before a public offering was made. Of the 27 new issues it distributed, 4 were for companies which had not begun production and had no history of earnings prior to the effective date of their registration statements. By late 1962, most of the issues were selling substantially below their offering prices, although they had risen to substantial premiums immediately following the offering. Ironically, in December 1961, this broker-dealer warned investors against indiscriminate investments in the very type of new offerings it had so vigorously promoted, and stated:

> We regard the confidence you have placed in us as a trust—if you, as our client, do not prosper over the long run, then it would be obvious that neither shall we.

In the eyes of unsophisticated investors, firms of this type are not clearly distinguishable from those which offer the full spectrum of securities to the public and whose recommendations are not limited to new, speculative issues. As is shown in the discussion above, efforts are made by some firms to pose as investment advisers and solicit the trust and confidence of investors. In such cases, the pose may be nothing more than a merchandising device to aid in the selling of their limited, low-quality inventories.

b. The boiler rooms

Among the firms specializing in low-grade, high-risk securities are those broker-dealers which, because of the "high pressure" generated in their selling efforts, have come to be called "boiler rooms." Firms which qualify for this ignominious appellation, almost without exception, operate in violation of existing legal and ethical standards. At the Study's public hearings Philip A. Loomis, Jr., Director of the Commission's Division of Trading and Exchanges, which is charged with the responsibility of suppressing boiler rooms, described them in the following manner:

> Generally speaking, a boiler room in its full flower means an organization which is engaged almost exclusively in selling securities over the long-distance telephone to customers whose names are derived from lists obtained from either prior boiler rooms or compilers of lists, and where the only criterion for a salesman's performance is how many sales can he make at the lowest cost of long-distance tolls, with the result that the high pressure really builds up. Hence the name boiler room.
>
> Usually the securities they sell are somewhat obscure, partly because these securities are easier to get hold of in quantity, and partially because the boiler room prefers to have a security about which there is not any information available, so nobody will check up on what they say or at least until it is too late.[72]

Boiler rooms are not new to the brokerage community. The term was used in a judicial decision as early as 1937.[73] Characteristically, boiler rooms flourish during periods when substantial numbers of new public offerings are being made to provide for legitimate capital expansion.[74] At such a time, the inexperienced, unsophisticated investor, the usual target of the boiler-room operation, is easy prey for promises of great profits from pie-in-the-sky securities. Such tradi-

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[72] See also, *Mac Robbins & Co., Inc.*, Securities Exchange Act release No. 6846 (July 11, 1962).
[73] *U.S.* v. *Rollnick*, 91 F. 2d 911 (2d Cir., 1937).
[74] 24 S.E.C. Ann. Rept. 2 (1958).

tionally popular speculations as mining stocks, oil and gas promotions, and companies with new inventions are from time to time joined by issues currently in vogue in the securities markets as the favorite merchandise of these unscrupulous operations.[75]

One of the most successful boiler rooms of the 1950's was the Jersey City, N.J., firm of Tellier & Co., through which Walter F. Tellier capitalized on the uranium bonanza. Tellier made use of telephone, radio, direct mail solicitation, and newspaper advertising to supplement his salesmen's local and long-distance telephone selling campaigns for a succession of uranium issues. Both the selling literature and the telephone calls misrepresented the future prospects of the companies, the risks of investment and the worth of ore deposits. A favorite selling point of Tellier's salesmen was their advice to a customer to buy the low-priced shares and put them away for his children or grandchildren.

When Tellier's operation was in high gear, it was believed to be the largest over-the-counter security selling organization in the United States. Part of his profits came from buying stock for as little as 1 cent per share and selling at prices ranging between 75 cents and $1.87. Although the prices of the shares sold by Tellier were low and the average customer invested only about $150, the aggregate losses were staggering. The Commission has estimated that Tellier sold over $20 million in securities to 80,000 investors. The Tellier empire collapsed when he was convicted of fraud in the sale of debentures of Alaska Telephone Corp., and sentenced to a 4½-year prison term.[76]

In recent years the glare of publicity and the Commission's enforcement program have made blatant large-scal boiler rooms of the Tellier variety relatively scarce, but boiler rooms remain a problem. In discussing the changing nature of this problem at the Special Study's public hearings, Loomis stated:

> As a result of a great deal of hard enforcement work both by the Commission and by other regulatory or enforcement agencies in the field, the old full-dress ultra-high-pressure big boiler room is rather rare now, but there are numerous smaller organizations which spring up and engage in boiler-room operations for a while on a smaller scale until somebody catches up with them * * *.

Typical of the small organization which opens its doors to sell one or two speculative issues before its activities are detected and stopped by enforcement agencies was the firm of Mac Robbins & Co., Inc. Throughout its relatively short existence the firm provided a striking example of one-product merchandising, selling only stock in Sports Arenas, Inc. (Sports), a company with a chain of bowling alleys. New salesmen were told that they would be selling Sports stock, and brochures describing the company were distributed to newly hired salesmen to familiarize them with the firm's merchandise. Between October 1957 and November 1958, 100,000 shares of this stock were sold to investors at prices ranging from $2 to $7.50 per share. Substantially all of the shares were sold over the telephone by salesmen supplied with lists of names of unknown persons.

In what the Commission described as "boiler-room operations," Mac Robbins followed a three-step pattern. Prospective customers

[75] 23 S.E.C. Ann. Rept. 4 (1957). Here the Commission warned against unscrupulous practices in the sale of new insurance and financial ventures.
[76] 23 S.E.C. Ann. Rept. 171 (1957).

throughout the country received brochures containing a misleading and glowingly optimistic picture of the industry and the company, designed to make them receptive to a telephone "pitch" which followed. Salesmen then followed up the mailings with high-pressure telephone solicitations. Finally, investors who had purchased Sports stock were "reloaded," or convinced to increase their original investments. There was no place in Mac Robbins' selling practices for disclosure of adverse information concerning the company, for realistic disclosure of the inherent risks involved in investing in a new, speculative venture, or for determining the suitability of Sports stock for the individual investor to whom it was recommended.[77]

Certain types of misrepresentations used by Tellier's and Mac Robbins' salesmen are popular in boiler-room selling. They include, among others, assurances of substantial increases in market price, spectacular earnings, and dividends, profitable mergers, and listing on a national securities exchange—all to occur in the near future. Misrepresentations do not exhaust the catalog of their devices. To satisfy potential investors that there is an active market in the security being recommended when in fact none exists, the unscrupulous broker may make arrangements with other brokers to publish fictitious quotations giving the appearance of a bona fide two-way market.[78] The prices of most securities sold by a boiler room are artifically fixed by the firm, with no relation to a bona fide market or the inherent value of the security.[79] The investor may find that when the selling effort is concluded, the "market" has disappeared.

Often the stock sold by boiler rooms consists of blocks of unregistered securities distributed in violation of the law requiring registration and circulation of a prospectus.[80] In such cases it is not surprising that the broker does not reveal to potential investors that the securities have not been registered.[81] In one such recent case, apparently part of the scheme involved inducing investors to place orders for shares of a well-established, over-the-counter security. Within a short time they were advised that the stock had advanced ⅛, that it was not doing so well as expected, and that they should take their profit and purchase shares of another company. These latter shares were unregistered and had been obtained by the firm from corporate insiders at prices well below the amounts paid by its customers.

Another device not uncommon to a high-pressure selling effort is known as the "wooden order." Under this practice, confirmations are mailed to individuals who have not agreed to purchase the stock being offered.[82] Although the wary investor can refuse to complete the transaction, an unsophisticated individual, intimidated or confused, may pay for the stock he had not ordered.

As has been seen above, sales by fraud, misrepresentation and material omissions are characteristic of boiler-room operations, and these firms therefore generally operate in violation of the law. How-

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[77] *Mac Robbins & Co., Inc.*, Securities Exchange Act, release No. 6846 (July 11, 1962).

[78] A full discussion of this device is included in the general discussion of over-the-counter wholesale quotations, in ch. VII.

[79] *S.E.C.* v. *Corporate Investors Co.* (D. Arizona, Jan. 18, 1963), litigation release No. 2487.

[80] *Theodore A. Landau*, Securities Exchange Act release No. 6792 (Apr. 30, 1962).

[81] *P. J. Gruber & Co., Inc.*, 38 S.E.C. 171 (1958).

[82] In the matter of the application of *Palombi Securities Co., Inc.*, Securities Exchange Act release No. 6961 (Nov. 30, 1962). *P. J. Gruber & Co., Inc.*, 38 S.E.C. 171 (1958).

ever, while the Federal, State, and industry enforcement agencies use a number of enforcement techniques to deal with the boiler-room problem, they usually cannot reach individual cases until damage has been done. Higher qualification standards and improved sources of information are the obvious answer to regulatory terms;[83] beyond this, alertness of the individual investor remains essential.[84]

The regulatory problem created by boiler rooms and similar brokerage firms which sell only low-grade speculative securities to unknown and unseen members of the public is primarily one of identification and elimination.[85] This segment of the industry, because of their selling techniques and the type of merchandise they handle, by their very nature do not conform to the requirement to deal fairly with their customers. On the other hand, regulatory problems which exist with respect to the great majority of firms who deal with the public primarily involve inadequate controls or lapses in supervision and rarely include situations where the overall operations of a firm are inconsistent with the concept of fair dealing. In the following section the problems of the large, well-established firms are discussed.

5. PROBLEMS OF THE LARGER FIRMS

The leading firms, unlike those discussed in the previous section, generally attempt to sell securities in an ethical manner, and to inculcate their salesmen with the importance of dealing fairly with their customers. On the other hand, unethical and improper selling practices by the more reputable segments of the industry do occur; they are more isolated; are more difficult to cope with, and can result in significant losses to the public because of the vast number of investors served by such firms. Abuses have occurred which, in some instances, have rivaled those caused by boilerroom salesmen. Maintenance of high standards of selling during the period of rapid growth recently experienced by the industry has been difficult, and added strains occur during periods of accelerated public participation in the securities markets—a fact recognized by some industry leaders. However, the requirement of the broker or dealer to deal fairly with his customers in accordance with the standards of the business is not relaxed in such times and, as the industry has recently rediscovered, the excesses of a bull market sow a harvest of complaints and bitterness when stock prices decline.

In this section are cited specific examples of improper selling practices which, as is shown, result from serious failures of individual salesmen to conform to established standards and serious defects of control and supervision by their firms. There is no evidence that these practices are typical of how business is conducted by most of the larger firms, but regardless of their frequency they represent problems too important to be ignored. While the public should not have the impression that they constitute a tornado, neither are they but "a few drops of rain," as suggested by President G. Keith Funston, of the New York Stock Exchange. Although most of the specific cases discussed in this section arose during the speculative fever of late 1960

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[83] See Ch. II.

[84] In this connection the Commission publishes a pamphlet, "Investigate Before You Invest," alerting investors to the dangers of high-pressure salesmen.

[85] For a discussion of external controls by the regulatory bodies, see sec. 6.b, below.

and early 1961, similar misconduct may occur, albeit on a more modest scale, in all segments of the industry at any time. Unless adequate preventive measures are taken, the next active bull market will undoubtedly bring a recurrence of these abuses, in similar volume.

a. Public complaints

A number of customers of large NYSE retail wire houses who feel they have been victimized by unethical practices of salesmen bring their complaints to the attention of the Commission. It is important not to exaggerate the significance of these complaints, since the fair treatment given the vast majority of customers of these firms is rarely reflected in letters of commendation to the Commission, and the complaints received must be duly discounted for the normal bitterness of investors and speculators with burned fingers. Nevertheless, public complaints can serve to point to troublesome situations and danger spots. Limitations of time, budget, and manpower prevented the study from investigating most of the complaints which came to its notice. Some of the public complaints which, though for the most part not verified, describe types of abuses recurring throughout the study's investigation, are reviewed in this subsection. The following subsections describe the results of three detailed investigations which the study did undertake.

Customers who complain of selling practice abuses often mention recommendations of unsuitable securities, high pressure sales tactics, and excessive trading in accounts. One disillusioned investor, who wrote that he had placed his small account in the hands of a highly regarded investment house to "keep clear of the so-called boiler shop operation," found cause to complain of the low quality of securities recommended to him, the qualifications of its salesmen, and his financial losses, and concluded that "a so-called boiler shop could do no worse."

Complaints often comment on salesmen's lack of knowledge of the merchandise they recommend. One investor wrote of a salesman for a large NYSE member firm, who, in recommending a stock when it was selling at $19 per share, noted the "very good profits of the company's * * * operations and suggested that the stock would go to $30 at least and might even double in price." The customer later learned that at the time he purchased the stock the company was—

> already hopelessly in debt with every one of its divisions losing money; it was even then on the verge of bankruptcy.

After selling the stock a year later for $1.75 per share, this investor attached less blame to the salesman—whom he considered honest but uninformed—than to the firm, whose recommendation—

> proved so incredibly unreliable that perhaps they should be asked to beef up their research department to a more dependable level.

Customers are equally disillusioned by salesmen's recommending of highly speculative securities when they have not been made aware of the risks involved, do not intend and can ill afford to speculate, and do not expect the firm for which the salesman works to recommend such securities. One such lady investor wrote that she had hoped to provide for her retirement years by investing in securities. In following the recommendation of a salesman with "an old reliable firm" in purchasing 200 shares of an obscure company not known to her, she relied on her trust in the firm and its salesman. When she later learned that the issue was unseasoned and speculative, she attempted to dispose of it, only to learn that a market for it no longer existed. She wrote:

> If an unknown person or firm had approached me I would have considered it a boiler tactic. In this sense I feel I was taken advantage of.

Two separate customers of another NYSE firm complained to the exchange of recommendations by their respective salesmen that they purchase shares of a new regulation A offering when they were unaware of the risks typically associated with this type of offering. When the bulk of the offering could not be sold and the two customers were told that the securities recommended to them had become unmarketable, they were understandably confused and resentful. One wrote:

> I realize that over-the-counter issues are speculative. I expected that I might either win or lose. However, I did expect it to be traded as I was told it would be. I may be misinformed, but my attitude toward a brokerage house that was a member of the [New York Stock] [E]xchange was the same as my feeling about a bank.

Quite apart from recommendations of speculative securities, complaints suggest that buy or sell recommendations unsuitable for the customer are also made by salesmen of larger firms. On the basis of filed complaints it would appear that the trusting widow, who is taken advantage of by her securities salesman, is no mere figment of fiction, nor a figure of a bygone era. One widow with two sons in school reported telling her salesman in a very large firm that investments were her only source of income, and that she could not afford to speculate. When she opened her account, most of her capital was invested in a balanced mutual fund. The salesman did not recommend speculations to her, but he did recommend that she sell the mutual fund and purchase a substantial amount of a security which paid no dividends. She reported that when, after 3 months, she asked about dividends on one of her stocks, the salesman told her "there wasn't any, that it was a growth stock, and that I had no business in the stock market." Investigation of her account showed examples of unusual activity in a period of less than 3 months, also based on his recommendations. On two occasions the same securities were bought and sold in less than 1 month, and another stock was sold within 7 weeks of its purchase.

Similarly inappropriate but even more expensive advice was complained of by another widow, who followed and immediately regretted a sell recommendation of a salesman of the same large firm. In this case, the investor, in her sixties, was called at her home at 9:30 p.m. on June 14, 1962, and urged to sell all of her holdings because the market was going to drop much lower. On the following day she visited the salesman at the firm's offices, where he repeated the advice to sell and produced charts to prove the wisdom of the advice. Frightened, she followed the recommendation and sold almost one-half million dollars in blue chip securities. On the day she sold her securities the market rallied 15 points. She wrote:

> This man never even took into consideration, or asked me about taxes, etc. With an estate of this size, should he not have called in a man with more experience * * *?
>
> One reason for selecting the firm to handle the estate of my late husband was their reputation that they would advise me correctly, and help me. I am sure

they would not approve of the conduct of this man who truly frightened me to death.

Members of the public also complained of high-pressure selling tactics by salesmen of large reputable firms. In one instance a secretary with little prior experience in securities responded to a major retail broker's newspaper advertisement by returning a coupon offering information on securities. She shortly began to receive telephone calls from a salesman for the firm who urged her to sell the stock she owned and buy shares of another company. Despite her initial rejection of his advice the salesman pressed on. In one call he told her that he had purchased 100 shares himself, that he would purchase additional shares, if he had the money, and that the price of the stock would go higher. A few days later he telephoned her at her employer's office and advised her to buy the stock immediately "as it was beginning to move." Despite another refusal the salesman called again within minutes "because it was about to move." At this point the harassed lady, busy at her job, consented to the purchase.

One customer of a leading NYSE member firm complained that he would not have purchased shares of a company recommended by his salesman had not the latter said that he himself had purchased a substantial number of shares. In an exchange of correspondence a partner of the firm conceded that actually the salesman did not own shares of that stock, and that in saying that he had "taken a big position" in the stock he was referring to his customer's holdings rather than his own.

Another practice of which investors complain is overtrading of customers' accounts or churning.[86] In one situation which came to the attention of the Special Study, a customer complained that the salesman of a major retail NYSE member firm churned his account, with more than 200 transactions executed within 1 year and with a resultant loss which he calculated at almost $11,000 on an investment of $20,000. The firm earned over $7,000 in commissions on the account during the period.[87] Before leaving for Saudi Arabia the customer had executed a power of attorney in favor of the salesman. Analysis of his account revealed that during 11 months of 1960 there were 124 purchases and 123 sales, with a gross value of over $500,000, and that in some instances the same securities were bought and sold in very short periods of time. For example, 200 shares of American Motors were purchased on February 11, 1960, and sold on February 18; 100 shares of Magnavox were purchased on February 18 and 19 and sold on March 1, 3, 4, 8, 14, and 16, and on March 17 another 100 shares were purchased, then sold on the next day, while on the following 2 days 400 shares were bought for the account.

Complaints of overtrading in accounts where no formal discretionary authority had been given were also made to the Commission. One investor stated that he—

had a busy dental practice and could not devote much time to the market and would be relying on his (salesman's) good faith and judgment from that time on.

Within 2 months his existing portfolio was almost completely sold out and replaced by other securities. One issue was bought and sold five

[86] Specific NYSE and NASD rules prohibit the practice in cases where the customer relies on the salesman to the extent of giving him a discretionary power of attorney over his account.

[87] The study verified the number of transactions and the amount of commissions paid by the customer, but not his total losses.

different times during the following months. After approximately 1 year, the firm had earned almost $4,000 in commissions and the value of the investor's portfolio had decreased substantially.

b. The Bache & Co. Seattle branch

An example of the deterioration of standards in one branch of a large organization, the result of a combination of a casual approach to such standards on the part of the branch office manager and lack of attention by the central supervisory personnel, was developed through the study's investigation of the Seattle office of Bache & Co. (Bache) the industry's second largest retail brokerage firm.

On September 1, 1959, Bache opened a new branch office in Seattle. By the end of March 1961, the assistant branch manager, a man with considerable back office experience who had been hired to set up the branch and act as operations manager, began to be disturbed by irregularities in the handling of customers' accounts by salesmen. He then brought the problem to the attention of the Bache home office in New York City. His general concern, expressed in a letter addressed to the firm's regional manager, was that salesmen were ignoring rules in their efforts to increase business and were thereby placing the firm's reputation in jeopardy. In communications to both the regional manager and the comptroller, naming the specific accounts which he believed were being mishandled and the specific salesmen who he believed were involved in improper conduct, he recited the following improprieties, among others: Permitting discretionary accounts to be handled by two salesmen whose personal checks to the firm involving their own transactions had been returned for insufficient funds; churning customers' accounts; repeatedly violating regulations in the extension of credit; and "free riding" by salesmen on new issues.

As a result of these communications, the regional manager was sent to Seattle in July 1961 to investigate, but apparently no significant action was taken by the firm. According to testimony at the study's public hearings, the firm felt that the allegations of the assistant manager were inaccurate.[88] On the other hand it should be recorded that in a 1-week on-the-spot investigation conducted by the Special Study in April 1962, many of the specific situations mentioned by the assistant manager were verified, additional irregularities were discovered, and none of the allegations which were investigated proved to be without foundation. Two specific cases of improperties which were covered in the study's public hearings are discussed below.

One of the customer accounts in which the assistant manager felt that there had been undue activity was that of a lady identified in the hearings as "Mrs. Blank." Questioned about this account, the regional manager testified:

> We * * * found that [the customer] had already been contacted by [the branch manager] because in his judgment he thought there had been a fair degree of activity in the account. He was told by the customer that she wanted this activity.
>
> [The manager] took over this account from the registered representative who had been handling it, and then began to handle the account for this registered representative.

[88] The assistant manager submitted his resignation to the firm in August 1961, and it was promptly accepted.

Neither this customer nor the several other customers whose accounts we looked over had made any complaint.

Trading in the account of Mrs. Blank, characterized by the regional manager as "a fair degree of activity," involved, in the period from October 16, 1959, to December 31, 1961, total purchases of $189,000, total sales of $178,000, or a rate of turnover of roughly 15 times the original investment of $12,458. Of the securities purchased for the account, 87 percent were held for 90 days or less. This activity entailed a loss to Mrs. Blank of over $7,000, including commissions of over $4,000 paid to Bache & Co. The salesman who handled the account with complete discretionary authority from the customer had himself been required by the firms to liquidate his margin account for overactivity and for delivering personal checks to the firms which had been returned by the bank for insufficient funds. He continued to be employed by Bache until May 1, 1962, when he left to go into the mutual fund business.

Mrs. Blank provided her version of the incident to the Commission in a sworn statement, which in pertinent parts reads as follows:

* * * I want to state first that [the salesman] is the son of a very good friend of mine, and I would not want to hurt her in any way. In a divorce settlement I received a house which I had sold with net proceeds of $10,000, which I had invested in two open-end stocks * * * In 1959 my divorce payments (alimony) were due to stop in about 2 years and I decided that the income from the open-end stock would not be sufficient to live on. Then I got in touch with [the salesman] because I was a friend of his mother's and he had always been a friend of my oldest son since childhood, and told him that I needed a greater return for my money. He made up a suggested plan for investment objectives. I told him that if I was not making money he was to let me know (because that was all I had to live on in the future) and we would stop and decide what to do next. I made it clear to him that this was all the money I had.

[The salesman] was authorized by me at this time to make all of the decisions in relation to my account. He after that did not ever call me about any transactions, both buying and selling. Therefore I never knew the status of my accounts until I received my confirmations. I would start to watch the stock which I thought I owned and then would receive a notice that it had already been sold. Whenever I asked [the salesman] how I was doing financially, he would reassure me and tell me everything was fine.

About April of 1960 my tax expert pointed out to me how many short-term trades I had made. I then told [the salesman] not to trade so fast, but to hold for long-term gains. (This was always by phone—I was never in his office.) He always told me when we talked on the phone that things were going well.

I finally went to see an officer at the [* * * National] Bank * * * who pointed out how much money Bache & Co. had made on my trading. I asked [him] to speak to [the] office manager of Seattle Bache & Co. branch * * *.

Improprieties of another sort, resembling a practice commonly known as "check kiting," were uncovered through the investigation of the account of another customer, identified in the public hearings as "Mr. S.," who subsequently became a salesman for Bache. In February 1960, Mr. S., who had no prior investment experience, opened a cash account in the Bache Seattle office. In April he bought several securities which he then sold prior to the settlement date for the purchase. To pay for them he delivered three checks aggregating nearly $93,000, written on a bank account which he knew did not have funds sufficient to cover them. The following day he received a check from Bache for the sale proceeds, which he immediately deposited to prevent an overdraft. In June he repeated the transaction, this time writing a check for $100,150 and receiving a check from Bache for $101,125. According to Mr. S., he engaged in these transactions only on the assurance of the Bache salesman that the branch manager had approved the nature of the transactions.

In April 1961, Mr. S. became a salesman for Bache and soon discovered that his transactions as a customer were neither customary nor permissible in the securities industry. On October 5, 1961, one of his customers purchased 200 shares of International Business Machines at a cost of $110,750, in a cash account. The shares were sold on October 9 for $111,423. On October 12, the customer issued a check for the purchase price, and the next day received a check from the firm for the proceeds of the sale, which he immediately deposited in his bank account to cover his check. Upon receipt of the first two checks, the customer's bank had contacted the Bache branch manager because of the large amounts involved and the very small balance in the account; neither check was honored. Similar purchase and sale transactions were attempted on October 11, 12, and 13, but no checks passed in connection with the latter transactions because by this time the customer's account had been frozen.

When the branch manager reported the matter to the New York office, Mr. S. was required to supply a written explanation for his conduct. His memorandum to that office denied knowledge of the exchange of checks. According to his sworn statement to the Commission, he was advised to prepare the memorandum by the branch manager, who, when reminded by Mr. S. that he had engaged in similar transactions as a customer, answered: "We knew you and knew who you were." For his participation in these transactions Mr. S. was discharged by Bache "without prejudice," and through his former salesman he subsequently obtained employment with the Seattle branch office of another large NYSE member firm, disclosing to them the facts that had led to his dismissal. In reporting the termination of his employment to the NYSE on its form RE-4, Bache stated that his record was "clear," despite the requirement of the exchange that member firms inform the exchange of the reasons for the termination of employment of registered representatives.[89]

Following the public hearings in May 1962, in which these facts concerning the Bache Seattle office were elicited, the Commission staff suspended its investigation to give the New York Stock Exchange opportunity to exercise its self-regulatory powers in the case. On February 26, 1963, after concluding its own investigation, the advisory committee of the exchange's board of governors censured and fined Bache & Co. $5,000; censured two partners, one formerly in charge of branch office administration and the other formerly in charge of the firm's operations division; censured the former regional manager and prohibited him from acting in a supervisory responsibility for 6 months and also required him to take and pass the exchange examination again; withdrew approval of the office manager's acting in that capacity for a period of 6 months, and required him to take the exchange examination again; suspended four registered representatives for 1 month with the additional requirement that each be reexamined; censured a fifth registered representative; and provided that any application for registration submitted for a sixth

[89] For a discussion of NYSE controls relating to salesmen's character and integrity, see ch. II.C.

salesman, whose employment had been terminated by the firm, be deferred for 2 months. The committee's sanctions were based on the submission by the firm to the exchange of what is called "manufactured" reasons on extensions of time for customers' payment for their securities and more generally on—

in adequate supervision of the firm's Seattle office. This was evidenced by a number of irregularities in the office which included violations of regulation T, "kiting" checks, meeting margin calls by liquidation, excessive trading, and improper allocation of hot issues. Although one of the firm's regional managers was sent to Seattle to investigate various problems, his report was inadequate and recognized as such by the firm's internal counsel, yet no effective corrective action was taken.

c. The Aquafilter selling effort

An outstanding example of the infection of the more reputable elements of the brokerage community with the virus of speculation was a short but disastrously effective selling effort involving over 600,000 shares of Aquafilter Corp. (Aquafilter). By early 1961, when enthusiasm for Aquafilter shares was at its peak, the company had a history which should have alerted any salesman who bothered to check, to the extreme risk involved in investing in its stock. From its organization in 1955 Aquafilter's principal business has been the development and marketing of a water-impregnated filter for cigarettes, which could be used for one pack and then discarded. Its only public offering of stock took place in 1956, when 150,000 shares were sold, pursuant to a regulation A exemption, for $2 per share. By 1960, a total of 1,446,920 shares were issued and outstanding, although no additional filings had been made with the Commission to cover the additional issued shares and the stock had not been split. By the end of 1960 the company's losses on all previous years' operations amounted to over $700,000, its total assets were approximately $50,000, it had about $3,000 in cash in the bank, and its current assets exceeded current liabilities by only $1,500. During 1960 it incurred a loss of $68,000 on total sales of $16,000, and the price of its shares declined from the offering price of $2 per share to 25 cents.

Ths is the record of the company of whose stock over 80 retail brokerage firms sold over 600,000 shares to more than 2,000 public customers in the short period between February 1 through May 15, 1961, at prices ranging from $0.75 to $6.75 per share. Among the firms which sold substantial quantities of the stock were a number of large NYSE wire houses and larger over-the-counter houses. For example: Approximately 300 individual customers of Merrill Lynch purchased 99,400 shares during this period; 94 customers of Bache & Co. purchased 26,000 shares; 46 customers of Eastman Dillon, Union Securities & Co. purchased 12,700 shares; 472 customers of E. F. Hutton & Co. purchased 116,600 shares, the largest amount purchased through a single firm; 79 customers of First California Co. purchased 20,300 shares; 68 customers of Harris, Upham & Co. purchased 27,300 shares; 112 customers of Hayden, Stone & Co. purchased 30,400 shares; 37 customers of Hemphill, Noyes & Co. purchased 13,500 shares; 66 customers of J. A. Hogle & Co. purchased 17,100 shares; 93 customers of Walston & Co., Inc., purchased 27,200 shares; and 88 customers of Dean Witter & Co. purchased 34,600 shares.

The high volume of activity in the shares of this unsuccessful company coincided with a high-pressure campaign promoting the company's single product through television, radio, and full-page newspaper advertisements in the Los Angeles area beginning in January 1961.[90] The campaign emphasized the advantages of the filter in reducing the intake of tars and nicotine, indicated that it had been approved by doctors, suggested that it would reduce the danger of heart disease, and used purported scientific tests and testimonials from medical journals. Public relations counsel was employed early in 1961, and the cigarette filter was displayed prominently by a chain of Los Angeles drugstores, which accepted it on a trial basis in January 1961.

In April 1961 the promotional campaign reached its height when Herman Shaw, the company's president, visited Los Angeles. After the public relations counsel[91] had arranged a conference for Shaw with David Rees, financial writer for the Los Angeles Daily Mirror, Rees devoted his April 18, 1961, column "Econoscope," to the company. The column was headed "Aquafilter's new product sends stock soaring as prospects brighten," and opened with a brief description of the company's background and history of losses. Most of the remainder of the article consisted of quoting the exaggerated predictions of the president. These included: The company intended to build a new $400,000 plant in the Los Angeles area, which would be in operation in 5 months and employ 150 people; the existing plant in Connecticut was "scrambling to keep up with orders" and would double production by June and redouble by October; profits would be $75,000 per month from June 1961, and rise to $200,000 a month beginning in September; earnings would be $2 per share in 1962 on $10 to $12 million in sales; the company hoped to pay cash dividends in 1962 and 1963, and to list on the American Stock Exchange in 1962. The column concluded by reporting the president's claim that retail sales of the product amounted to $100,000 per month in the local Los Angeles area.

The day following the appearance of this column, Shaw held a cocktail party attended by a number of representatives of the local brokerage community. At the party he repeated and enlarged upon the information which had appeared in the paper the previous day. A number of sales were the direct result of this cocktail party, as is seen below.

During the course of the promotional campaign of the company's product, the market price of Aquafilter stock rose from its low of 25 cents per share to approximately $3.50 per share, and during Shaw's visit to Los Angeles, it jumped to a high of $7 per share. By the end of 1961 the price had declined to less than 50 cents per share, and in September 1962 the stock's price appeared in the over-the-counter wholesale sheets at 5 cents bid, 15 cents offered.

With Aquafilter's promotional efforts concentrated in southern California, it is hardly surprising that much of the activity in its stock was centered there. Undoubtedly, some members of the public were independently influenced to make purchases by the promotional campaign, but it also is clear that a substantial number of purchasers

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[90] Similar promotional activities had been conducted by the company in 1958 and 1959 in the Midwest and in Washington, D.C.

[91] For a description of the activities of public relations counsel and the securities industry, see ch. IX.C.

were solicited by and made their purchases on the recommendations of salesmen who were themselves victims of the high-pressure promotion. It was estimated by a Merrill Lynch official that his firm's salesmen sold approximately 60,000 shares by actively soliciting orders from their customers. An E. F. Hutton salesman whose 26 customers bought 9,560 shares—mostly at his recommendations—based his recommendations on a conversation with a friend, personal discussions with local druggists, and chainstore operators concerning their sales of the filter and his own use of the filter. This salesman advised his customers to purchase Aquafilter shares despite unsuccessful attempts to obtain information on company through such more orthodox techniques as the standard financial services and his firm's research department.[92] Another salesman in a southern California branch office of Dempsey-Tegeler Co. first heard of Aquafilter through a conversation with a customer of his firm, who had in turn heard about the company through her insurance agency. After trying the product himself and reading an old magazine article about the company, this salesman had a telephone conversation with Shaw, who spoke favorably about Aquafilter's immediate prospects. Without other investigation, the salesman advised approximately 30 customers to purchase a total of 30,000 shares of the stock.[93]

A striking example of the direct and indirect influence of the public relations efforts on salesmen's activities occurred in Merrill Lynch's Pasadena office. One of the salesmen from this office, his interest in Aquafilter stimulated by the column in the Los Angeles Daily Mirror, attended the cocktail party given by Aquafilter's president on April 19, 1961. Leaving the party at about 6 p.m., he returned to his office and began calling his customers and recommending that they purchase shares of Aqualfilter. Two other Merrill Lynch salesmen who were in the office at the time overheard his description of the company, and when they asked him about it, were given the information learned at the cocktail party. They immediately began calling their customers. During the evening of April 19 and through the next day, salesmen of the Pasadena office induced their customers to purchase over 20,000 shares of Aquafilter stock, passing on to them both the statements made by Shaw at the cocktail party and those contained in the newspaper article of the previous day. One of the salesmen who did not attend the party repeated to a customer the predictions in the newspaper column and added that the stock would reach $10 per share by October.

The salesman who had attended the president's cocktail party called one investor at 9 p.m. on the evening of April 19, and told him that he had just come from a meeting sponsored by the company, that the product looked very good and that Aquafilter production could not keep up with demand. The salesman also said that the filter had not been offered for sale in the East since the company could not supply even local demand, but that when the eastern market could be supplied, one could expect a very interesting future for the company.[94] Shortly after the customer purchased the stock the price dropped over 3 points,

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[92] See ch. IX for a discussion of the absence of disclosure in the over-the-counter market.

[93] While recommending this highly speculative offering to his customers, this salesman purchased none himself because his funds were invested in Sinclair Oil debentures.

[94] In fact, the filter had been offered for sale in the East for a number of years and the demand had never been to the point where the supply was unable to meet it.

and he called the salesman, who assured him that the price decline was temporary and that the stock could be expected to recover. To another customer called at his home during the evening of April 21, 1961, this salesman pointed out that the price had risen from 25 cents per share to $5 per share and that it was expected to go at least $10 per share. This customer was also told that a favorable Dun & Bradstreet report had been obtained on the president, that Aquafilter was "a new company just starting out with a completely new product," and that other plants were to be built to distribute the product in other parts of the country. None of the statements had any basis in fact. No information regarding the current financial condition of the company was transmitted to the customer, nor was he told that the company had suffered losses of over $700,000 since beginning its operation.

Although Merrill Lynch has a large research department in New York, none of its salesmen requested an analysis of Aquafilter before recommending its shares to public customers. One Aquafilter purchaser reported that he—

> did not consider it necessary to question the recommendation made by one of the Merrill Lynch representatives.

Not only did salesmen fail to verify in even the most cursory way the information which they freely passed on to investors, but they also failed to consider the suitability of this admittedly high-risk security for the particular customers to whom the shares were recommended. Another investor who purchased 100 shares of Aquafilter stock at $6 per share, a sheet metal draftsman, had opened his account with Merrill Lynch during the previous year for the express purpose of investing in growth securities to provide for his son's college education. It should also be noted that a Merrill Lynch executive stated:

> We would never recommend Aquafilter as a speculation to anyone. I would not say this was a suitable stock for any speculative customer of Merrill Lynch that I know of.

Yet, in a 14-week period, Merrill Lynch salesmen sold almost 100,000 shares of this security.

It is significant that the activities of the Merrill Lynch salesmen were in clear violation of the firm's own rules and policies. In failing to consult with the firm's research department concerning the merits of Aquafilter prior to recommending it to customers, the salesmen violated Merrill Lynch rules relating to speculative over-the-counter securities. In soliciting orders for the securities of a corporation whose stock had been offered under a regulation A exemption, another firm policy was violated.[95] Ironically, at the same time that Aquafilter was being sold to Merrill Lynch customers in California, the firm was warning the public and its employees of the dangers of imprudent speculation.

Merrill Lynch places great emphasis on the matter of supervision:

> Just as public laws require law enforcement agencies, a business must provide supervision to see that its policies and procedures are followed.

Substantial responsibility for supervision rests with the branch manager, who is required to make a daily review of all transactions in his

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[95] The salesmen ignored still another firm policy by failing to have the approval of the marketing department manager before accepting unsolicited purchase orders for the stock. The firm also prohibits execution of an order of a security believed to be "unscrupulously promoted," but it is not clear that the salesmen who sold Aquafilter were conscious of the deliberate promotion involved.

office. Additionally, electronic data-processing machines provide the home office with a daily transcript of transactions in all of the firm's branch offices, giving management an overall view of activity in a particular stock in all its branch offices. In the case of over-the-counter securities, such as Aquafilter, the "trader" has the authority to refuse to execute any order for a security issued pursuant to a regulation A filing. If the Merrill Lynch supervision mechanism had been operating efficiently, sales of substantial amounts of Aquafilter shares would have been discovered at an early date by one of the firm's three supervision techniques and appropriate steps taken to prevent further activity in the stock.

A number of factors were cited by Merrill Lynch to explain the evident failure of their supervision system. These included the illness at that time of both their Pasadena branch manager and the assistant manager of the trading department. However, the principal reason given for the firm's lapse was the high volume of over-the-counter transactions which accompanied the "speculative fever" in the securities market in the spring of 1961. In emphasizing the pressures to which the firm was subjected, Donald T. Regan, vice president and secretary, testifying for Merrill Lynch at the study's public hearings, said:

> If you put this in perspective as we reported [in the] over-the-counter questionnaire [questionnaire OTC-3 [96]] we handled $2.4 billion of securities over the counter in the year 1961. This [Aquafilter] involved several hundred thousand dollars. So that it was that type of transaction that slipped through.

Throughout the portion of his testimony which related to Aquafilter, Regan candidly admitted that a serious error had been made in permitting substantial sales of Aquafilter shares to the public.[97] Management of Merrill Lynch was alerted to the Aquafilter situation by an inquiry to the firm in August 1961 during the course of an investigation conducted by the staff of the Commission, and the firm promptly began its own investigation. It received its first and only customer complaint concerning Aquafilter in October. In December, after consideration of the facts then known to the firm, Merrill Lynch decided to "offer to make good the losses" suffered by its customers.[98] The market price for Aquafilter stock was below $1 per share at the time the offer was made and every customer to whom it was extended accepted.[99] The firm also proceeded to discipline eight salesmen who solicited orders for purchases of Aquafilter shares. Fines up to $2,000 were assessed against individual salesmen, the office manager was reprimanded, and the NYSE was notified of the steps taken by the

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[96] This questionnaire is described in ch. VII.

[97] At various points in his testimony, at the study's public hearings Regan made the following comments:

"Let us face it. This is one in which we goofed."

"That is how it slipped through, frankly. People were busy."

[98] It has not been determined whether any of the other firms whose customers purchased and held Aquafilter shares made the same offer. As of Mar. 26, 1962, at least three firms with a substantial amount of solicited business in Aquafilter shares, had decided that restitution was not warranted under the circumstances.

[99] In a letter dated January 26, 1962, from Merrill Lynch to the Commission's New York regional office, the text of letter to the firm's customers who purchased Aquafilter was enclosed and stated in part:

"We are writing to you about your purchase earlier this year of Aquafilter common stock in your account carried by our firm. We have reviewed this transaction and have concluded that it was inconsistent with the policies of our firm. Accordingly, we are willing to pay you an amount equivalent to your loss in the security, but in order to obtain the payment, we ask you to visit our office and contact the undersigned within the next 30-day period."

firm. The home office also instituted procedures to prevent a recurrence of this type of selling activity.

In January 1962, the NYSE, learning of Commission interest in the Aquafilter case, commenced its own on-the-spot investigation of member firm activities relating to Aquafilter in the Los Angeles area. The exchange was primarily concerned with whether any salesmen of member firms received "cheap stock" from Aquafilter's president as consideration for "their pushing the stock into customer accounts" in a possibly illegal distribution of unregistered stock. As a result of the investigation, one salesman was suspended for 3 months by the exchange for purchasing Aquafilter shares from the company's president at 50 cents per share when the market price was $1.50. In its investigation the exchange interviewed 50 customers and approximately 75 member firm employees, and reported that it found no indication of misrepresentation, nor did any customer blame his broker for his purchases of Aquafilter. Although the exchange excluded Merrill Lynch from its investigation because the firm had made restitution to customers and had disciplined its salesmen, the findings contrasted with the obvious inferences about the activity in Aquafilter which arose from the results of the Commission's investigation of Merrill Lynch's selling activities.

d. Shearson, Hammill & Co. and USAMCO

A striking illustration of the havoc that can be wrought on the investing public through irresponsible selling practices and a total breakdown in supervision involves the extensive activities in the stock of United States Automatic Merchandising Corp. (USAMCO) carried on by partners and registered representatives of the firm of Shearson, Hammill & Co. (Shearson), self-styled as "The House That Research Built."

Shearson, one of the oldest and largest brokerage houses in the country, is primarily a New York Stock Exchange commission house, although it does a substantial amount of business in over-the-counter securities, mutual funds and underwriting, maintains an active trading department in 60 to 70 securities, and provides extensive research and investment advisory services for its salesmen and customers. In 1961, Shearson was among the industry's 10 largest firms in the amount of its net NYSE commission business, and in the dollar value of its over-the-counter transactions. The firm is a member of all the major exchanges, and has 27 general partners and approximately 570 active salesmen in its New York home office and 47 branch offices located throughout the United States and in two foreign countries. Its activities in connection with the distribution and subsequent selling and trading of USAMCO stock, however, relate primarily to the firm's branch offices in southern California.

(1) *USAMCO*

USAMCO was organized in California in July 1960 by Richard S. Stevens, one of its three directors and its president and treasurer, to engage in the automatic food-vending machine business. Its initial financing authorized by the first meeting of the board of directors included a private sale of $700,000 in subordinated debentures, convertible into common stock at the rate of $1 per share commencing in September 1962, and a regulation A public offering of 290,000 shares of common stock at $1 per share.

According to John B. Dunbar, who was senior partner in charge of Shearson's 11 branch offices in California and 2 in Arizona and was also one of USAMCO's three original directors, the company was to engage in "an entirely new idea in the vending business." It was planned that the company would furnish automatic vending machines to operators without charge, upon condition that the operators purchase minimum quantities of food products and beverages from USAMCO, which would realize sufficient profit on the sales to repay the cost of the machines. Stevens, the promoter of USAMCO, and the original subscribers to the convertible debentures were all affiliated with United States Chemical Milling Corp. (Chemical Milling), a company engaged in manufacturing automatic vending machines, from which USAMCO planned to purchase its machines.

On October 3, 1960, 3 days after the convertible debentures were issued, USAMCO filed a regulation A offering circular to cover the proposed public offering of its common stock. Distribution of the shares to the public commenced on November 14, 1960. The market price of the stock immediately began rising in a manner characteristic of other "hot issues" during the new-issue craze.[100] The stock, issued at $1 per share, was quoted at 3 bid to 3½ asked on the day the distribution commenced, and was selling at $5 per share within 1 week. In April 1961, the shares reached their price peak of 19⅞. Thereafter the price declined slowly to around 15 in June and 9 in early September. Then the stock plummeted—by October 1961, it was quoted at 5 cents bid to 20 cents asked.[101]

As was true of many of the hot issues of 1960, the business operations of the issuer hardly justified the soaring market price of the stock. In USAMCO's case, the reality never even began to approach the price. By February 1961, USAMCO had already run into problems through the acquisition of a company which, Stevens advised the board of directors, had liabilities far in excess of what had been disclosed by its management. By April of 1961 it had become clear to management that the company needed an additional $2 million in capital in order to produce a profitable sales volume, and on April 28 Stevens wrote a letter to the board of directors discussing 11 possible sources of capital, and concluding:

> To be brutally honest, without additional resources to set up our own finance company, and embark upon an aggressive program of acquisitions, we are going to have to face the reality that losses will continue for several months until we can get the existing organization on a profitable basis.

One path to financing which management pursued unsuccessfully was a merger with a financing company which would give it a greater line of operating credit. In May, after months of losses, the company achieved its only profitable month through a nonrecurring sale of inventory, but its operations never showed a profit.

By June 1961, its original method of operation proved to be so unsuccessful as to be abandoned. The company then attempted to lease or enter into conditional sales contracts for its machines, but found itself unable to finance the leases and sales. Finally, by acquiring several small vending companies primarily through the issuance of stock,

[100] See ch. IV, below.
[101] All prices have been taken from the daily quotations of the National Daily Quotation Service, Pacific Coast Section.

the company became engaged in the business of operating the vending machines itself. The combined result of these abortive activities was a loss of $600,000 for the fiscal year ending August 31, 1961, and by March 1962 the company was in the process of liquidation.

(2) *Relationship between USAMCO and Shearson*

From the very beginning of USAMCO's existence it had close ties with Shearson. Dunbar was instrumental in arranging the original financing of the company, and his sale to his customers of $300,000 in convertible debentures out of the $700,000 issue provided a substantial portion of the company's initial capital. It was originally hoped by USAMCO's promoters that Shearson would underwrite the regulation A public offering of the company's common stock. However, Dunbar was informed by the New York office of the firm that the underwriting of a new, highly speculative issue would be inconsistent with Shearson's policy. The original offering circular filed by USAMCO with the Commission stated:

> The issuer has no underwriter for this proposed issue. However any statutory dealers who may sell the securities may be statutory underwriters, and amongst these will be Shearson, Hammill & Co. * * * [102]

After Shearson's New York partners again made clear that they would not undertake to underwrite the issue and the Commission advised USAMCO that if Shearson acted as underwriter, the regulation A exemption from registration would not be available,[103] the circular was amended to remove Shearson's name and to represent that the entire offering would be sold by the issuer without employing the services of any broker-dealer. Although it refused to act as underwriter for the USAMCO offering, Shearson did not prohibit its partners and salesmen from purchasing USAMCO shares for themselves or selling USAMCO shares to their customers, and also it permitted its trading department to conduct the primary trading market in the stock after the commencement of the distribution.

Despite the evident reluctance of the New York office to have the firm formally involved in the public offering, Dunbar was able to determine the allocation of the majority of the 290,000 shares being offered, with 36,800 shares, or almost 13 percent of the issue, going to himself and other Shearson partners and salesmen, and 136,000 shares, or 47 percent, to 78 Shearson customers. Another large block of 92,200 shares, or 32 percent of the issue, was allocated to officers, directors, and employees of USAMCO, to officers, directors, and large stockholders of the closely connected Chemical Milling, and to relatives and business associates of both groups. Dunbar himself subscribed for 10,000 shares. Other large amounts purchased by Shearson employees included 4,500 shares each by the firm's Los Angeles office manager, Richard J. Teweles (who subsequently became a partner), and James E. Brum, the firm's over-the-counter trader in Los Angeles, and 5,000 shares by William Troutman, Dunbar's assistant. Altogether, allocations were made to 2 Shearson partners and 19 employees, including 6 managers or comanagers of branch offices, 6 registered

[102] USAMCO, form 1-A notification, item 7, dated Sept. 30, 1960.

[103] Shearson was technically barred by rule 252(c)(1) under the Securities Act from acting as underwriter of the USAMCO offering because the firm had been one of the underwriters of Ultrasonic Corp., against which a stop order was issued by the Commission on Jan. 18, 1957, under sec. 8(d) of the Securities Act.